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Insurance Contract Law

SUMMARY OF RESPONSES TO ISSUES PAPER 8
The Broker's Liability for Premiums: Should Section 53 be Reformed?

This document summarises the responses to the Law Commissions' Issues Paper 8: The Broker's Liability for Premiums: Should Section 53 be Reformed?

April 2011

THE LAW COMMISSION
THE SCOTTISH LAW COMMISSION

Joint Review of Insurance Contract Law

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CONTENTS

NOTES

APPROACH TAKEN IN THIS PAPER

Describing responses

N.1 This paper describes the responses we have received to the proposals set out in Issues Paper 8, "The Broker's Liability for Premiums: Should Section 53 be Reformed". We provide a short description of the current law in Part 1 and our proposals in outline in this document, but readers should refer back to the Issues Paper for a fuller explanation.

N.2 This document aims to report the arguments raised by consultees. It does not give the views of the Law Commission or the Scottish Law Commission.

COMMENTS AND FREEDOM OF INFORMATION

N.3 We are not inviting comments at this stage. However, if having read the paper, you do wish to put additional points to the Commissions, we would be pleased to receive them.

N.4 Please contact us:

By email at commercialandcommon@lawcommission.gsi.gov.uk, or

By post, addressed to Christina Sparks, Law Commission, Steel House, 11 Tothill Street, London SW1H 9HL

N.5 As the Law Commission will be the recipient of any comments, the Freedom of Information Act 2000 will apply and all responses will be treated as public documents. We may attribute comments and include a list of all respondents' names in any further report we publish. Those who wish to submit a confidential response should indicate this expressly. Automatic confidentiality disclaimers generated by an IT system will be disregarded.

THANKS

N.6 Many people have devoted considerable time and resources to this project. We would like to thank all those who have sent written responses to the Issues Paper, who have written articles on the proposals and who met us to discuss their views. We read and consider all responses we receive to our Issues Papers. Whilst we are unable to directly quote all consultees' submissions in this brief summary, those views are important to us as we put together our proposals for the next Consultation Paper.

PART 1
INTRODUCTION

1.1 In July 2010, the Law Commission and the Scottish Law Commission published Issues Paper 8, “The Broker's Liability for Premiums: Should Section 53 be Reformed”.[1] This looked at section 53 of the Marine Insurance Act 1906, the principal effect of which is to make a broker directly responsible to an insurer for the payment of premiums. We considered the historical customs out of which that provision developed and the case law surrounding it.

1.2 Section 53(2) also provides the broker with a lien over the insurance policy, allowing it to recover any money it is owed by the policyholder. We discussed the scope and extent of the lien.

1.3 This document summarises the responses we received to that paper. We are currently considering our proposals in the light of these comments. We intend to publish further proposals in a joint consultation paper in 2011.

1.4 We received 18 responses, as shown in the table below. While the number of responses is comparatively low, this is a specialist area of law which, it would seem, is not particularly well-known and has an impact on a comparatively narrow range of stakeholders.

Table 1: Respondents to Issues Paper 8, by category

Type of consultee	Number
Insurers, reinsurers and insurance trade associations	5
Regulatory bodies	1
Lawyers, legal representative associations, and the judiciary	5
Other	2
Brokers and brokers’ associations	5
Total	**18**

BACKGROUND

1.5 Section 53 of the Marine Insurance Act 1906 provides as follows:

Policy effected through broker

(1) Unless otherwise agreed, where a marine policy is effected on behalf of the assured by a broker, the broker is directly responsible to the insurer for the premium, and the insurer is directly responsible to the assured for the amount which may be payable in respect of losses, or in respect of returnable premium.

[1] Insurance Contract Law, Issues Paper 8: The Broker's Liability for Premiums: Should Section 53 be Reformed? (July 2010).

(2) Unless otherwise agreed, the broker has, as against the assured, a lien upon the policy for the amount of the premium and his charges in respect of effecting the policy; and, where he has dealt with the person who employs him as a principal, he has also a lien on the policy in respect of any balance on any insurance account which may be due to him from such person, unless when the debt was incurred he had reason to believe that such person was only an agent.

1.6 Outside of the field of marine insurance law, an agent would not usually be personally liable under a contract made on behalf of their principal. However, section 53(1) of the 1906 Act makes a broker acting on behalf of an insured directly responsible to the insurer for the premium in the absence of a clear agreement to the contrary. Section 53 appears to apply only to marine insurance, although its scope is not wholly clear.

1.7 Section 53(1) codified a custom of the marine insurance industry, which originated in the Lloyd's London Market but has been held to extend to the marine insurance market outside Lloyd's. Under that custom, the insurer did not claim premium from the insured but from the broker. The broker, in turn, looks to the insured for payment.

1.8 In our Issues Paper, we discussed alternative rationales for the custom, which included the following: the broker is not solely agent; he is the principal to receive money from the assured and to pay it to the underwriters; dual agency; and the fiction of lending approach. The fiction of lending approach appears to have received the most support in case law and the courts.

1.9 The fiction is that the broker has paid the premium to the insurer, thus discharging the policyholder's liability to pay, and that the insurer has lent back the money to the broker, creating a personal debt obligation. It was probably intended to provide underwriters with some security against unfamiliar policyholders. The broker was liable to pay the premium to the insurer whether the insured had paid or not and the courts have held that the insurer has no redress against the insured if the broker became insolvent.

1.10 On its face, section 53(1) does not apply "if otherwise agreed". However, the courts have insisted on clear wording to exclude it, and there is uncertainty as to whether the common law fiction has survived the codification of the custom in 1906. This means it is doubtful whether alternative contractual structures provide the broker with complete protection in the event of policyholder insolvency. Furthermore, there is doubt whether some contract terms would be sufficient to give the insurer a right of redress against the policyholder in the event of the broker's insolvency.

1.11 Therefore the effect of section 53(1) is not clear. One view is that it means what it says: that 'the broker is directly responsible to the insurer for the premium'. Another view is that the section should be interpreted in the light of the custom, which included the common law fiction. As Issues Paper 8 discusses, this could lead to complex issues and conflicting decisions, particularly regarding premium payment clauses.

Premium payment warranties

1.12 As we discuss in Part 2, the market currently operates on the basis that a marine insurance contract can be brought to an end by the insurer if the policyholder defaults on the premium. The two chief mechanisms by which this can be achieved are the premium payment warranty and the cancellation clause.

1.13 The premium payment warranty is a clause incorporated into the policy between the insurer and the policyholder stating that the contract will be treated as never having come into being if the policyholder fails to pay the premium.

1.14 On the other hand, a cancellation clause will typically give an insurer the option of terminating the policy if the policyholder fails to pay, along with a provision to the effect that the policyholder remains liable to pay the premium pro rata. If the insured has a valid claim that arose while the insurer was on risk, the insurer will typically be entitled to the whole of the premium.

1.15 The language of section 53(1) does not seem to prevent insurers from relying on such clauses. In some cases, however, the courts have held that the fiction means that these clauses can never operate, since under the fiction the premium is deemed to have been paid on time.[2] Despite this, recent decisions have cast doubt on the conclusion that a marine insurer may never cancel an insurance policy by relying on an automatic termination clause. In two cases, the Court of Appeal has disapproved of courts relying on the common law fiction.[3]

Terms of Business Agreements (TOBAs)

1.16 A Terms of Business Agreement (TOBA) may govern the conduct of insurance business between a broker and an insurer. TOBAs come in two types. Under a risk transfer agreement, the broker holds money as agent for the insurer. This means that once the broker has received the premium it is deemed to have been received by the insurer. Under a non-risk transfer agreement, the broker remains the agent of the policyholder.

1.17 In our Issues Paper, we doubted whether a TOBA between the broker and the insurer would be sufficient to contract out of section 53 unless the policyholder is a party to the agreement. If section 53 applies, the broker may remain liable to pay the premium, even if it has not received it from the policyholder.

The effect of insolvency on section 53(1)

1.18 Under section 53, if a broker were to go into liquidation:

(1) The broker may sue the policyholder for any unpaid premium, but the premium may then be passed to the broker's general creditors.

[2] *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc* [1998] 2 Lloyd's Rep 326.

[3] *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] CLC 860; *Heath Lambert Ltd v Sociedad de Corretaje de Seguros* [2004] EWCA Civ 792; [2004] 1 WLR 2820. Most recently, the Commercial Court rejected the policyholder's argument that a premium payment warranty was ineffective because the premium had (fictionally) already been paid. However, this part of the judge's decision was non-binding. See *Allianz Insurance Co Egypt v Aigaion Insurance Co SA* [2008] EWHC 1127 (Comm); [2008] 2 Lloyd's Rep 595.

(2) Although the insurer would have a claim against the broker, it may be impossible to recover the full premium in the face of competing claims from the broker's other creditors.

(3) The question arises whether the insurer could operate a premium payment warranty against the policyholder in these circumstances. The issue is open to doubt and it remains possible that the courts may revive the common law fiction to protect policyholders.

1.19 Where the policyholder has paid the broker:

(1) The question whether a premium payment warranty can be exercised arises (unless a risk transfer TOBA is in place);

(2) Some policyholders will benefit from regulatory protection under the Client Assets Sourcebook 5 (CASS 5), which provides that authorised firms carrying on mediation activities must hold client money in a statutory or non-statutory trust account.

1.20 If the policyholder becomes insolvent, the broker remains liable to the insurer for the full amount of the premium.

1.21 As discussed above, we considered in our Issues Paper the basis of the custom codified by section 53(1) which included whether it was based on the broker acting as principal or on the basis of a fiction. There could arguably be a question of whether money paid over by the insured was 'client money' if the broker was considered the 'principal', although this has not been explored further at this point.

Proposals

1.22 In Issues Paper 8, we asked consultees whether they agreed that the existing law should be repealed and replaced with a new default rule under which a broker would no longer be personally liable to pay the premium to the insurer. We sought consultees' views on this proposal, and on its impact on the associated broker's lien under section 53(2). We also dealt with section 54 of the 1906 Act, which governs the effect of clauses in policies acknowledging receipt of premium.

CONTENTS OF THIS PAPER

1.23 This paper is divided into five further parts:

(1) Part 2 examines the current law and practice regarding section 53;

(2) Part 3 discusses consultees' views on our proposed reform;

(3) Part 4 considers consultees' views about the effect of reform on a broker's lien over a marine policy; and

(4) Part 5 considers whether section 54 of the 1906 Act has any relevance today.

PART 2
CURRENT LAW AND PRACTICE

2.1 In our 2006 Joint Scoping Paper on insurance contract law, we noted that section 53(1) might be out of step with the realities of the current insurance marketplace. In Issues Paper 8, we asked consultees whether that provision was reflective of practice in either the marine or non-marine insurance markets.

2.2 We tentatively took the view that market practice had overtaken the provision. It struck us as anomalous that a mandatory statutory provision remains on the statute book which the market typically circumvents by the adoption of alternative contractual credit control mechanisms. Section 53(1) created a division between marine and non-marine insurance, the reason for which was not readily apparent.

2.3 Consultees' views were mixed as to whether payment premium warranties and cancellation clauses circumvent section 53(1) or whether they are merely complementary to it. In the main, brokers fell into the former camp.

2.4 Consultees pointed out that there were some differences between marine and non-marine insurance that might justify a difference of approach. However, the majority of consultees who considered whether marine and non-marine insurance should be treated differently thought that there was no justification for treating one differently from the other.

2.5 Some consultees suggested that more reliance was placed on the broker in marine insurance, but a number of others pointed out that the insurer had access to more data on the insured's creditworthiness today, meaning that this consideration was less pressing.

CURRENT PRACTICE

2.6 Of the 15 respondents who gave an indication as to the nature of current market practice, nine (60%) said that section 53 in some way reflected market practice in either the marine or the non-marine markets. Five (33%) indicated that it did not. A further consultee said that they were not aware of it reflecting practice in the non-marine market.

2.7 Some consultees distinguished between non-marine and marine insurance and indicated that there were differences in the way the markets function. In relation to the marine markets at Lloyd's and the London companies market, Harbour Insurance Brokers Limited (Harbour) observed:

> Certainly at Lloyd's and with the London market companies [section 53] reflects current market practice…
>
> Under the standard London market Terms of Business Agreements (TOBAs) with brokers, brokers are made personally liable for the premiums. However, this position may be altered by insurers who issue TOBAs different from the standard wording. Some insurers do not issue TOBAs at all.

> The situation is further complicated where placing brokers issue TOBAs to their producing brokers. Again, these TOBAs may or may not make the producing broker liable for the premium.

2.8 In relation to other parts of the marine market, Harbour went on to say:

> However, markets outside of London may or may not look to the brokers to be personally liable for the premium.

2.9 Harbour explained that non-marine TOBAs also tended to make the broker liable for the premium:

> Generally, the broker is held to be liable for the premium but only by reason of the fact that the TOBAs make him so.

2.10 The Institute of Insurance Brokers (IIB) also said that TOBAs in the provincial non-marine insurance broking marketplace ultimately make the broker liable for the premium:

> If the broker has not collected a premium by the time it is due to the insurer, then the broker has to fund the premium and/or arrange cancellation.

2.11 The Lloyd's Market Association (LMA), who represent managing agents at Lloyd's, described current market practice as follows:

> (1) that the insurer and the broker have in place a TOBA;
>
> (2) that slips should be in the standard "Market Reform Contract" format and contain a settlement due date for the premium;
>
> (3) that a premium payment clause should be included in the slip.

2.12 The LMA indicated that in the Lloyd's market, the extent to which non-marine practice differed from marine practice depended on whether the TOBA was risk-transfer or non-risk transfer. Under the market model non-risk transfer TOBA, the broker would be responsible for the premium in respect of marine policies, but would probably not incur liability in respect of non-marine policies. Under the risk transfer TOBA, the broker was personally liable for the premium under a marine policy, but in non-marine insurance, the broker was only liable once the premium had been paid to it.

2.13 The significance of section 53(1) to market practice also has to be considered in the light of electronic account management processes that automatically make the broker responsible for payment of the premium whether they are legally liable to pay it or not. As the International Underwriters' Association (IUA) explained:

> To an extent [the imposition of personal liability on the broker] happens in market practice already, for example in the automatic debiting of instalment premium from broker accounts where not received by the insurer by the settlement due date.

2.14 To the same effect, the City of London Law Society (CLLS) observed that the liability under section 53(1) is bypassed:

> by the process of net accounting of premium and claims between the insurer and the broker – the premium (due and payable by the broker) being offset against the claims (payable by the insurer under the policy), effectively resulting in the broker being deemed to have already paid the premium to the insurer.

2.15 Harbour explained that in the marine Lloyd's and London companies markets, this is the default position in the absence of a special agreement:

> … where premiums are agreed by underwriters to be deferred, usually half-yearly or quarterly, the brokers will pay the first instalment of premium upon receipt from the policyholder to the market via Xchanging. Xchanging will collect the subsequent instalments due direct from the brokers's bank accounts unless a special agreement is made to sign each instalment individually.

2.16 We were told by the LMA, however, that many payments were now "delinked", which entailed that:

> the processing of the premium is not automatically linked to the initial processing of the risk. Therefore, the broker will not be automatically debited on processing the risk but only when the premium is presented for settlement.

2.17 Likewise, London & International Insurance Brokers Association (LIIBA) said that section 53(1):

> was more of a concern when deferred instalments were automatically debited from the broker, but this can now be de-linked.

Premium payment warranties and cancellation clauses in the current market

2.18 Some consultees suggested that in parts of both markets, looking to the broker to fund the premium is not the sole, or even main, method relied on by insurers to secure payment. While there was some element of disagreement as to whether alternative safeguards are meant to replace or complement the personal liability of the broker for the premium, it was clear from consultees' responses that the use of these mechanisms is widespread.

2.19 The CLLS explained that brokers often agree contractual safeguards to limit the risk that the policyholder fails to pay the premium:

> Brokers commonly circumvent section 53(1) by inserting into policies premium payment warranties, which provide that the insured is personally responsible for payment of the premium and payment is a condition precedent of the policy coming into force, and cancellation clauses, which give the broker authority to cancel the policy if premium is not received.

2.20 The LMA indicated that these terms were the chief mechanisms ensuring payment of the premium:

> The right to cancel for non-payment is of primary importance… We understand that the credit control departments of managing agents do rely on premium payment clauses and issue notices of cancellation on a regular basis (usually resulting not in cancellation but in actual payment).

2.21 In the LMA's view, this did not mean that section 53(1) was of no relevance to market practice. Having said that the effectiveness of contractually agreed credit control mechanisms was of primary importance, they went on to explain that section 53 remained important:

> s 53(1) continues to serve a useful purpose in the marine market as a statutory backdrop to the way business is done and should not be repealed.

2.22 The issue consultees differed on was whether section 53(1) has been superseded altogether by premium payment warranties and cancellation clauses, or whether it retains some significance as an underpinning to those contractual credit control mechanisms. The LMA made this distinction clear in their response, arguing that section 53(1) should be amended to make clear:

> that an insurer's right to cancel for non-payment under a [cancellation clause] can be exercised and is complementary to the section – i.e. the insured's undertaking to pay does not conflict with or exclude the broker's direct responsibility.

2.23 Representatives of the insurance industry generally thought that section 53(1) provided a protection that was additional to cancellation clauses and premium payment warranties. Like the LMA, the IUA stated that while other methods of securing payment would be relied on in the first instance, section 53(1) provided insurers with a "useful additional protection". The Association of British Insurers (ABI) also said section 53(1) was a "justifiable… additional protection" for marine insurers.

2.24 A representative of the brokerage industry agreed that section 53(1) reflected market practice in the sense that it underpinned the broker's duty to collect the premium. The IIB also indicated that brokers' liability for the premium is a corollary of their role as the party responsible for collecting premium.

2.25 Without saying that it reflected market practice, Marsh indicated that section 53(1) was sometimes relied on by insurers:

> Our experience is that insurers do sometimes rely on section 53(1). In addition… standard market TOBAs refer to it. The fact that section 53 remains on the statute books remains a major concern for brokers.

2.26 Not all representatives of the insurance industry saw section 53(1) as complementary to cancellation clauses and premium payment warranties. Munich Reinsurance Company (Munich RE) stressed that all market participants pay close attention to the existence and application of a premium payment warranty. They then went on to say that there would be "no difficulties" if section 53(1) were to be repealed and that it would be sensible to align the law with existing practice:

> The repeal of section 53(1), including an express repeal of the common law fiction which predated it, would therefore be a very welcome development in the law. We see no difficulties with the proposed default rule that brokers should not be automatically responsible for the premium unless the contract provides otherwise.

2.27 In the same vein, the CLLS and the British Insurance Law Association (BILA) both said that the effect of cancellation clauses and payment premium warranties was to "circumvent" section 53(1), without going so far as to say it was superseded altogether. However, BILA made the point that:

> We believe it is important that such premium payment clauses, contained in a slip or policy, should override s53(1), since it reflects the negotiated position between insured and insurer.

2.28 Moreover, in our Issues Paper, we referred to the suspension of section 53(1) by agreement within the Lloyd's marine market between 1996 and 2001.[4] Both the CLLS and BILA suggested this was evidence that section 53(1) was not an essential element of market practice. As BILA commented:

> In the late 1990s the operation of section 53(1) was suspended by agreement and so far as we are aware this did not cause particular difficulties to the functioning of the London insurance market.

CONSULTEES' VIEWS ON THE CURRENT LAW

2.29 By and large, the responses to our Issues Paper revealed a consensus among brokers, insurers and lawyers alike to the effect that (i) the scope of section 53(1) is unclear and that (ii) there was uncertainty regarding the common law fiction embodied in that provision, its effect and the ability to contract out of it.

2.30 Views diverged primarily on two issues:

(1) Whether different rules should apply to marine and non-marine (or the same apply to both); and

(2) Whether the existing law allocates insolvency risk fairly between the parties.

[4] Issues Paper 8, above, at p 15, fn 52.

The scope of section 53(1) is unclear

2.31 All 14 consultees who expressed a view on the scope of section 53 said that it was unclear. It was not clear whether this uncertainty had had any practical effects. The IUA indicated that it had led some industry participants to adopt firm-wide practices for premium payment and credit control applicable to non-marine business. On the other hand, Munich RE thought that section 53 was only taken to apply to marine insurance in practice.

The existing law undermines existing contractual arrangements

2.32 The freedom to negotiate contractual terms was important to consultees from both the brokerage and insurance industries. 11 of 13 consultees (85%) who expressed a view thought that the parties should have an unfettered right to agree whatever arrangements they saw fit.

2.33 We observed in the Issues Paper that section 53 codified a custom that there is a common law fiction whereby the insured is always deemed to have paid the premium to the insurer and the insurer to have lent the money back to the broker, creating a personal debt. We said that this has produced unprincipled and conflicting case law, particularly in the context of premium payment warranties and additional premium payments.

2.34 All 14 consultees who expressed a view on this point agreed. Munich RE said this caused "analytical difficulties with the use" of payment protection warranties and cancellation clauses that needed to be eliminated.

2.35 We went on to observe in our Issues Paper that, at present, attempting to contract out of section 53 may prove difficult. Of the 13 consultees who expressed a view, 12 consultees (92%) agreed. Consultees indicated there were two problems. One was the requirement for "clear wording" to displace section 53(1). The other was, as we observed in our Issues Paper,[5] that a TOBA might need to be a tripartite agreement in order for the insured to be bound by it or to take the benefit of it.

Justifications for imposing personal liability on the broker

2.36 We asked consultees whether there were any justifications for imposing personal liability on the broker in either the marine or non-marine markets. 15 consultees gave us their views, of whom nine (60%) said that there was no justification, barring certain specific circumstances.

2.37 Those opposed to the imposition of a default liability on the broker thought that paternalistic protections for the benefit of insurers were inappropriate. As the Bar Council Law Reform Committee (Bar Council) put it, insurers could be "expected to look after themselves". The CLLS observed that an insurer can now carry out checks on the creditworthiness of an insured online. BILA remarked to similar effect:

[5] Issues Paper 8, above, p 46 at para 6.13.

> Although it remains the case today it is the broker who has principal contact with the insured and may, practically speaking be in a better position to collect premium from his client, it is also the case that insurers in today's market generally have considerably more knowledge about their insureds than was historically true.

2.38 Some consultees, who thought that automatically imposing personal liability on the broker was not normally justified, identified specific circumstances where it might be appropriate. BILA suggested that these include circumstances where risk transfer arrangements are in place, which would support the position under agency law.

2.39 Harbour considered that justifications for imposing personal liability on a broker were 'few and far between'. They suggested, however, that it might be justified in the following situations:

> Where the premium has been funded by a premium finance company and the broker has received the full 100% brokerage within, say, 60 days of inception paid for by the financier in circumstances otherwise where the broker would have received the brokerage by instalments, say, half yearly or quarterly.
>
> When the broker has guaranteed the creditworthiness of the policyholder to the insurer.

2.40 The LMA put forward justifications for the automatic imposition of liability in both marine and non-marine insurance. They commented that it was the broker's responsibility to collect the premium as the "primary client contact", noting that it was especially difficult for an insurer to enforce the insured's payment obligation where there was a chain of brokers. These comments extended to both marine, and non-marine insurance: they suggested that we consider extending section 53(1) to all classes of insurance (excluding treaty), or to all classes of insurance where a risk transfer TOBA is in place.

2.41 Similarly, without saying whether the default position should be different where a risk transfer TOBA is in place, BILA pointed out that:

> The broker must remain personally liable for premium where there is a risk transfer TOBA and premium has actually been received by the broker but not passed to the insurer.

2.42 Not all representatives of the insurance industry took the view that brokers should be automatically liable to pay the premium. Munich RE were neutral as to the adoption of the proposal, stating that they "saw no difficulties" with it. The IUA and ABI also both stated that the automatic liability to pay the premium was only justifiable in relation to marine insurance.

2.43 Conversely, the IIB made the following comments:

> There would appear to be no pressing demand from brokers for a change to the current position as brokers' responsibility for collecting and passing over premiums to the insurers is entrenched in market practice… if policyholders rather than brokers were responsible for paying the premiums, existing market practice could be seriously compromised.

2.44 Nonetheless, the IIB qualified their remarks by saying:

> Members have expressed the view that there ought to be some concession in relation to a policyholder who becomes insolvent with premiums outstanding, so that the broker is not obliged to bear the credit risk alone.

It is not clear whether a special rule should apply to marine insurance

2.45 Out of 14 consultees who gave an indication as to whether it was anomalous to limit the applicability of section 53(1) to marine insurance, nine consultees said that it was anomalous and that no special rule should apply to either marine or non-marine insurance (64%).

2.46 Of the remaining consultees, the LMA thought that section 53(1) ought perhaps to extend to non-marine business as well. The IUA indicated that while it was "logical" to have a "universal approach to premium payment", there were reasons why marine insurance might be distinguished from non-marine. Lord Justice Longmore also said that marine insurance was "different" and that he saw "no problem" with the existing arrangements. The ABI stated that section 53 was "fundamental to marine business".

2.47 As a justification for treating marine insurance differently, consultees referred to the greater credit risk posed by the insured. As the IUA explained:

> Marine risks are commonly written on a bespoke, short term basis - thus with limited scope for long-standing business arrangements with the insured. In such cases - often high risk, large premium business - there is increased reliance on the broker in bringing the business to the insurer. Premium is rarely received up front and it would be impracticable in such circumstances, and contrary to general practice, for the underwriter to request it. Indeed, often a claim is made prior to the receipt of premium.

2.48 Likewise, both the LMA and the ABI said that section 53(1) gave marine insurers protection from unknown insureds receiving high-risk, short-term cover in relation to mobile assets. While it had no objection to freeing the broker from liability in the context of non-marine insurance, the ABI emphasised a number of unique features of marine insurance that in their view justified default broker liability:

> Marine insurance is different. The high insured limits and mobility of assets insured, compounded by the unfamiliarity between insurer and policyholder, are specific concerns of the marine insurance market and would unduly expose the insurer if the broker were not made personally liable for the premium.

2.49 BILA did acknowledge specific aspects of marine business that obscured the credit risk posed by the insured:

> An underwriter covering a fleet of vessels may deal primarily with a shipping manager in a location such as Piraeus, but the owners of the vessels (who are ultimately liable to pay the premium) may be one-ship companies incorporated in locations such as Monrovia or Panama. There is, under such circumstances, still a serious issue concerning the allocation of credit risk on the insured between the underwriter and the broker.

2.50 Nonetheless, in BILA's view, that risk ought, on balance, to be borne by the insurer; the contract was ultimately an agreement between the insurer and the insured.

The allocation of insolvency risk

2.51 In Issues Paper 8, we asked whether consultees agreed that the current law puts the risk of the policyholder's insolvency on the broker. 13 consultees gave us their views on this point. Of these, 10 consultees (77%) agreed or broadly agreed with this proposition.

2.52 However, the LMA were of the view that as long as proper contractual safeguards were in place, there was no practical risk:

> We do not believe the risk of policyholder insolvency in practice falls on the broker where there is a [payment protection clause] in the slip – either the insurer has the right to cancel the policy or the broker has the money.

2.53 BILA agreed with the LMA's position, adding as a rider that this was only the case if premium payment and cancellation clauses were valid. LIIBA, by contrast, thought that the issue was one of timing.

2.54 We also sought views as to whether section 53(1) unfairly exposed insurers to the credit risk posed by brokers and brokers to the credit risk posed by policyholders. Opinions diverged on this issue.

2.55 Lord Justice Longmore made the point that it is for the broker and not the insurer to judge his client's insolvency risk and it is right that the risk of the policyholder's insolvency should therefore be on the broker and not the insurer. Two other consultees stressed that the position could always be amended by contract. A further consultee said that whatever the current position, insolvency risk should only be borne by a broker where it is in breach of the TOBA.

2.56 The ABI said that section 53(1) does unfairly expose the insurer to the credit risk posed by brokers. They said it left an insurer on risk in the event of broker insolvency without an insurer being able to pursue the policyholder. Conversely, they did not consider that brokers are unfairly exposed to the credit risk posed by policyholders. In their view, however, brokers could always either negotiate to opt out of section 53(1) in the TOBA or require upfront payment of the premium or purchase credit insurance.

2.57 By contrast, a few consultees representative of the brokering industry said that while unfair to brokers, section 53 was not unfair to insurers. The essential point they made was that FSA CASS rules gave policyholders a measure of security in relation to the risk of a broker's insolvency that is not afforded to brokers in relation to their clients. The IUA agreed that this was the case. Moreover, BILA suggested that brokers were not in a position to accept the premium risk as they may potentially be in conflict with obligations imposed through CASS under FSA regulation for the purpose of ensuring financial stability. The potential financial burden on brokers by virtue of section 53, they suggest, could be disproportionately large by comparison to a broker's capital.

Broker insolvency

2.58 In relation to broker insolvency, we suggested in Issues Paper 8 that the consolidation of brokers may pose a risk to the insurance industry. We asked consultees whether they agreed with this. The 11 consultees who provided a view on this issue expressed mixed views. Of these, four consultees (36%) agreed with this proposition. One consultee partly agreed, pointing out that FSA CASS rules had undoubtedly mitigated the risk for insurers.

2.59 On the other hand, two consultees thought that consolidation was likely to diminish risks for insurers rather than increase them. A view was expressed that larger brokers were better equipped to absorb risks. On the other hand two consultees expressed the view that brokers small and large alike could become insolvent at any time. A few consultees suggested that there was no risk provided that cancellation clauses were effective.

2.60 Lord Justice Longmore made the point that the existing law protects the policyholder from the risk of broker insolvency. The policyholder, he said, needed the fiction that the broker has always paid the premium, to the extent that policyholder protection was necessary. However, the Faculty of Advocates was of the view that where a premium is paid to the broker and an insured risk materialises before that premium is paid over to the insurer, the insured should retain his rights under the contract, implying the effect of a risk transfer TOBA. The Faculty also suggested:

> While not every insolvency will lead to a winding-up of the broker's business, there ought to be a statutory provision or industry regulation requiring client's/insured's funds, when paid to the broker but intended for payment of premiums, to be paid direct into a designated and ring-fenced fund or client account, thereby protecting the interests of the actual and principal parties to the insurance contract.

2.61 However, the Financial Services Authority (FSA) took the view that the CASS rules already afforded a sufficient measure of protection to the policyholder:

Where a broker holds client money and the broker has become insolvent then, where the policyholder has paid the premium to the broker, the credit risk of a shortfall in the client money account passes to the insurer. Likewise where there is risk transfer… In the event that the policyholder is exposed to double liability under a risk transfer arrangement then the policyholder should normally be able to recover the sum paid to the broker, if not from the broker then from the FSCS. Accordingly… this is not a significant issue.

PART 3
CASE FOR REFORM

3.1 In Issues Paper 8, we put forward our provisional view that the default position should be that a broker is not personally liable to pay the premium. The default position should be that policyholders are liable for the premium payments due under their insurance policies.

3.2 This would represent a reversal of the rule in section 53(1) and would allow the insurer to sue the policyholder for the premium if it remains unpaid. We are of the view that this situation is justified since the policyholder receives the benefit of the insurance coverage, so it is the policyholder alone who should be liable to pay the insurer.

3.3 The majority of consultees agreed with our proposal, although some thought special considerations might apply to marine insurance that justified a different default position. Most consultees also thought that there ought to be complete freedom of contract, a number stressing that paternalism was not justified and that insurers ought to have sufficient bargaining power to negotiate a different position. Some insurance industry bodies suggested that insurers would find it difficult to negotiate a term imposing personal liability on the broker if section 53(1) were repealed.

Default position – liability of policyholder

3.4 15 consultees expressed a view as to whether our tentative proposal should be adopted. Of these, eleven consultees (69%) agreed with it. Those who agreed expressed the view that, as the ultimate beneficiary of the insurance, the policyholder alone should be liable to pay the premium. As BILA said:

> The insurance contract – under which the liability to pay premium arises – is a contract between the insurer and the insured. Unless agreed otherwise, obligations arising out of the contract should remain with the parties to it.

3.5 However, two of these 11 consultees thought that the default position should be different in relation to marine insurance. As we mentioned in Part 2, consultees highlighted a number of features of marine insurance that warranted a difference of approach.

3.6 The consultee who disagreed with our proposal in relation to both types of insurance (marine and non-marine), the LMA, said:

> No, so long as the right to cancel an insurance contract for non-payment of premium… is effective, we believe the better default position is that the brokers are responsible for premium – the reason for this is the extensive use of risk transfer TOBAs (which brokers appear to prefer) and the fact that risk transfer is mandatory in certain overseas jurisdictions.

3.7 The essence of the LMA's objection to our proposal was that section 53(1) provides an "important statutory backdrop to the way business is done". If the default liability of brokers to pay the premium were abolished, insurers would find it difficult in practice to negotiate a term restoring that liability.

> In principle, we believe that the broker could be made personally liable under contract if all parties agree. However, if s53 was not the statutory default position, this would in practice be difficult to negotiate, not only in a TOBA but also on a risk by risk basis (to obtain the insured's agreement), and probably not practical to do so in the time frame of placing many risks.

3.8 However, the majority of respondents thought that it should be possible, if desired, to impose liability for the premium on a marine broker contractually, if section 53 were repealed or replaced. We asked consultees whether liability for the premium could be imposed on a marine insurance broker without the need for a statutory provision to that effect. 15 consultees expressed a view, of whom 12 (80%) expressed the view that the repeal or amendment of section 53 would not prevent the parties to a TOBA from agreeing their own position contractually.

3.9 Among those who did not specifically endorse or oppose our proposal, the Bar Council took the view that there should be no special rule of liability and the ordinary rules of agency should apply. Munich RE simply said that they saw no difficulties with our proposed reform.

Contracting out of the default position

3.10 In addition, having proposed a change to the default position, so that the policyholder is liable for the premium payments, we asked whether it should be possible for the parties to contract out of it. 14 consultees dealt with this question. Of these, ten consultees (71%) agreed. In addition, the Bar Council simply said that there should be no default position in the first place, instead suggesting that the matter be left to contract. Eleven consultees (79%), therefore, supported total freedom of contract in this area. Only 3 consultees disagreed (21%).

3.11 By way of justification, most consultees cited the fact that freedom of contract was important generally. The IIB went further and stressed that it would fundamentally undermine the operation of the existing market if personal liability for the premium could not be imposed on a broker.

3.12 Marsh on the other hand said that contracting out of our proposed default position should not be allowed. While Harbour Insurance Brokers initially said no to the possibility of contracting out of our proposed default position, they also commented:

> This is the commercial reality, in many cases, in any event. Many TOBAs insist… that brokers remain liable.

The effect of eliminating default broker liability for the premium

3.13 Some of the consultees saw the removal of automatic personal liability for the premium as beneficial. The main financial advantage for brokers would be that their credit control costs would fall. As Harbour pointed out:

> If the automatic liability was removed, brokers' savings in credit control costs would be massive. Much time is "wasted" in a broker's office chasing clients for outstanding premium.

3.14 Moreover, brokers would no longer be faced with an awkward conflict of interests in the event of policyholder default as Harbour also said:

> Further, the embarrassment of chasing clients for late premium payment, at the same time as trying to keep them sweet, retain their business and court more business from them, is avoided.

3.15 Some consultees who thought that the proposed default position would have negative effects were all insurers or insurers' associations. The LMA raised a number of concerns, which can broadly be summarised as follows:

(1) Insurers might undertake credit-checking on a larger scale than at present, which would slow the placement of risks and lead to less delegation of underwriting authority in London.

(2) Not only would there be a duplication of administrative processes pre-placement such as credit checks, there was a possibility that enforcement action might be taken by the broker and insurer simultaneously to collect the same monies.

(3) Without the ability to have recourse to the broker in the event of policyholder default, insurers would be quicker to cancel policies. They would also shorten credit periods, and be less willing to take on foreign business resulting in a loss of competitiveness for London.

3.16 The IUA also pointed out that costs were likely to go up:

> Marine insurers will as a matter of good practice revisit their existing protections and ensure that they remain fit for purpose. From an administrative perspective it is likely that costs will rise as the broker is no doubt in a better position to manage their client than the insurer with regard to collection and payment of premium. Increased administration and risk assessment costs for those short term one off risks will likely impact the cost of cover.

3.17 Two consultees thought that there would be little practical impact if the default position were changed. The IIB indicated that "commercial arrangements were unlikely to be affected". Likewise, while the ABI argued for the retention of default broker liability for marine insurance; it observed:

> The tendency of most insurers is to contract out of section 53(1), so the costs are likely to be comparatively less than a more substantial transformation in the law.

3.18 Similarly, BILA took the view that the effect of the proposed reform would be limited, subject to the proviso that section 53(1) could be successfully ousted.

3.19 The remaining consultees who expressed views said the principal benefit would be to rationalise the law by getting rid of an "anachronism" (Geoffrey Lloyd and Derek Cole). The reform would bring an "out-of-date" law into line with modern custom and practice (CLLS). It would remove an "anomaly" from the law (Adam Samuel).

THE MECHANICS OF REFORM

3.20 Assuming that our consultation disclosed a willingness to reform the law in this area, we asked consultees how that reform would be implemented. Our findings are set out below.

The repeal of section 53(1)

3.21 We asked consultees whether section 53(1) should be repealed. 15 consultees responded to this question, of whom twelve (80%) agreed.

Replacing section 53(1)

3.22 We asked consultees whether section 53(1) should be replaced with a new statutory provision to make it clear that the broker is not automatically liable for the premium. 14 consultees dealt with this question, of whom eight (57%) agreed. One consultee said that it should be repealed rather than replaced. The remaining 5 consultees indicated that section 53(1) should be replaced, but simply with a provision removing the broker's default liability.

3.23 Two consultees said that there should be clarification that a non-marine broker is not liable for payment of the premium by default, but that the status quo should be preserved as regards marine brokers (IUA, ABI).

3.24 The need to do away with the common law fictions was raised by two consultees who did not object to our proposed default position (Munich RE, Bar Council). Among those who did object to our proposal, the LMA also said that the fiction had to be abolished.

3.25 The LMA also stressed that a number of other matters required statutory clarification: the validity of cancellation clauses as complementary to section 53; the types of insurance contract to which it applies; and its applicability to adjustment premiums and premium instalments. It also said that there was an argument for making it applicable to all types of insurance where risk transfer applies.

NOTIFICATION REQUIREMENTS AND PREMIUM PAYMENT WARRANTIES

Obligation to notify

3.26 In the Issues Paper, we observed that there may be a problem where an insured has paid premium to the broker but that payment has not been paid over to the insurer. In those circumstances, the insured may not be aware that the premium has not been paid. We therefore asked consultees whether insurers or brokers should be under an obligation to notify policyholders in the event premium was not paid on time or at all.

Notification by insurer

3.27 Of the 13 consultees who considered whether an insurer should be bound to notify the insured of non-payment of the premium, eight (62%) disagreed. Two consultees argued that notification was the broker's responsibility. Two consultees pointed out that an insurer would expect a broker to notify the insured, and that this was current market practice. BILA pointed out that the insured would have be aware (i) whether it had paid the premium and (ii) of the consequences of failing to do so.

3.28 The ABI acknowledged it was in an insurer's interests to contact the broker or policyholder, but this should not be a statutory requirement.

3.29 The CLLS said that it would not be practical; suggesting that an insurer would not, for example, know the address for service of the notice. Three consultees (Munich RE, IUA, and BILA) stressed that brokers would be keen to maintain their exclusive client relationship with the insured.

3.30 The Faculty of Advocates and Harbour both supported a mandatory obligation to notify the insured. Whereas the former's view was that the insured should be given every opportunity to make payment, the latter stressed that ultimately the policy was a contract between the policyholder and the insurer. It was the insurer's responsibility to set the terms of credit. Adam Samuel thought that it was only a sensible idea in relation to consumers and small businesses.

Notification by broker

3.31 Two consultees were of the view that a broker should have an obligation to notify the insured in the event of non-payment of the premium. Most consultees who addressed the position of a broker indicated that brokers already notified insureds in the event of non-payment. The Faculty of Advocates was concerned to give the insured every chance to make payment.

3.32 Munich RE were of the view that:

> The additional obligations regarding provision of policyholder contact information to the insurer and notification by the insurer prior to the exercise of a premium payment warranty are sensible measures to ensure [our proposed default position] functions fairly. However, we are inclined to agree that brokers generally wish to be the only point of contact for their clients and would therefore suggest that these obligations should only take effect where the contract is silent on these issues.

3.33 In relation to commercial parties, the LMA stressed that the standard Lloyd's market LSW-3001 cancellation clause contains an obligation to notify the insured in any event. The relevant part of which provides:

> It is agreed that (Re)Insurers shall give not less than [ ] days prior notice of cancellation to the (Re)Insured via the broker. If premium due is paid in full to (Re)Insurers before the notice period expires, notice of cancellation shall automatically be revoked.

3.34 They also pointed out that in consumer cases, the broker would also be subject to the Unfair Terms in Consumer Contracts Regulations 1999 and FSA Conduct of Business rules. Marsh thought that a broker's duties under the existing common law were sufficient.

Notification as a precondition to exercising a right to cancel

3.35 We asked consultees whether an insurer should be required to notify the insured of non-payment of the premium before exercising its rights under a premium payment warranty. 13 consultees addressed this question, of whom six (46%) disagreed. Only three consultees (23%) agreed. One consultee understood our question to refer to cancellation clauses as well as premium payment warranties.

3.36 One consultee agreed that notification by the insurer should be required in consumer and small business cases, but not in others (Adam Samuel). The CLLS indicated that it ought to be given by the insurer where a non-risk transfer TOBA is in place, as the insured will not know whether the premium has been paid. Finally, two consultees indicated that notification may be necessary in order to comply with Treating Customers Fairly principles.

3.37 The LMA, who disagreed, pointed out that in some cases, it is important that the insurance is automatically cancelled without notice.

Notification as a matter to be dealt with by contract

3.38 We asked consultees whether, instead of creating a statutory obligation to notify the insured, the parties should be left free to agree their position by contract. 11 consultees answered this question, of whom eight (73%) agreed. One consultee agreed, except in relation to consumers and small businesses and one pointed out that the inclusion of the premium payment warranty and terms of credit generally were matters an insurer had to negotiate by contract in the first instance, without expressing a view either way. Only one consultee disagreed outright.

3.39 Consultees pointed out that many TOBAs already have notification obligations in them. However, these notification obligations often only govern the broker-insurer relationship and the insured cannot take the benefit of them. Moreover, the broker is already subject to an obligation to notify the insured of the existence of payment premium clauses.

PART 4
THE BROKER'S LIEN

4.1 Section 53(2) of the Marine Insurance Act 1906 gives the broker a lien over the policy, and the courts have held that this lien extends to any policy monies it receives from the insurer. We observed that while this form of security is limited, notably because it does not apply to composite insurance policies, brokers have other means of securing payment from the insured.

4.2 We asked consultees whether the law governing the lien was satisfactory[1], and asked for information as to whether, and how often, the lien was relied on in practice.

4.3 We addressed other aspects of the broker's lien in our Issues Paper 9, "The Requirement for a Formal Marine Policy: Should Section 22 Be Repealed",[2] a summary of the responses to which will be published shortly.

The scope of the lien

4.4 Out of 13 consultees who answered this question, seven consultees (54%) indicated that the current law did not create any real problems and 6 consultees (46%) indicated that there was uncertainty as to its scope. Only three (17%) expressly stated that the law was unsatisfactory.

4.5 Three key points were raised by consultees:

(1) Marsh said that they had experienced practical situations where they had not been able to exercise the lien over proceeds because of the rights of the mortgagee of a policy.

(2) Two consultees said that it was illogical to extend the lien to non-marine insurance. The ABI pointed out that in non-marine insurance, the broker had no personal liability for the premium. It was the insurer alone who had a right to payment of the premium, and so there was no debt in respect of which the lien could operate.

(3) Two consultees said that the lien should be extended to both marine and non-marine insurance.

4.6 Two consultees took the view that there was no pressing need for a special statutory regime. A broker could always obtain security for payment of the premium contractually. The CLLS also pointed out that all a broker was concerned with was having a right of set-off.

[1] While noting the general Scots law in relation to brokers and lien. See Part 4 of Issues Paper 8.

[2] Insurance Contract Law, Issues Paper 9: The Requirement for a Formal Marine Policy: Should Section 22 Be Repealed? (October 2010)

The practical application of the lien

4.7 Out of 12 consultees, seven (58%) said that the lien was rarely applied in practice. Five (28%) expressly stated that they did not know.

4.8 Consultees informed us that the reasons why the lien is rarely applied in practice were three-fold:

(1) **The lien is not an effective form of security.** Of the seven consultees who indicated the lien was occasionally used, some said that it was only used as a “threat”, “bargaining chip” or “negotiating lever”. They stressed that mortgagees’ rights in the policy significantly reduced the effectiveness of the lien as a form of security. Marsh also pointed out that it was rare for there to be a single insured.

(2) **Other methods are used to enforce payment**. Two consultees indicated that broker’s cancellation clauses were the principal weapon relied on by brokers to ensure payment of the premium by the insured. Harbour pointed out that an actual default by the insured was rare. The practical problem that arose was delay by the insured in making payment.

(3) **There may be no ‘’policy’’ over which a lien can operate**. BILA pointed out that the current practice in the market is to use the Market Reform Contract,[3] a single document replacing slip and policy.

Preserving the lien

4.9 We also asked consultees whether, if section 53(1) were to be abolished, section 53(2) should be retained. Out of 13 consultees who responded to this question, 9 consultees agreed that section 53(2) should be re-enacted. One consultee stated that it should be re-enacted with an extension of the lien to all policies held by the policyholder. Two consultees said that a broker simply needed to have a right of set-off, which the broker could already agree by contract. A further two consultees disagreed, stating that it would be redundant once section 53(1) was abolished.

[3] See the London Market Group website at http://www.marketreform.co.uk/index.php?option=com_content&view=category&id=36&Itemid=137.

PART 5
THE RELEVANCE OF SECTION 54

5.1 Section 54 of the 1906 Act provides that, where a marine insurance policy acknowledges receipt of the premium, the acknowledgment is conclusive as between the insurer and the policyholder, but not as between the insurer and the broker. It is our view that the existence of section 54 in the Marine Insurance Act 1906 casts doubt on any argument that section 53(1) codified the common law fiction as well, rather than just the custom that the broker was liable for the premium. This is because, if the Act had intended to codify the fiction as well, section 53(1) would render section 54 entirely superfluous. We asked consultees whether these clauses were still in use, and whether they remained relevant.

Do policies include these clauses?

5.2 We asked whether modern insurance policies ever include clauses acknowledging receipt of the premium, particularly if the premium has not actually been received by the insurer. 13 consultees responded to this question, of whom six (46%) indicated that they were not aware that they were being used. Four consultees (31%) indicated that their use was rare; two consultees (15%) said they were not used and one consultee said they were used sometimes, referring to a clause in the IUA Marine Policy form.

What relevance has Section 54 in modern insurance law?

5.3 Of the 13 consultees who dealt with this question, only one thought that it had any relevance. They explained that while no policies were issued until the premium had been paid, market practice sometimes saw the insurer allow payments to be made on a deferred basis. The policy would be issued only on payment of the first instalment. Section 54 was therefore relevant where an insured had paid an instalment covering the period in which a claim arose but then failed to make a subsequent payment. It would prevent an insurer from arguing a total failure of consideration.

5.4 However, two consultees pointed out that in such a situation, a clause acknowledging payment could be relied on as an estoppel or contractual warranty. There was therefore, no need for an additional statutory protection.

LIST OF CONSULTEES

We considered 18 responses to our Issues Paper.

We were very sad to learn that Derrick Cole died suddenly last month. Derrick was an active contributor to our work. He was a deeply knowledgeable and charming correspondent. We will greatly miss his involvement, experience and wisdom.

WRITTEN RESPONSES

Association of British Insurers

British Insurance Brokers' Association

British Insurance Law Association

City of London Law Society

Financial Services Authority

Harbour Insurance Brokers Limited

Institute of Insurance Brokers

International Underwriting Association

Lloyd's Market Association

London and International Insurance Brokers' Association

Marsh Limited

Mr Adam Samuel

Mr Derrick Cole and Mr Geoffrey Lloyd

Munich Reinsurance Company

Royal Bank of Scotland Insurance

The Faculty of Advocates

The General Council of the Bar

The Right Honourable Lord Justice Longmore