THE BROKER'S LIABILITY FOR PREMIUMS: SHOULD SECTION 53 BE REFORMED?

SUMMARY

S.1 In this Issues Paper we consider whether there should be legislative reform of section 53 of the Marine Insurance Act 1906. Section 53(1) makes the broker directly responsible for the premium to the insurer. This means that brokers are personally liable to pay premiums whether or not they have received them from the policyholder. Effectively, the section potentially imposes the risk of a policyholder's insolvency on the broker, and the risk of a broker's insolvency on the insurer.

S.2 Section 53 appears to apply only to marine insurance, though its scope is not wholly clear. It is a complex and anomalous provision, which has generated many inconsistent decisions.

S.3 Section 53(2) provides the broker with a lien over the insurance policy, allowing it to recover any money it is owed by the policyholder. This provision has received less attention, both in the law reports and the text books.

S.4 In our 2006 Joint Scoping Paper on insurance contract law, we suggested that section 53 no longer reflects the realities of the insurance market place and should be reviewed. Of the 93 responses to the scoping paper, 72 thought that the provision should be included in our review of insurance contract law.[1]

S.5 This Issues Paper sets out our preliminary thinking. Its purpose is to promote discussion before we formulate our proposals. We seek responses by 19 October 2010, to the address on page 1 of the paper.

THE BROKER'S LIABILITY FOR PREMIUMS

S.6 Section 53(1) of the Marine Insurance Act 1906 states:

> 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] Law Commission and Scottish Law Commission, Insurance Contract Law: A Joint Scoping Paper (January 2006), available at http://www.lawcom.gov.uk/docs/ins_scoping.pdf at para 2.54.

S.7 This section codified a custom of the marine insurance industry, under which the insurer did not claim the premium from the policyholder but from the broker. The custom originated at Lloyd's but was held to extend to the marine insurance market outside Lloyd's as well. It was probably intended to provide underwriters with some security against unfamiliar policyholders. It overrides the normal rule of agency law that an agent is not personally liable on a contract effected for its principal.

S.8 Before 1906, the legal basis for the custom was a fiction that the broker had paid the premium to the insurer, thus discharging the policyholder's liability to pay, and that the insurer had lent the money back to the broker. This created a personal debt obligation between the broker and the insurer. The question that the courts continue to grapple with is how, if at all, the common law fiction applies under the modern law.

The insurer cannot recover the premium from the policyholder

S.9 Although the custom appears to have been originally intended to protect insurers from the credit risk of unknown policyholders, it may also disadvantage insurers. Before 1906, the courts held that the common law fiction precluded an insurer from pursuing a known policyholder for the premium, even if recovery from the broker was impossible.[2] This could leave the insurer without any means of recovering the premium in cases where, for example, the broker had become insolvent. Although the position nowadays is less clear, this probably remains the case under section 53(1).

S.10 In addition, the courts have long held that insurers may not refuse to pay a loss on the ground that the broker has not paid the premium.[3] As a result the insurer will normally be on risk from the outset of the policy. The consequences of non-payment by the broker will depend on the precise wording of the insurance policy. The insurer may be able to rely on a provision allowing it to terminate the policy if the broker does not pay. However, without suitably worded provisions, the insurer is required to pay relevant losses.

S.11 As soon as the insurance policy is concluded, the broker may recover the premium from the policyholder. This right may be exercised even if the broker has not paid the premium itself, since the insurer could call upon the broker to pay at any time.[4]

Is section 53(1) limited to marine insurance?

S.12 It has not been finally settled whether the custom now reflected in section 53(1) applies outside the marine insurance market. However, it seems that it does not.[5] Even in non-marine insurance *within* Lloyd's (which is, we understand, conducted in much the same way as marine insurance), it seems that the broker will not be automatically responsible to the insurer for the premium.

2 *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93.

3 *Scott v Irving* (1830) 1 B & Ad 605; *Sweeting v Pearce* (1861) 9 CB (NS) 534.

4 *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] CLC 860.

5 *Wilson v Avec Audio-Visual Equipment Ltd* [1974] 1 Lloyd's Rep 81.

S.13 In *Pacific and General Insurance Co v Hazell* it was held that a broker was not liable for the premiums due under a Lloyd's non-marine policy when the policyholder had gone into liquidation.[6] The court explained that brokers at Lloyd's may have implied authority to pay premiums on the policyholder's behalf, but this authority was terminated when the policyholder's provisional liquidator was appointed. The decision implies that brokers placing non-marine insurance at Lloyd's are not automatically liable for premiums.

Terms of Business Agreements

S.14 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.

S.15 We doubt 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 TENSION BETWEEN THE COMMON LAW FICTION AND SECTION 53(1)

S.16 The effect of section 53(1) is not altogether clear. On one view it means just what it says: "the broker is directly responsible to the insurer for the premium". On another view, the section should be interpreted in the light of the custom on which it was originally based, which included the common law fiction that the broker had paid the premium and the insurer had lent it back to the broker. This leads to complex issues and conflicting decisions, particularly regarding payment clauses.

Adjusted premium clauses

S.17 Insurance policies sometimes provide for the premium to be increased if, for example, a vessel enters a war zone. Section 53(1) does not make any exception for such "adjusted" or "additional" premiums, and it may therefore be assumed that the broker is responsible for them as usual. This does not, however, fit well with the common law fiction that the premium has been paid at the outset of the policy, and then lent back to the broker, since the additional premium (if any) cannot be determined at that time. Consequently, the court in *The Litsion Pride* held that section 53(1) did not apply to an adjusted payment clause, since it was incompatible with the common law fiction.[7] This raises difficult questions about the status of adjusted premiums under marine policies, as well as implying that section 53 maintains the common law fiction.

[6] *Pacific and General Insurance Co v Hazell* [1997] BCC 400; [1997] LRLR 65.

[7] *Black King Shipping Corporation and Wayang (Panama) SA v Mark Ranald Massie ("The Litsion Pride")* [1985] 1 Lloyd's Rep 437.

Premium payment warranties

S.18 Insurance policies often include automatic termination clauses, which purport to terminate the policy upon late payment of an instalment of a premium. These are known as "premium payment warranties". The language of section 53(1) does not seem to prevent insurers relying on such clauses. In some cases, however, the courts have held the fiction means that these clauses can never operate, since under the fiction the premium is deemed to have been paid on time.[8]

S.19 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.[9] 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.[10] However, this part of the judge's decision was non-binding.

S.20 We consider what would happen under section 53 if a broker were to go into liquidation. The broker may sue the policyholder for any unpaid premium, but the premium may then be passed to the broker's general creditors. Although the insurer would have a debt 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. 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.

THE BROKER'S LIEN IN SECTION 53(2)

S.21 Section 53(2) gives the broker a lien over both the policy and any policy proceeds it receives from the insurer. This lien allows the broker to recover the cost of the premium paid (or due to be paid) under their obligation in section 53(1), although it does not apply to composite insurance (that is, insurance policies where more than one interest is involved).[11]

S.22 The lien in section 53(2) may be exercised in respect of "any balance on any insurance account which may be due" to the broker from the policyholder.[12] In English law, it has not yet been settled whether the same rule extends to the broker's lien in non-marine insurance.[13] We are not convinced that there should be a difference between marine and non-marine insurance on this issue, and we ask whether the rule in section 53(2) should be explicitly extended to the non-marine market.

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

9 *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.

10 *Allianz Insurance Co Egypt v Aigaion Insurance Co SA* [2008] EWHC 1127 (Comm); [2008] 2 Lloyd's Rep 595.

11 *Eide UK Ltd v Lowndes Lambert Group Ltd ("The Sun Tender")* [1999] QB 199.

12 Marine Insurance Act 1906, section 53(2).

13 In Scots law, however, brokers are recognised as being among the limited categories of persons endowed with a general lien, which extends to the general balance of the policyholder's account.

SECTION 54

S.23 Section 54 provides that:

> Where a marine policy effected on behalf of the assured by a broker acknowledges the receipt of the premium, such acknowledgement is, in the absence of fraud, conclusive as between the insurer and the assured, but not as between the insurer and broker.

S.24 We are not aware that this section is ever used nowadays. We are interested to hear whether it has any practical effect in modern insurance law.

THE CURRENT LAW OUTSIDE SECTION 53

S.25 The default position outside section 53 is that a broker acting within the scope of its authority is not personally liable to the insurer for the premium (with some exceptions). Rather the policyholder is liable as the broker's principal.

S.26 Where the policyholder has already paid the broker, this does not relieve the policyholder of its duty to pay the insurer. However, many policyholders benefit from regulatory protection in the event of their broker's insolvency. Authorised firms carrying on mediation activities must hold client money in accordance with the Client Assets Sourcebook (CASS). This provides for client money to be held in a statutory or non-statutory trust account. Alternatively the broker and the insurer may enter into a risk transfer TOBA, described above.

S.27 We consider what would happen if the policyholder were to pay the broker and the broker were then to go into liquidation. In theory, in the absence of a risk transfer agreement, the policyholder would be liable to pay the premium again, this time to the insurer directly. However, in many cases the policyholder would be protected by the CASS rules, and it should be able to recover the first premium from the broker's segregated client money account.

S.28 Given that the position outside section 53(1) appears to be generally satisfactory, we are not convinced that section 53(1) is needed in the market.

CASE FOR REFORM

S.29 Our views on proposals for reform are provisional. We tentatively observe that:

(1) The application of section 53(1) is unclear.

(2) The limited application of section 53(1) is anomalous.

(3) The common law fiction, which was invented to give effect to the custom before it was codified by section 53(1), has produced unprincipled and conflicting case law.

(4) Even in the marine market, it is unclear whether there is any justification for section 53(1).

(5) The risk of a broker's insolvency appears to fall on the insurer. The consolidation of brokers may have serious consequences for insurers.

(6) The risk of a policyholder's insolvency falls on the broker, which may be a burden for those entering the market.

S.30 If, as seems likely, the section is limited to marine insurance only, this leads to the question: why should the broker have personal liability in marine insurance but not otherwise?

S.31 Notwithstanding recent case law, it remains possible that the common law fiction could be invoked and relied on by the courts in difficult and in unusual cases. This leaves the law in a state of confusion, which could lead to extremely costly litigation in the event of one of the parties becoming insolvent.

S.32 Whilst TOBAs provide market flexibility, we do not think that they can solve all the problems of the current law. It seems unlikely that a TOBA could entirely exclude section 53(1) because the only parties to a TOBA are the insurer and the broker.

S.33 It is worth noting the current Australian position. Section 59 of the Australian Marine Insurance Act 1909 was identical to section 53 of the Marine Insurance Act 1906, but has now been repealed. Under the Corporations Act 2001, money paid to an intermediary by the insured is a discharge, as between the insured and the insurer, of the liability of the insured to the insurer in respect of that money. This effectively imposes a risk transfer arrangement on the parties. We briefly consider whether to impose this as a rule, but conclude that the matter is best decided by the market, leaving the parties to work out the best relationship between them.

PROPOSALS FOR REFORM

S.34 We tentatively propose that section 53(1) should be reformed. We think the default position should be that policyholders are liable for the premium payments due under their insurance policies. This would allow the insurer to sue the policyholder for the premium, if unpaid. The policyholder receives the benefit of the insurance coverage and so it is the policyholder who should primarily be liable for it. The broker would not be liable for the premium unless it had expressly assumed such liability.

S.35 We think that reforming section 53 in this way would have the following benefits:

(1) It would bring marine insurance law into line with general contract and agency law.

(2) It would enable the parties to agree their own contractual arrangements on issues including credit risk through their TOBAs, allowing greater flexibility.

(3) We have found no obvious evidence of policyholder or consumer detriment that would nowadays require special rules such as those in section 53(1).

S.36 We have considered simply repealing section 53(1). However, the effect of this is unclear, as the common law custom and fiction may remain in place. We therefore tentatively conclude that a new statutory provision would be needed to implement our proposed default position. We ask for views.

S.37 We also ask whether the lien provision in section 53(2) should be retained for marine insurance only, or extended to non-marine insurance as well.

S.38 A full list of questions may be found in Part 8 of the Issues Paper.