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# Reforming Insurance Contract Law

## Issues Paper 8: The Broker's Liability for Premiums: Should Section 53 be Reformed?

**July 2010**

**The Law Commission**
**and**
**The Scottish Law Commission**

# INSURANCE CONTRACT LAW

Issues Paper 8

## The Broker's Liability for Premiums: Should Section 53 be Reformed?

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**Topic**: We consider section 53 of the Marine Insurance Act 1906, which makes the broker directly liable to the insurer for premiums. We examine the custom on which section 53(1) was based, and discuss the conflicting case law arising from it. We ask whether reform of section 53 is required.

**Geographical scope**: England and Wales, Scotland.

**Duration of the consultation**: from 19 July 2010 to **19 October 2010**.

**How to respond**

Please send your responses either –

**By email to**: commercialandcommon@lawcommission.gsi.gov.uk or

**By post to**: Christina Sparks, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ

Tel: 020 3334 0285 / Fax: 020 3334 0201

If you send your comments by post, it would be helpful if, where possible, you also send them to us electronically (in any commonly used format).

**After the consultation**: In the light of the responses, we will work towards a full Consultation Paper, which we hope to publish in 2011.

**Freedom of information**: We will treat all responses as public documents in accordance with the Freedom of Information Act. We may attribute comments and include a list of all respondents' names in each of our publications. If you wish to submit a confidential response, you should contact us before sending it.

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THE LAW COMMISSION
THE SCOTTISH LAW COMMISSION

# Joint Review of Insurance Contract Law
# Issues Paper 8

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

## CONTENTS

# 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.

# PART 1
# INTRODUCTION

1.1 This Issues Paper is part of a joint review of insurance contract law by the Law Commission and Scottish Law Commission. It considers the history and interpretation of section 53 of the Marine Insurance Act 1906, which makes the broker directly responsible to the insurer for premiums. It examines the custom on which the section is based and analyses the case law arising from it. The aim is to determine whether legislative reform of section 53 is required, and if so, what the reform should attempt to achieve.

1.2 This paper sets out our preliminary thinking. Its purpose is to promote discussion before the formal consultation process begins.

1.3 Our tentative proposals and questions are listed in Part 8. We seek views on these issues by **Tuesday 19 October 2010** and would be grateful if responses could be sent:

by email to commercialandcommon@lawcommission.gsi.gov.uk;

by post to Christina Sparks, Law Commission, Steel House, 11 Tothill Street, London SW1H 9LJ (tel: 020 3334 0285); or

by fax to 020 3334 0201, marked for the attention of Christina Sparks.

1.4 This paper focuses, in particular, on the transfer of credit risk brought about by section 53. This risk transfer arrangement may be particularly important in the event of insolvency, on the part of the insurer, broker or policyholder. We examine the liability facing a broker in the event of a policyholder's insolvency, or where an insurer (or, more likely, an insurer's liquidator) wishes to recover premium payments from whoever it can. Our analysis indicates that the law under the Marine Insurance Act 1906 may be out of line with modern commercial practice. The legal position may not at first glance seem relevant to everyday business, but that position may change dramatically upon a serious insolvency.

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.

(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 In our 2006 Joint Scoping Paper on insurance contract law, we said of section 53:

> It has been suggested to us that this provision no longer reflects the realities of the insurance market place, and it should therefore be repealed or amended. We have not conducted the research necessary to establish whether there is consensus on this point.[1]

The Scoping Paper said nothing further about the realities of the insurance market place or how section 53 failed to reflect them.

1.7 We received 93 responses to the Joint Scoping Paper. Of these, 72 (77%) thought that the provision should be included within our review of insurance contract law. We discuss these responses in this Issues Paper where relevant.

**STRUCTURE OF THIS PAPER**

1.8 The structure of this Issues Paper is as follows:

(1) In Part 2 we describe the current law on section 53(1), which makes the broker personally liable to the insurer for the insurance premium. We cover both the background and scope of this provision.

(2) In Part 3 we examine the tension between the common law fiction supposedly underlying section 53(1) and the words used in the provision itself.

(3) In Part 4 we examine the current law on section 53(2), which gives the broker a lien over the policy (and its proceeds) in respect of money owed by the policyholder.

(4) In Part 5 we describe the current law on the authority and liability of brokers outside section 53.

(5) In Part 6 we consider the case for reform of section 53.

(6) In Part 7 we review the options for reform and set out tentative proposals for reform.

(7) In Part 8 we list our tentative proposals and questions.

[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.

# PART 2
# SECTION 53(1): THE BROKER'S LIABILITY FOR THE PREMIUM – BACKGROUND AND SCOPE

2.1 In this Part, we discuss section 53(1) of the Marine Insurance Act 1906 in detail. We examine the custom on which the provision was originally based and identify the rationale for it. We then discuss the scope of the rule that a broker is personally liable for the premium, which clearly applies to marine insurance but may not apply to non-marine insurance. We consider how particular agency agreements between insurers and brokers may affect the broker's liability under section 53(1). Finally, we briefly discuss whether section 53(1) applies when the insurance policy is governed by the law of a jurisdiction other than that of the United Kingdom.

## CUSTOMARY BASIS: HISTORY AND INTERPRETATION

2.2 Section 53(1) of the 1906 Act codified a custom of the marine insurance industry, which originated in the London Lloyd's market. This custom overrides the normal rule of agency law that an agent is not personally liable on a contract effected for its principal. Instead, as *MacGillivray* explains:

> By reason of a long established custom or usage of Lloyd's, the underwriter does not claim the premium from the assured but from the Lloyd's broker, and the broker in turn looks to the assured for payment. The custom is founded in the ancient usages of the marine underwriting business in London, and the courts have had it proved a sufficient number of times to accord it judicial notice. So far as the Lloyd's broker and underwriter are concerned, the premium is treated as a debt due from the broker alone, so that the broker is the principal debtor to the underwriter for it in addition to being an agent of the assured to negotiate the insurance cover.[1]

2.3 It is important to note that, unlike the custom on which it was based, section 53(1) does not explicitly state that the premium is a debt due from the broker alone. Rather, it provides that "the broker is directly responsible" for the premium.[2] The policyholder's liability, if any, should its broker fail to pay the premium is not specified. The common law position prior to the 1906 Act was that the policyholder was not liable to pay the premium to the insurer, and we have found no English or Scottish authority that would suggest the situation is any different under section 53(1).[3]

[1] N Legh-Jones (ed), *MacGillivray on Insurance Law* (11th ed 2008), at para 35-013.

[2] Marine Insurance Act 1906, s 53(1).

[3] See *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93 and paras 2.13 to 2.18 below.

### The custom and the common law fiction designed to give effect to it

2.4 The custom codified by section 53(1) has apparently been in use since at least the early nineteenth century, and was probably intended to provide some security for insurers.[4] In *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd*, Lord Justice Chitty explained both the purpose of the custom and its legal rationale:

> The established custom in marine insurance effected through a broker is that the assured is not, and that the broker is, liable to the underwriter for the payment of the premium. The ground of the custom appears to be that in most cases the assured is not, and the broker is, known to the underwriter, and, accordingly, that the underwriter gives credit to the broker alone; and that there is an account between the broker and the underwriter in which credit is given for the payment of the premium. In order to sustain this course of business, and to enable the underwriter to recover from the broker the premium, when it is not in fact paid, it is considered in law that the premium has been paid to the underwriter by the broker, and that the underwriter has lent the premium to the broker.[5]

2.5 According to Lord Justice Chitty, therefore, the legal basis of the custom is a fiction that the broker has paid the premium to the insurer, thus discharging the policyholder's liability to pay, and that the insurer has then lent the money back to the broker. This creates a personal debt obligation between the broker and the insurer, while discharging the policyholder's liability to pay the premium to the insurer.

2.6 An alternative legal rationale for the custom was put forward by Mr Justice Bayley in the early nineteenth century case of *Power v Butcher*:

> [The broker] is not solely agent; he is the principal to receive money from the assured, and to pay it to the underwriters.[6]

[4] N Legh-Jones (ed), *MacGillivray on Insurance Law* (11th ed 2008), at para 35-014. The custom was recognised in the days of Lord Ellenborough: see *Edgar v Fowler* (1803) 3 East 222; *Dalzell v Mair* (1808) 1 Camp 533; *Shee v Clarkson* (1810) 12 East 507; and *Minett v Forrester* (1811) 4 Taunt 541. There does not appear to be any Scottish case law or literature discussing either the custom underlying section 53(1) of the Marine Insurance Act 1906 or section 53(1) itself.

[5] *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93, by Chitty LJ at pp 99 to 100.

[6] (1829) 10 B & C 329, at p 340. By contrast, Parke J said that the fiction of lending was the true basis of the custom at p 347.

2.7 Professor Merkin appears to agree with this view and adds a further alternative basis for the custom, that of "dual agency":

> A more realistic explanation [of the custom reflected in section 53(1)] is that the broker is acting as a principal in his own right or under some form of dual agency, and not merely as the agent for the assured.[7]

2.8 It therefore seems that at least three different legal rationales have been used to explain the operation of the custom: the "fiction of lending" approach; the "broker as principal" approach; and the "dual agency" approach (sometimes called the "common agent" approach). Although Mr Justice Bayley, in the passage from *Power v Butcher* cited above, advanced the second of these explanations, later commentators appear to have conflated his argument with that of the "dual agency" approach. In 2007, for example, Dame Elizabeth Gloster[8] explained why the "dual agency" approach cannot apply under section 53(1) by reference to Mr Justice Bayley's judgment:

> Bayley J in *Power v Butcher* suggested that the broker is viewed as the insurer's agent for the purpose of receiving the premium in discharge of the payment obligation. But that cannot be right, since, if that were the case, the premium would be regarded as paid once the assured paid the broker, whereas the custom codified in section 53(1) regards the premium as paid as soon as the risk is subscribed to by the underwriter, notwithstanding that the assured has not in fact paid the broker.[9]

2.9 Although we do not think that this is quite the suggestion that Mr Justice Bayley made, we agree with Dame Elizabeth Gloster that the argument against the "dual agency" approach is convincing, as it is incompatible with the outcome of both the custom and section 53(1) itself.[10] Neither the custom nor section 53(1) require the broker to have actually received the premium from the policyholder before the broker will be liable to the insurer.

[7] R Merkin in D R Thomas (ed), *The Modern Law of Marine Insurance (Volume 1)* (1996), at pp 282 to 283.

[8] Also Gloster J of the Commercial Court.

[9] E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 309.

[10] Despite the apparent incompatibility between the "dual agency" approach and section 53(1), the Court of Appeal appeared to favour this rationale in *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; [1998] CLC 860, where Sir Brian Neill said (at p 865) that the "concept of the broker acting as a dual agent, or as an independent intermediary, provides a useful starting point". In *Heath Lambert Ltd v Sociedad de Corretaje de Seguros* [2004] EWCA Civ 792; [2004] 1 WLR 2820, a differently constituted Court of Appeal agreed with this analysis.

2.10 Under the "dual agency" approach, the broker would receive and then hold the premium as the insurer's agent. If this was the correct analysis of section 53(1), the insurer would gain a certain degree of protection. If, for example, the broker committed a breach of fiduciary duty (such as mishandling the premium money) the insurer would be able to rely on the proprietary remedy of tracing.[11] By contrast, an important consequence of both the "fiction of lending" approach and the "broker as principal" approach (but not the "dual agency" approach) is that the broker does not become the insurer's agent by virtue of merely receiving the premium payment from the policyholder. The fact that the broker does not receive the premium as agent for the insurer means that the insurer's remedy is limited to a claim for payment of a debt.[12]

2.11 Of the three alternative approaches, the "fiction of lending" has received the most support in both case law and insurance textbooks.[13] The other two are rarely referred to or relied upon. As we discuss below, the common law fiction is regularly invoked by the courts, even though this often produces unsatisfactory results.

2.12 To summarise, it is necessary to distinguish three different concepts: first, the market custom that the broker, not the policyholder, is liable to pay marine insurance premiums; second, the common law fiction used by the courts to give effect to this custom prior to the 1906 Act; and third, section 53(1) of the Marine Insurance Act 1906. The question the courts continue to grapple with is, therefore, to what extent (if at all) the common law fiction applies under the modern law.[14]

### Insurer cannot recover the premium from the policyholder

2.13 Although the custom was originally intended to protect insurers from the possible credit risk of unknown policyholders, the courts have held that one effect of the custom is to preclude an insurer pursuing a known policyholder for recovery of the premium, even if recovery from the broker is impossible.[15] This could leave the insurer without any means of recovering the premium in cases where, for example, the broker has become insolvent.

[11] The position of Scots law on "tracing" is unclear: there may be room in this situation for personal remedies of unjustified enrichment.

[12] See R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0352.

[13] See, for example, R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 23-74; N Legh-Jones (ed), *MacGillivray on Insurance Law* (11th ed 2008), at para 35-014; and R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0352. For more details of the case law, see n 4 to para 2.4 above, and the discussion below. As noted in n 4 to para 2.4 above, however, there does not appear to have been any discussion at all in the context of Scots law.

[14] See H N Bennett, *The Law of Marine Insurance* (2nd ed 2006), at para 6.22.

[15] *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93. See also N Legh-Jones (ed), *MacGillivray on Insurance Law* (11th ed 2008), at para 35-015.

2.14 In the *Universo* case referred to above, a reinsurer attempted to claim the premium due to it from the policyholder rather than from the broker, which had become insolvent. The reinsurer argued that the custom was only applicable to policies written at Lloyd's and, in any event, that the policy included an express promise by the policyholder to pay the premium. The Court of Appeal rejected both of these arguments, holding that the custom was of general application to marine business and that "the promise by the assured to pay the premium may be read as a promise to pay in the customary manner, namely, by the broker".[16] As a result, the custom applied and the reinsurer could not recover the premium from the policyholder directly.

2.15 The *Universo* case was decided in 1897, before the custom was codified in section 53(1) of the Marine Insurance Act 1906. We explained above that there is apparently no English or Scottish authority on whether the rule in *Universo* survives under section 53(1) or whether an insurer might now be able to claim payment of the premium from the policyholder directly.[17] Professor Bennett's view on the current position under section 53(1) is, however, shared by most commentators:

> Where marine insurance is placed through a broker, the insurer's sole right to premium lies against the placing broker. The assured has no liability to the insurer at all, even at a secondary level should the broker default.[18]

2.16 This conclusion is supported by a decision of the High Court of Australia from 1986, when it considered section 59 of the Australian Marine Insurance Act 1909.[19] Although the provision has since been repealed,[20] section 59 of the Australian Act was identical to section 53 of the Marine Insurance Act 1906. The High Court of Australia held:

[16] Above, by Chitty LJ at p 101.

[17] It was apparently suggested in the unreported case of *Re Vehicle Insurance Plan* (31 July 1984) that there was some doubt whether the *Universo* decision survived the enactment of section 53, but Goff LJ did not directly address the point. The case is referred to in the Financial Law Panel's report on the broker's liability for non-marine premiums at Lloyd's. See Financial Law Panel, Non-Marine Insurance at Lloyd's – Brokers' Liability for Premium (September 1994), at p 109.

[18] H N Bennett, *The Law of Marine Insurance* (2nd ed 2006), at para 6.25.

[19] *Con-Stan Industries of Australia Pty Ltd v Norwich Winterthur Insurance (Australia) Ltd* [1986] HCA 14; (1986) 160 CLR 226.

[20] See paras 6.15 to 6.20 below.

> The principal issue arising for consideration is whether an insurer may recover outstanding premiums from an assured who has already paid them to his insurance broker, but which the broker has failed to pass on to the insurer. In contracts of marine insurance the matter is governed by section 59 of the Marine Insurance Act 1909 which provides, in terms which are declaratory of the common law governing such contracts, that 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. The necessary corollary is that an insurer has no recourse against the assured if the broker defaults on payment of the premium.[21]

It seems likely that the same "necessary corollary" would apply to section 53(1) of the 1906 Act, which suggests that the rule in *Universo* survives.

2.17 Even though an insurer is probably unable to claim the premium directly from the policyholder where section 53(1) applies, the English courts have long held that insurers cannot refuse to pay out for a loss on the ground that the broker has not yet paid the premium. As Lord Chief Justice Tenterden said in 1830:

> The general rule is, that the broker is the debtor of the underwriter for the premiums, and the underwriter the debtor of the assured for the loss.[22]

2.18 As a result, the insurer will usually be on risk from the outset of the policy, regardless of whether it has been paid the premium, and will have to pay out for any relevant loss suffered by the policyholder. However, the exact consequences of non-payment by the broker will depend on the precise wording of the insurance policy, and it is possible that an insurance contract may include a provision allowing the insurer to terminate the policy in the event that the broker does not pay.[23]

[21] *Con-Stan Industries of Australia Pty Ltd v Norwich Winterthur Insurance (Australia) Ltd* [1986] HCA 14; (1986) 160 CLR 226, by Gibbs CJ, Mason, Wilson, Brennan and Dawson JJ at para 2.

[22] *Scott v Irving* (1830) 1 B & Ad 605, at p 612. See also *Sweeting v Pearce* (1861) 9 CB (NS) 534.

[23] See our discussion on the effect, if any, of premium payment warranties when the insurer has not been paid the premium and wishes to cancel the policy, at paras 6.40 to 6.47 below.

### Broker can sue the policyholder for the premium

2.19 As the broker is directly liable to the insurer for the premium as soon as it falls due, the broker immediately has a corresponding right to an indemnity for that payment from the policyholder. Moreover, it was established in the nineteenth century that the broker could sue the policyholder to recover the premium even if it had not actually made any payment itself. Recent decisions have confirmed that this analysis is correct. In *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret*,[24] for example, the broker had not paid the premium to the insurer and, owing to the fact that the broker was in liquidation, it was likely that it would never do so. Despite this, the policyholder remained liable to pay the insurance premiums to the broker. Sir Brian Neill commented:

> As a general rule, the broker can recover premiums even if he has not yet paid them to the insurer.… It is true that section 53 of the 1906 Act does not deal expressly with the rights and liabilities between the broker and the assured.… But it was common ground that it is the *general* rule that the broker has a cause of action in his own right against the assured in respect of unpaid premiums.[25]

2.20 The idea that a broker could claim payment from the policyholder before actually paying the insurer has worried several judges, including Mr Justice Littledale in *Power v Butcher*:

> Even where the policy is in the common form, it may be difficult to say upon what principle the broker can recover the premiums as for money paid before he has actually paid them to the assurers. But it has been so decided.[26]

2.21 However, as *MacGillivray* points out, allowing the broker to recover in such cases is justified by the imposition of personal liability on brokers:

> [Permitting the broker to recover the premium from the assured when it has not yet actually paid the insurer] troubled at least one eminent judge… as a matter of legal principle, but there is undoubted justice in it, seeing that the assured cannot be sued by the underwriter for the premium which the broker is liable to pay, and the underwriter cannot refuse to pay a loss on the ground that the broker has not accounted to him for the premium. Moreover the assured can sue the underwriter for return of the premium where the risk is not run, as where a vessel never sets out on an insured voyage.[27]

[24] [1998] Lloyd's Rep IR 377; [1998] CLC 860.

[25] Above, at pp 862 and 865 (emphasis in original).

[26] (1829) 10 B & C 329, at p 344.

[27] N Legh-Jones (ed), *MacGillivray on Insurance Law* (11th ed 2008), at para 35-015.

**Producing and placing brokers**

2.22 In many cases, more than one broker will be involved in the placement of insurance. It is quite common for the policyholder's broker (the "producing broker") to instruct a second broker (the "sub-broker" or "placing broker") to place the risk with an appropriate insurer. Producing brokers are often based overseas, and they rely on placing brokers in the market in which they wish to obtain cover. Producing brokers also use placing brokers if they do not possess the expertise to place specialist risks.[28]

2.23 In cases where there is more than one broker, the placing broker rather than the producing broker is responsible to the insurer for the premiums under section 53(1). There is usually no contractual relationship (or "privity") between the placing broker and the policyholder, so the placing broker must instead look to the producing broker for an indemnity.[29] The producing broker can then in turn recover this payment from the policyholder.[30] In this sense, the credit risk is effectively passed down the chain of brokers.

## THE SCOPE OF SECTION 53(1): LIMITED TO MARINE INSURANCE?

2.24 It has not yet been finally decided whether the custom (and therefore section 53(1) as well) extends to non-marine insurance *outside* Lloyd's or even whether it applies to non-marine insurance *within* Lloyd's. Professor Merkin states the position clearly:

> The only proposition beyond doubt is that the usage applies to marine insurance both at Lloyd's and in the company market.[31]

2.25 However, the custom or usage codified in section 53(1) seems to be limited only to marine insurance policies and apparently does not extend to non-marine business.[32] One possible exception to this general rule arose in *IGI v Kirkland Timms*,[33] where the court held that the usage applies where the broker acts as intermediary between underwriters and a "cover-holder" (that is, a firm which is authorised by a Lloyd's syndicate to enter into insurance contracts on its behalf) under a binding authority. However, the basis for this was stated to be commercial convenience rather than legal principle.[34]

2.26 As we will now discuss, current case law suggests that section 53(1) is usually limited to marine insurance only, regardless of where it is written, and that it does not apply to non-marine insurance at all.

28 See R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 15-29.

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

30 See R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 23-75. For more details about indemnification, and in particular the broker's lien under section 53(2), see Part 4 below.

31 Above.

32 See N Legh-Jones (ed), *MacGillivray on Insurance Law* (11th ed 2008), at para 35-013.

33 5 December 1985 (QBD, Commercial Court), unreported.

34 See R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0353.

### Non-marine business outside Lloyd's

2.27 The leading decision on non-marine business outside Lloyd's is *Wilson v Avec Audio-Visual Equipment Ltd*,[35] where the claimant broker placed two insurance policies on behalf of the defendant policyholder with an insurer in January 1971. The policies were made against burglary and to cover goods in transit. In March 1971, the insurer was compulsorily wound up and the liquidator asked the broker to pay the premiums in full. When it found out about this request, the policyholder wrote to the broker stating that it would only pay a proportionate sum, representing the period from January to March. Despite this, the broker paid the full premium sum to the liquidator and sued the policyholder for the full amount.

2.28 The Court of Appeal upheld the lower court's ruling that the claimant broker had not proved that he was automatically liable to the insurer and that he had simply chosen, possibly under a mistaken belief, to assume such a personal liability. The broker could not therefore recover the entire premium from the policyholder. This outcome suggests that the custom does not extend to non-marine business outside Lloyd's. However, the case appears to have been poorly presented at trial, with little or no authority cited, as Lord Justice Edmund Davies made clear:

> What is here attempted on the plaintiff's behalf is to import some special rule applicable to insurance brokers which, in so far as I have been able to understand the way the case was presented below (and I am far from being sure that I do understand) has this effect: that an insurance broker who puts business in the way of an insurance company renders himself personally liable to that insurance company in respect of any premiums payable under any policies effected through his instrumentality. One naturally hoped that there would be some authority forthcoming for that proposition, but none has been forthcoming.[36]

2.29 Lord Justice Scarman took care to note the limits of this case with regard to the duties of insurance brokers generally:

> This case should not be taken, in my judgment, as any indication as to the nature of the duties and liabilities of an insurance broker vis-à-vis the assured when a premium has not been paid. The facts are just not there to enable either the court of first instance or the appeal court to consider that branch of law.[37]

2.30 The decision is therefore inconclusive and the outcome could be different in future cases if the arguments were put differently. It is clear, however, that outside both the marine and Lloyd's markets, the custom is not well enough established to command recognition by judicial notice.[38] Before it can be recognised by a court as binding, it would have to be shown that the practice is uniformly followed.

35 [1974] 1 Lloyd's Rep 81.

36 Above, at p 82.

37 Above, at p 85.

38 See R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0354.

### Non-marine business at Lloyd's

2.31 Even if the custom does not extend to non-marine insurance outside Lloyd's, it used to be thought that it might apply to all business, whether marine or non-marine, conducted within Lloyd's itself. In *Julian Praet et Cie SA v H G Poland*, Mr Justice Pearson accepted the validity of the practice in the context of foreign motor insurance business without expressing any reservations:

> The underwriter looks to the Lloyd's broker for the premium, and has his account with the Lloyd's broker.[39]

2.32 However, as Julian Flaux QC[40] wrote in 1998:

> An undecided question until recently had been the extent to which the custom and practice of the marine market enshrined in section 53(1) is also applicable in the non-marine market. In the case of both Lloyd's and the companies market, central accounting systems exist in relation to both marine and non-marine business which involve brokers accounting to underwriters for premiums irrespective of whether the brokers had received the premium from their clients.
>
> One school of thought considered that the existence of these central accounting systems was only consistent with the same custom and practice applying in non-marine business as in marine, certainly at Lloyd's and probably in the companies market as well. However the point had never been tested in the courts and a report by the Financial Law Panel a few years ago doubted whether the custom and practice applied outside the marine market and outside Lloyd's.[41]

2.33 The Financial Law Panel report referred to was commissioned by Lloyd's and involved senior legal figures.[42] It considered the following questions:

(1) Is there a trade custom in relation to all Lloyd's non-marine business, that the Lloyd's broker who places the business pays the premium to the underwriters, whether or not he receives it from the assured?

(2) If not, is there such a trade custom in relation to one or more discrete types of Lloyd's non-marine business?

39 [1960] 1 Lloyd's Rep 416, at p 428. See R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 8-07 and n 46.

40 Now Flaux J of the Commercial Court.

41 J Flaux QC, "Brokers' Liability for Premium" [1998] *British Insurance Law Association Journal* 34, at p 38. The suggestion that the question may recently have been decided refers to the case of *Pacific and General Insurance Co v Hazell* [1997] BCC 400; [1997] LRLR 65, discussed at paras 2.35 to 2.39 below.

42 See R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0353.

(3) If it appears that the trade custom exists (either in relation to all or to some Lloyd's non-marine business), is there evidence that it extends beyond making the broker liable, so as to preserve the business efficacy of the contractual arrangements as a whole?[43]

2.34 The Financial Law Panel concluded:

> If these questions were asked of an English court, we think the court would conclude that no trade custom exists in relation to Lloyd's non-marine business, or to any discrete type of that business, that the Lloyd's broker who places the business should pay the premium to the underwriters, even if the assured does not pay the premium to him.
>
> This conclusion obviates the need to answer the third question posed. However, for completeness, we would say that we found no evidence of a trade custom or customs which address the contractual consequences which would flow, if the principal term of the alleged custom were implied.
>
> It does not follow from our conclusions that a Lloyd's broker is never personally liable for a non-marine premium. A Lloyd's broker and underwriters are always free expressly to agree that the broker will be so liable for the premium. Contractual liability may also arise between underwriters and a Lloyd's broker if the parties have adopted such a term by a course of dealing.[44]

2.35 In *Pacific and General Insurance Co v Hazell*,[45] Mr Justice Moore-Bick[46] held that a broker was not liable for the premiums due under a Lloyd's non-marine reinsurance policy when the policyholder had gone into liquidation, even though the broker had paid the first premium instalment through a central accounting system. Instead, the policyholder was liable to pay the outstanding premiums and it had effectively repudiated the reinsurance contract when it refused to pay them. Accordingly, the reinsurer was entitled to cancel the reinsurance policy.[47]

2.36 In reaching this conclusion, the court explained that, although brokers at Lloyd's usually have implied authority to pay premiums on behalf of the policyholder, the appointment of a provisional liquidator brings the broker's appointment to an end. The broker's authority (and contractual obligation, if any) to pay premiums on the policyholder's behalf is terminated along with that appointment.[48]

43 Financial Law Panel, Non-Marine Insurance at Lloyd's – Brokers' Liability for Premium (September 1994), at p 50. The questions are reproduced here verbatim.

44 Above, at pp 50 to 51.

45 [1997] BCC 400; [1997] LRLR 65.

46 Now Moore-Bick LJ of the Court of Appeal.

47 Above, at pp 420 to 421.

48 Above, at pp 408 to 410.

2.37 The reasoning of Mr Justice Moore-Bick is inconsistent with the custom codified in section 53(1), as under the custom the broker would have been personally liable to the reinsurer for the whole premium from the start of the policy. The policyholder apparently attempted to raise this argument in order to establish that the reinsurance remained in place:

> [The policyholder's] primary argument under this limb of its case was that it is a custom of the non-marine market in London, as it is of the marine market, that the broker is personally liable to the underwriter for payment of the premium, but that part of the case was abandoned by [Counsel] when it became clear that there was no evidence before the court capable of supporting it.[49]

2.38 It is significant that this decision involved a central accounting system, as it confirms that the custom is not automatically applied where such a system exists, even if the broker usually pays the premium as a matter of course or according to the established practice of that industry. Mr Justice Moore-Bick described the central accounting system in some detail:

> The Central Accounting Office operated rather like a banker, maintaining accounts due for brokers and underwriters which were credited and debited with sums notified to it as falling due from time to time by way of premiums, additional premiums, return premiums, claims and recoveries.…
>
> An important feature of this system for the purposes of the present case is that once a broker lodged the slip and [premium advice note] relating to a new risk with [the Lloyd's Policy Signing Office] the procedure for settling the premium would be set in motion leading to the eventual debiting of his account at the Central Accounting Office (and, if appropriate, his bank account) without any further action on his part.… [It] would have been commercially disastrous for a broker not to have maintained sufficient funds in his bank account to meet payments … .[50]

[49] Above, at p 413.

[50] Above, at pp 403 to 404.

2.39 Despite this payment arrangement, and in contrast to the custom underlying section 53(1), the broker was not automatically liable for the premium. Rather, the practice was explained in terms of the broker's implied authority:

> At the time in question settlement by the broker under the market procedures was already an established practice and in general an agent has implied authority to act in the execution of his express authority according to the usages and customs of the business in which he is employed … . In the ordinary case I think the insured must be taken to have authorised the broker to pay premium on his behalf through the operation of these procedures … . In my view that accords with the commercial realities of instructing a broker to place reinsurance at Lloyd's or in the London companies' market.[51]

**Conclusion: the limited scope of section 53(1)**

2.40 The custom codified in section 53(1) is almost certainly now limited to the marine insurance market, wherever the business is conducted, and does not extend to non-marine insurance at all.[52] While the point awaits a final resolution, it appears there is little or no support for any argument that the broker's liability for the premium under section 53(1) extends beyond the marine market. As Julian Flaux QC concluded in 1998:

> Whilst it would be theoretically open to parties in another case to adduce better evidence of the custom and practice than in [*Pacific and General Insurance Co v Hazell*], for all practical purposes, the case spells the death-knell of direct brokers' liability to underwriters for premium outside the limited context of marine insurance, which can now be regarded as anomalous.[53]

2.41 Dame Elizabeth Gloster agreed:

> That decision (and there was no appeal from it) does not conclusively establish that the custom and fiction underlying section 53(1) does not apply in relation to premiums in the non-marine market, since the matter was disposed of, effectively, in the absence of evidence to support the proposition. But in reality, I suspect, it would be impossible to raise the argument again.[54]

[51] Above, at p 405.

[52] Even in the context of marine insurance, it should be noted that both the custom and section 53(1) were suspended by agreement within the Lloyd's marine market from 1996 to 2001. Underwriters at Lloyd's agreed not to hold brokers liable for premiums under section 53(1) in exchange for the brokers' contributions to the Lloyd's "Reconstruction and Renewal" plan. Professor Bennett doubts whether this agreement was actually effective to exclude section 53. See H N Bennett, *The Law of Marine Insurance* (2nd ed 2006), at para 6.37. See further paras 7.14 to 7.16 below.

[53] J Flaux QC, "Brokers' Liability for Premium" [1998] *British Insurance Law Association Journal* 34, at p 39. See also R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0356.

[54] E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 314.

2.42 In *Goshawk Dedicated Ltd v Tyser & Co Ltd*, [55] Mr Justice Clarke noted that in the *Pacific and General* case an attempt to extend the customary marine insurance principle to the non-marine market had failed. This has led at least one major insurance textbook to conclude that the "usage is inapplicable to non-marine business".[56]

2.43 Although the Marine Insurance Act 1906 is often said to have codified the common law on insurance generally (and is thus not normally limited to marine insurance), section 53(1) does not seem to be included in this codification. In *Pan Atlantic Insurance Co v Pine Top Insurance Co*, Lord Mustill stated that "the Act embodies a partial codification of the common law".[57] If the custom underlying section 53(1) is indeed limited to marine business only, the provision must be considered part of the Act that does not codify general insurance law.

### TERMS OF BUSINESS AGREEMENTS

2.44 A Terms of Business Agreement ("TOBA") may govern the conduct of insurance business between a broker and an insurer. It is important to note that the policyholder is not a party to any TOBA agreed between those two parties. TOBAs may transfer the credit risk from the policyholder to the insurer (risk transfer) or not (non risk transfer).

#### Risk transfer TOBA

2.45 A risk transfer agreement is an agency agreement between a broker and insurer which sets out when the broker will hold money as agent of the insurer. The TOBA will state whether it is just the premiums that are held for the insurer or whether the agency extends to other funds such as claims and premium refunds. Under such a risk transfer arrangement, the insurer is deemed to be paid when the premium reaches the broker. Paying the broker is the equivalent of paying the insurer directly. The risk of the broker becoming insolvent and for losses arising therefore falls on the insurer, since it will be bound to provide cover for the policyholder under the terms of the insurance policy.

2.46 Overall, when the policyholder pays the premium to the broker, the effect of a risk transfer TOBA is similar to the outcome under section 53(1), since the broker will be responsible to the insurer for any premium it has actually received from the policyholder (although under section 53(1) the broker is liable for the premium whether it has received it or not). The broker receives such payment as the agent for the insurer, which discharges the policyholder's obligation to pay the premium.

[55] [2005] EWHC 461 (Comm); [2005] Lloyd's Rep IR 379, at para 49. *Goshawk* involved an application by a Lloyd's syndicate to require the broker to produce premium accounting information in respect of non-marine business. When the case reached the Court of Appeal, there was no discussion of the marine custom underlying section 53(1).

[56] N Legh-Jones (ed), *MacGillivray on Insurance Law* (11th ed 2008), at para 35-013. See also R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 1-12 (difference (j)).

[57] [1995] 1 AC 501, at p 518.

2.47 If section 53(1) does not apply to the insurance policy (because it is a non-marine policy, for example), a risk transfer TOBA would mean that, once the broker has received the premium, it is deemed to have been received by the insurer. In the case of the broker's insolvency, if the broker has not received the premium, the insurer may still be able to seek the premium direct from the policyholder. In the case of section 53(1) applying, the broker will be liable to pay the premium to the insurer whether the broker has received it or not, and the insurer would presumably be unable to claim the sum direct from the policyholder.[58]

### Non risk transfer TOBA

2.48 By contrast, a non risk transfer TOBA provides that the broker holds the premium as the agent of the policyholder. This essentially reflects the position under normal agency principles, since the broker generally acts for the policyholder. As a result, the insurer is not deemed to have received the premium until it is actually passed from the broker to the insurer. Merely paying the premium to the broker is not enough to discharge the policyholder's payment obligations under the policy.

2.49 If section 53(1) does not apply to the insurance policy, a non risk transfer TOBA would mean that, in the event of the broker's insolvency, the insurer should be able to recover the premium directly from the policyholder, even if the policyholder has already paid the premium to the broker. By contrast, if section 53(1) does apply to that policy, the broker would presumably still be liable to pay the premium to the insurer and, more importantly, the insurer would be unable to claim the sum directly from the policyholder.[59]

### TOBAs and section 53

2.50 A TOBA may include a provision expressly stating that the relationship between the broker and the insurer continues to be subject to section 53. If it does not contain such a clause, the position may be less clear. Even if a TOBA attempted to "contract out" of section 53(1), we doubt whether this would be sufficient to remove the policyholder's protection against the insurer because the policyholder would not be a party to the agreement.[60] The most that such a TOBA could probably achieve is to modify the effect of section 53(1) as it applies between the broker and the insurer, so that (for example) the broker would not be liable to the insurer where the policyholder has not paid the premium. This could potentially leave the insurer with no way of recovering the premium, as it would be barred from claiming the premium from both the broker (because of the TOBA) and the policyholder (by the operation of section 53(1)). In this situation, the insurer would have to rely on a premium payment warranty or equivalent clause in order to cancel the insurance policy for non-payment.

[58] See paras 2.13 to 2.18 above.

[59] Above.

[60] For further discussion of the difficulty of contracting out of section 53, see paras 6.48 to 6.53 below.

## CONFLICT OF LAWS: WHEN WILL SECTION 53 APPLY?

2.51 One further area of uncertainty surrounds whether section 53 applies to a policy of insurance which is written in the United Kingdom (at Lloyd's, for example) but is made subject to the law of a foreign jurisdiction, so that the law applicable to the policy is not English law. It is not clear whether such a policy would incorporate section 53, with the result that the broker may not be liable to the insurer for the premiums due under the policy.

2.52 By contrast, Professor Merkin takes the view that section 53(1) would continue to govern the relationship between the broker and the insurer, even if English law did not apply to the insurance policy itself, because the custom underlying section 53(1) "arises out of the market relationship between the broker and the underwriters and not out of the surrounding contracts".[61]

2.53 Although a full consideration of this issue is beyond the scope of this paper, a broker being asked to place insurance in an English market will no doubt also be subject to terms of business in its relationship with the insurer. Such terms of business will probably be governed by English law, even if the main insurance policy between the insurer and the policyholder is not.

2.54 We would be interested to receive consultees' views on how this issue is dealt with in practice, and in particular how insurers protect themselves from the credit risks posed by foreign policyholders. We wish to understand how market practice operates when there is a chain of brokers between the insurer and the ultimate policyholder, and whether payment premium warranties or TOBAs are usually relied upon in such cases.

[61] R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 23-74, n 5.

# PART 3
# THE TENSION BETWEEN THE COMMON LAW FICTION AND SECTION 53(1)

3.1 In Part 2, we discussed the scope of section 53(1) and concluded that, although the position is not entirely clear, it is probably limited to marine insurance. We explained the "fiction of lending" which was invented by the courts to give effect to a custom of the insurance industry, namely that the broker was liable for the premium. In this Part, we consider some of the problems that have arisen when the courts have been asked to apply the common law fiction to section 53(1). We examine how several decisions have suggested that the fiction continues to operate under the provision and how, as a result, certain clauses in insurance policies have been rendered ineffective.

## PAYMENT CLAUSES IN MARINE INSURANCE POLICIES

3.2 Even in the context of marine insurance, to which section 53 definitely applies, several cases have demonstrated that the courts encounter difficulties with the provision. In particular, there is a tension between the common law fiction used to give effect to the custom before it was codified and the words actually used in section 53(1). This tension is usually most obvious when the courts have had to apply section 53(1) to various types of payment clauses in marine insurance policies, such as adjusted premium clauses and premium payment warranties (also known as "payment default clauses"). We consider each of these in turn.

### Adjusted premium clauses

3.3 In most forms of non-marine insurance, the amount of premium payable is fixed from the start of the insurance policy, and cannot later be varied.[1] Marine insurance policies, by contrast, often contain clauses that provide for premiums to be increased. Thus the insurer may charge higher premiums where a vessel enters a war zone or when the volume of goods shipped on board is greater than originally anticipated.[2] In such cases, it is difficult to apply the common law fiction to payment of the additional premium because "it is impossible to see how the unascertained premium can have been notionally paid by the broker and notionally loaned back if the amount is not certain".[3]

[1] R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0365.

[2] E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 310.

[3] Above.

3.4 The insurance policy at issue in *The Litsion Pride* involved such an additional premium clause.[4] In that case, a vessel was insured against war risks. The policy provided that the policyholder would be in breach of warranty if the vessel entered into certain specified waters that were deemed to be high risk. However, the policy would continue subject to the policyholder paying an additional premium calculated by the length of time the vessel remained in dangerous waters. While sailing in the Persian Gulf, which was included in the list of specified waters, the vessel was struck by missiles from an Iraqi helicopter.

3.5 In the course of the owner's subsequent claim against the insurer, it was argued that a broker would not be liable to pay any additional premiums under such an adjusted premium clause because it was impossible to apply the common law fiction underlying the custom. Mr Justice Hirst[5] accepted the argument that an additional premium could never fictionally be deemed to have been paid (by the policyholder) or lent back (by the insurer) and so held that section 53(1) could in principle never apply to adjusted payment clauses.[6]

3.6 The outcome in *The Litsion Pride* has been criticised. For example, Dame Elizabeth Gloster has said:

> [*The Litsion Pride*] appears to be an acceptance that the old fiction does indeed survive and that, in each case, the court has to ascertain whether it can indeed be applied. But, I ask rhetorically, why does resort need to be had to the fiction in these circumstances at all? If no regard is had to the fiction that an indeterminate sum cannot actually be loaned and then paid but regard is merely had to the wording of section 53 ("the broker is directly responsible to the insurer for the premium"), there would appear to be no reason why section 53 should not equally impose a liability on the broker in relation to an additional premium, once determined or quantified. In light of the later cases, I doubt, with respect, whether Hirst J's conclusion on this point would be followed today.[7]

[4] *Black King Shipping Corporation and Wayang (Panama) SA v Mark Ranald Massie ("The Litsion Pride")* [1985] 1 Lloyd's Rep 437. *The Litsion Pride* was overruled by *The Star Sea* [2001] UKHL 1; [2003] 1 AC 469 on other grounds.

[5] Subsequently Hirst LJ of the Court of Appeal.

[6] *Black King Shipping Corporation and Wayang (Panama) SA v Mark Ranald Massie ("The Litsion Pride")* [1985] 1 Lloyd's Rep 437, at pp 510 and 512. The section 53 point was raised in the context of the owner's argument that there was no duty of disclosure, and therefore no breach of duty by the owner in failing to disclose the vessel's estimated date of arrival in the war zone. The argument was that, because section 53 applied, the duties of disclosure were owed to the broker and not to the insurer. Hirst J rejected these arguments and held that section 53 did not apply, which meant that the duty of disclosure was still owed to the insurer.

[7] E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 311. For details of the cases to which she refers, see paras 3.14 to 3.20 below.

**Payment default clauses**

3.7 Insurance contracts also frequently contain clauses purporting to give the insurer the right to cancel the policy in the event of late or non-payment of the premium. These payment default clauses appear in numerous different forms. Some provide for automatic cancellation, whilst others allow the insurer a choice as to whether to cancel the policy or not.

3.8 In *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc*,[8] for example, a marine insurance policy included an "automatic termination" clause which provided:

> This policy shall automatically terminate (no notice to the assured(s) being required) and all liability of underwriters herein shall end at noon of the tenth day following non-payment of any of the last three instalments [of premium] on the due date thereof, unless such payments are made within such ten day period.[9]

3.9 The claimant Lloyd's broker (the placing broker) had placed marine insurance with Lloyd's underwriters on behalf of the defendant producing broker, which was based in New York. The claimant had received two instalments of premium from the defendant but had not received the third or fourth payments. When the claimant sued to recover these payments, the defendant denied liability. One of the defendant's arguments was that, because the second instalment had been paid late, the automatic termination clause had brought the policy to an end, with the result that the third and fourth payments did not have to be made.[10] Rejecting this argument, and denying that the clause automatically terminated the policy for late payment of the premium, Mr Justice Rix[11] held that:

> The automatic termination clause cannot operate under English law to forfeit the policy, for the assured's obligations in respect of the premium will always have been timeously discharged.[12]

3.10 Mr Justice Rix relied on the "fiction of lending" approach, citing the cases of *Power v Butcher*[13] and *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd*,[14] to reach the conclusion that the policyholder was always treated as if it had paid the premium to the insurer. As a consequence, even an express termination provision based on late or non-payment of the premium could never take effect under English law.

8 [1998] 2 Lloyd's Rep 326.

9 Above, at p 328.

10 The defendant producing broker also advanced an argument based on the relationship between principal policyholders, producing brokers and placing brokers. This argument is referred to at para 2.23 above.

11 Now Rix LJ of the Court of Appeal.

12 *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc* [1998] 2 Lloyd's Rep 326, at p 335.

13 (1829) 10 B & C 329.

14 [1897] 2 QB 93.

3.11 Lord Justice Rix later expressed the same view, albeit in a non-binding part of his judgment, when considering another cancellation clause in the Court of Appeal in *Charman v New Cap Reinsurance Corp Ltd (in liquidation)*:

> [The payment default clause] may not have been effective, however, since the "General Conditions" contained a reference to "UK Law and Practice with respect to all issues", and it has long been established as a matter first of custom in the English marine insurance market and as subsequently reflected in section 53(1) of the Marine Insurance Act 1906 that premiums are deemed to have been paid by broker on behalf of assured to underwriter and advanced by underwriter back to broker again by way of loan.[15]

3.12 Dame Elizabeth Gloster notes that the approach of Mr Justice Rix in *Prentis Donegan* was followed by Tamberlin J in *Jetopay Pty Ltd v Ocean Marine Mutual Insurance Association (Europe) OV*, a decision of the Federal Court of Australia. The case involved section 59(1) of Australia's Marine Insurance Act 1909, which was identical to section 53(1) of the Marine Insurance Act 1906.[16] As Dame Elizabeth Gloster said of the Australian decision:

> The Federal Court held, in effect, that an insurer could never cancel an insurance policy (save where otherwise expressly agreed) because of the custom and fiction reflected but not specified in section 59.[17]

3.13 Subsequent conflicting English decisions have, however, cast doubt on the conclusion reached in *Prentis Donegan*,[18] and Professor Merkin has suggested that it cannot stand in the light of subsequent case law.[19]

15 [2003] EWCA Civ 1372; [2004] Lloyd's Rep IR 373, at para 10.

16 [1999] FCA 1773; 95 FCR 570. The case was summarised in M Davies, "Australian maritime law decisions 1999" [2000] *Lloyd's Maritime and Commercial Law Quarterly* 404, at pp 417 to 419. It should be noted that section 59 of the Australian Act has now been repealed, following the recommendations of the Australian Law Reform Commission. See paras 6.15 to 6.20 below.

17 E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 311.

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

19 See R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0380. In particular, Professor Merkin says that *Prentis Donegan* cannot stand in light of the decisions of the Court of Appeal in *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret*, discussed at paras 3.14 to 3.17 below, and *Heath Lambert Ltd v Sociedad de Corretaje de Seguros*, discussed at paras 3.18 to 3.20 below.

## JUDICIAL DISAPPROVAL OF RELIANCE ON THE COMMON LAW FICTION

3.14 *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* was decided by the Court of Appeal two months before the *Prentis Donegan* case, but was apparently not referred to in the latter even though both involved premium payment clauses.[20] In *Chapman*, a broker (or, rather, the broker's liquidator) claimed premium payments from the policyholder, even though the broker had not yet paid the premium to the insurer and might never pay it. The broker argued that this was the effect of section 53(1), since it was potentially liable to the insurer from the outset of the policy. By contrast, the policyholder argued that section 53(1) did not apply since it had been "otherwise agreed" under the policy, evidenced by the inclusion of a premium payment warranty.

3.15 Mr Justice Thomas[21] held at first instance that a premium payment warranty, which purported to discharge the underwriter from liability in the event of non-payment, was not inconsistent with the application of section 53(1) and the policyholder's liability to the broker for the premium. He said:

> Looking at the terms of the policies as a whole… I conclude that the parties did not "otherwise agree". The terms relating to the payment of premium were quite simple. The premium was to be paid… in instalments. It was made clear that if the underwriters did not receive the premium on the due date then there would be a breach of warranty with the usual consequence that would flow from that: the payment by the assured was to be made to the brokers, and they were to be responsible for the paying of the underwriters.[22]

3.16 Mr Justice Thomas therefore rejected the policyholder's argument that, once the premium payment warranty was introduced, the common law fiction on which the custom was based fell away and therefore section 53(1) could not apply. Instead, clear words were required to displace the rule recognised in section 53(1).[23]

3.17 The Court of Appeal agreed that section 53 had not been ousted by virtue of the premium payment clause, and was clearly not impressed with contrary arguments based on the common law fiction. Sir Brian Neill said:

> The authorities and the textbooks throw valuable light on the genesis of the custom and its rationale. One therefore sees the background against which these policies must be construed, though I agree with the judge that since the enactment of the 1906 Act one is concerned primarily with a regime regulated by statute.[24]

[20] *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; [1998] CLC 860.

[21] Now Thomas LJ of the Court of Appeal.

[22] *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret*, 14 November 1997 (QBD, Commercial Court), unreported. See *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; [1998] CLC 860, at p 863.

[23] The Court of Appeal agreed with this analysis, as the passage from Sir Brian Neill's judgment, set out at para 6.49 below, demonstrates.

[24] *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; [1998] CLC 860, at p 865.

3.18 Lord Justice Clarke[25] referred to this passage from *Chapman* in the subsequent case of *Heath Lambert Ltd v Sociedad de Corretaje de Seguros*, which involved another premium payment warranty.[26] This warranty provided that the premium was payable "within 90 days of attachment [of risk]". The defendant reinsured argued that the claimant broker's claim for the premium was now time-barred because the premium had been due and payable to the reinsurer upon attachment of the risk and so the broker immediately had a right to an indemnity from the reinsured. The Court of Appeal rejected this argument and held instead that the broker had 90 days to pay the premium under the warranty, which meant that the broker's right to an indemnity was also postponed for 90 days. The claim was therefore not time-barred.

3.19 Lord Justice Clarke gave the opinion of the Court of Appeal and was dismissive of the view in *Prentis Donegan* that the common law fiction precluded reliance on such a payment warranty.[27] He said:

> It seems to us that it is in this regard care should be taken before having regard to the fiction to which the cases refer. Thus for example, could it be said on the facts of a case like this that the broker is deemed to have paid the premium on account of the assured and that it follows that the premium is deemed to have been paid to the underwriter so that there was no breach of warranty? No one suggested that such an argument could be successfully advanced on the basis of the policy in this case.… No one suggested that the warranty did not have effect as a warranty because of the fiction.[28]

3.20 The courts have therefore clearly moved towards a position where section 53(1) will be read on its own terms and not made subject to the common law fiction by which the original custom was given legal effect:

> Both the Court of Appeal and House of Lords refused permission to appeal in *Heath Lambert* so one can assume that there was no judicial appetite for arguments based on the continued existence of the fiction.[29]

[25] Now Lord Clarke of Stone-cum-Ebony, Justice of the UK Supreme Court.

[26] [2004] EWCA Civ 792; [2004] 1 WLR 2820, at para 21.

[27] Above, at paras 19 to 23, referring to *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc* [1998] 2 Lloyd's Rep 326, discussed at paras 3.8 to 3.13 above.

[28] Above, at para 23.

[29] E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 313.

### *Allianz*: the end of the common law fiction?

3.21 The conflict between the fiction and the provision arose most recently in *Allianz Insurance Co Egypt v Aigaion Insurance Co SA*.[30] The claimant policyholder had obtained reinsurance from the defendant through a broker. When the policyholder made a claim under the policy, the reinsurer refused to pay on the basis that the policy included a premium payment warranty. The reinsurer argued that it was automatically discharged from liability when certain premium instalments were not paid on time (the policyholder had in fact paid the instalments to its broker, but the broker had failed to forward them to the reinsurer). In response, the policyholder argued, first, that the warranty had not actually been incorporated into the reinsurance policy, and second, that in any event such a payment warranty was ineffective because the common law fiction underlying section 53(1) meant that the policyholder was always deemed to have paid the premium to the insurer.

3.22 On the facts, the Commercial Court accepted that the premium payment warranty had not been incorporated into the policy.[31] This finding was sufficient to determine the case. However, the court went on to address the policyholder's second argument concerning the effect, if any, of the common law fiction on section 53(1).

3.23 The policyholder had argued that section 53(1) "embodies a fiction to the effect that the broker is deemed to have paid the premium to the underwriter and to have borrowed from him the money with which he pays… the fiction necessarily involves the assumption that the assured has been discharged of his duty to pay the premium to the insurer".[32] The court recognised that this fiction formed part of the common law prior to the passage of the 1906 Act:

> The fact that practically no one in the market is now aware of the fiction that enabled the insurer to look to the broker for payment is irrelevant to the interpretation of the statute. The statute falls to be interpreted against the background at the date of its enactment. Immediately prior to the enactment of the statute, the common law embodied the fiction. But the fiction was a means to achieving an end and not that end in itself.[33]

3.24 Accordingly, the court focused on the words actually used by section 53(1), and held that the common law fiction should not be read into the provision. As Judge Chambers QC said:

> The wording of section 53(1) is clear. It procures a situation in which, absent agreement to the contrary, the insurer may look to the broker for payment of the premium. There is no mention of the fictitious mechanism by which that result was achieved at common law. Nor was there any need for such a mention. Statute has produced the necessary result.

[30] [2008] EWHC 1127 (Comm); [2008] 2 Lloyd's Rep 595.

[31] Above, at paras 56 to 57.

[32] Above, at para 60.

[33] Above, at para 64.

> I cannot imagine that an intelligent member of the Lloyd's marine insurance market looking at the [Marine Insurance Act] in 1906 could have been expected to read the fiction into the section with the consequence that, not only could an insurer obtain the premium from the broker but, without more, no policy could ever be treated as invalid for non-payment of the premium because the assured was always to be treated as having paid it.
>
> I find that section 53(1) means what it says and no more.[34]

3.25 This suggests that, if the premium payment warranty had been incorporated into the insurance contract, it would have been effective to automatically terminate the policy following late payment of the premium instalments. It must be stressed, however, that this part of the judge's decision was strictly non-binding, since it was not necessary to decide the case.[35] Nonetheless, the case indicates that the courts are nowadays less willing to adopt a strained interpretation of section 53(1) based on the old common law fiction.[36]

3.26 The response to the *Allianz* decision seems to have been broadly positive. For example, Addleshaw Goddard's reinsurance group e-mail update commented:

> It is reassuring to see a Court take the common sense approach by refusing to apply an archaic legal fiction to today's market practices…. The section only allows insurers to look to the broker for payment of the premium, but no more. In the absence of "deemed" payments from the broker, a premium warranty should operate as intended, i.e. failure to comply automatically discharges insurers from liability.[37]

## THE COMMON LAW FICTION AND SECTION 54 OF THE MARINE INSURANCE ACT 1906: ARE THEY COMPATIBLE?

3.27 Section 54 provides that:

*Effect of receipt on policy*

> 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.

[34] Above, at paras 66 to 68.

[35] It is also notable that section 91(2) of the Marine Insurance Act 1906, which provides that rules of the common law which are consistent with the Act continue to apply under it, was apparently neither cited to the court nor mentioned in the final judgment.

[36] The court's finding regarding the unincorporated warranty was upheld by the Court of Appeal in *Allianz Insurance Co Egypt v Aigaion Insurance Co SA* [2008] EWCA Civ 1455; [2008] 2 CLC 1013. It seems that the argument on section 53(1) was not raised on appeal.

[37] Addleshaw Goddard, Reinsurance Group E-Alert (16 September 2008), available at http://www.addleshawgoddard.com/asset_store/document/reinsurance_group_ealert_16_sept_08_11936.pdf .

3.28 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, 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.

3.29 Under the Marine Insurance Act 1906, if an insurance policy contains an acknowledgment that the insurer has received the premium, section 54 provides that the statement will be binding against the policyholder but not against the broker. In other words, the insurer cannot look to the policyholder for payment of the premium, but may recover it instead from the broker. That is all it would seem that section 54 was designed to achieve.

3.30 If, however, section 53(1) preserved (and so includes) the common law fiction, then the policyholder would always be deemed to have paid the insurer and the insurer would never be able to claim the premium from it, regardless of whether there was any acknowledgment of payment in the policy or not. Viewed alongside the common law fiction, section 54 would therefore be a redundant provision, and an acknowledgment of payment in an insurance policy would serve no purpose. This suggests that section 53(1) was designed to codify the custom (that is, the broker's personal liability for the premium), but not the common law "fiction of lending" invented by the courts to give effect to that custom.

3.31 There is a second inconsistency between the common law fiction and section 54. Under the common law fiction, the insurer is deemed to have received the premium as against all parties, including the broker. The broker remains liable to pay the premium, but on different grounds, namely that the insurer lent the premium back to it. The fact that section 54 provides that an acknowledgment in the policy is not conclusive as between the broker and the insurer is therefore contrary to the "fiction of lending".

3.32 It seems more plausible that section 54 was designed to operate alongside section 53, without the old common law fiction, as a form of protection for a policyholder whose broker fails to pay the premium.[38] That is, the policy would conclusively acknowledge payment by the policyholder, so the insurer would not be able to refuse to pay out a claim on the ground that the policyholder had not paid the premium. The insurer would, however, still be able to claim the premium back from the broker, relying on the broker's direct liability under section 53(1). By virtue of section 54, any acknowledgment in the policy that the premium had been paid would be of no assistance to the broker in resisting the insurer's claim.

3.33 We are not sure how regularly, if at all, such acknowledgments of payment are included in modern insurance policies. It may be that they are now so uncommon that section 54 is no longer of any use for policyholders. We would be interested in consultees' views on this provision and its use.

[38] See R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0361.

## CONCLUSION: A SATISFACTORY POSITION REGARDING THE FICTION?

3.34 We have seen how the fiction designed to give effect to the custom at common law has caused difficulties for the courts when they have had to apply section 53(1). This is particularly the case when the insurance policy includes some form of payment clause that appears to be incompatible with the common law fiction that the broker has already paid the premium.

3.35 We have also seen that section 54 would be rendered superfluous if the common law fiction continued to apply after the Marine Insurance Act 1906 codified the custom in section 53(1). Consequently, we think that section 53(1) gave statutory effect to the custom or usage that a broker is liable for the premium, but did not maintain the fiction invented by the courts to give effect to the custom at common law.[39]

3.36 In agreement with other commentators, we doubt whether the decisions on section 53(1) in *Prentis Donegan*[40] and *The Litsion Pride*[41] can stand in light of subsequent cases, such as *Chapman*,[42] *Heath Lambert*[43] and *Allianz*.[44] While the older cases suggested that the fiction should continue to apply so that a broker will always be deemed to have paid the premium on time, we think the law has now developed so that, when an insurer has not actually been paid, the court's decision will be more likely to reflect the reality of that situation.

3.37 We think that this accords with the true intentions and expectations of the parties. Otherwise, freely negotiated contractual provisions (particularly payment premium warranties) could be rendered ineffective by an outdated and unnecessary common law fiction. As Judge Chambers QC held in the *Allianz* case, the law no longer requires the fiction because the 1906 Act produces the desired result.[45] Accordingly, section 53(1) should be read to mean what it says and no more.

[39] Section 91(2) of the Marine Insurance Act 1906 provides that rules of the common law which are consistent with the Act shall "continue to apply" under it. This begs the question, of course, whether the common law fiction is "inconsistent" with section 53(1) or not, in which case the fiction may continue to apply under the modern law.

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

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

[42] *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; [1998] CLC 860.

[43] *Heath Lambert Ltd v Sociedad de Corretaje de Seguros* [2004] EWCA Civ 792; [2004] 1 WLR 2820.

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

[45] Above, at paras 66 to 68.

3.38 Having said that, there remains obvious uncertainty over the effect, if any, of various payment terms in marine insurance policies. Although *Allianz* firmly states that premium payment warranties should not be rendered ineffective by the common law fiction, the fact that the warranty was not incorporated into the policy in that case means that the statement is strictly non-binding.[46] We understand that premium payment warranties and adjusted premium clauses provide the insurer with essential protection in certain circumstances. The uncertainty created by section 53(1) is therefore undesirable for insurers and likely to produce more litigation in the future.

3.39 It is also worth adding that we foresee the potential for further problems of a similar nature. For example, some insurance policies include “risk inception” clauses, which provide that the insurer is only “on risk” for the policyholder’s loss when it receives payment of the premium.[47] If the fiction were applied to these clauses, we think that the insurer might be deemed to be on risk as soon as the contract was concluded, even if it has not actually been paid.

[46] Above.

[47] See, for example, R Merkin, *Colinvaux’s Law of Insurance* (8th ed 2006), at para 8-04.

# PART 4
# SECTION 53(2): THE BROKER'S LIEN

4.1 Parts 2 and 3 discussed the broker's personal liability for the premium under section 53(1). This Part considers section 53(2) of the Marine Insurance Act 1906, which provides that the broker has a lien over the insurance policy to recover money owed to it from the policyholder. Section 53(2) has received less attention both in the law reports and in insurance law textbooks. However, the provision can be of importance to brokers when they are faced with policyholders who refuse to pay.

## SCOPE OF THE BROKER'S LIEN IN SECTION 53(2)

4.2 Section 53(2) gives the broker a lien over both the policy and any policy monies it receives from the insurer. This lien may be used in respect of "any balance on any insurance account which may be due" to the broker from the policyholder.[1] In circumstances where the broker has retained the policy, therefore, this lien allows the broker to recover the cost of the premium paid under their obligation in section 53(1). This lien operates whether the broker's duty to account for the policy's proceeds is owed to the policyholder directly or to an intermediate producing broker.[2]

4.3 In 1911, Lord Justice Scrutton expressed some doubt as to whether the broker's lien on the policy necessarily included a lien on any proceeds collected under it.[3] His was, however, an isolated view, and other case law confirms that the lien does extend to such proceeds.[4] The Court of Appeal reached the same conclusion in *Eide UK Ltd v Lowndes Lambert Group Ltd*, where Lord Justice Phillips[5] said:

> [The judge below] erred in failing to recognise that a broker who has a lien over a policy of marine insurance is normally entitled, when he collects under the policy, to apply the proceeds collected in discharge of the debt that was protected by the lien.[6]

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

2 See paras 2.22 to 2.23 above.

3 *Fairfield Shipbuilding and Engineering Co Ltd v Gardner, Mountain and Co Ltd* (1911) 104 LT 288.

4 See, for example, *Man v Shiffner and Ellis* (1802) 2 East 523; *Mann v Forrester* (1814) 4 Camp 60; *Westwood v Bell* (1815) 4 Camp 349; *Cahill v Dawson* (1857) 3 CB (NS) 106; *Montagu v Forward* [1893] 2 QBD 350. All of these cases were discussed by Phillips LJ in *Eide UK Ltd v Lowndes Lambert Group Ltd ("The Sun Tender")* [1999] QB 199, at pp 208 to 210.

5 Now Lord Phillips of Worth Matravers, President of the UK Supreme Court.

6 *Eide UK Ltd v Lowndes Lambert Group Ltd ("The Sun Tender")* [1999] QB 199, at p 211.

### Does section 53(2) apply to non-marine insurance?

4.4 As we saw above, the scope of the broker's personal liability under section 53(1) is probably limited to marine insurance only. The question arises whether the same is true of the broker's lien in section 53(2). Does a broker have a lien over a non-marine insurance policy when the premium is paid on the policyholder's behalf?

4.5 Under general principles of agency law, a broker is entitled to be reimbursed for all expenses reasonably incurred in carrying out the policyholder's instructions. Thus a broker which has paid the premium on the policyholder's behalf would normally be entitled to recover that payment from the policyholder. Moreover, the broker would have a "possessory lien" over the policyholder's property.[7] This lien allows the broker to retain the policyholder's property, including the insurance policy itself, until it has been properly reimbursed.[8] As Professor Clarke explains:

> Insurance intermediaries have such a lien on insurance policies in their possession, a lien which, it has been held, entitles them to decline to deliver the policies to customers until paid the amount of any premium owed. Where the intermediaries are authorised to collect losses or return premiums they may retain and apply them in discharge of that liability.[9]

4.6 As we have seen, however, in marine insurance the broker's lien extends to the general balance of the account between the broker and the policyholder. In English law, it has not yet been settled whether this rule also extends to non-marine insurance.[10]

### Composite insurance

4.7 The case of *Eide UK Ltd v Lowndes Lambert Group Ltd* was mentioned above,[11] as it confirmed that the broker's lien in section 53(2) includes the proceeds of the policy. However, the importance of the *Eide* case goes further than this, as it actually involved a composite insurance policy. Lord Justice Phillips described composite insurance as:

7 In Scots law, a lien, whether special or general, always requires possession of corporeal moveable property of the debtor.

8 See *Levy v Barnard* (1818) 8 Taunt 149.

9 M A Clarke (with J M Burling & R L Purves), *The Law of Insurance Contracts* (looseleaf), at para 9-7C.

10 See above, at para 9-7C, n 2. In Scots law, however, brokers are recognised as being among the limited categories of persons endowed with a general lien. Brokers are therefore entitled to detain the policyholder's property until the general balance of the account is settled. See Bell, *Commentaries* II, 115. See also A J M Steven, *Pledge and Lien* (2008), at paras 17-39 to 17-47. In the United States of America, by contrast, agents have a possessory lien over policies, but the lien does not extend to insurance monies in unconnected transactions nor even to a subsequent policy on the same subject-matter (see *Bleicher v Heeter* (1942) 4 NW 2d 897 and *Re Sejo Ice Cream Co* (1910) 81 F 627).

11 [1999] QB 199.

> Where one of a number of persons who are individually interested in the subject matter of a marine adventure takes out insurance for the benefit of all, so that each has a right to sue in respect of his own interest… .[12]

4.8 In *Eide*, the operators of a fleet of ships secured insurance policies using a broker. The operators then hired an extra vessel which was mortgaged to a bank, and asked the broker to add this vessel to their existing insurance policies. The vessel's owners assigned their interests in the policies to the bank, so that the operators, the owners and the bank were all co-assured under the policies. When a claim was later made under the policies, the broker asserted the right, by virtue of a lien under section 53(2), to retain the entirety of the claims proceeds in satisfaction of the operators' outstanding liabilities with regard to an unrelated insurance account. At first instance, Mr Justice Toulson[13] ruled that section 53(2) conferred a lien over the policy itself and no more, and in any event did not apply to cases of composite insurance.

4.9 As we noted above, the Court of Appeal rejected the judge's first conclusion, and held that the broker's lien normally extended to the proceeds of the policy as well as to the policy itself.[14] However, the Court of Appeal upheld the judge's second conclusion, agreeing that the broker's lien under section 53(2) did not apply to composite insurance. Lord Justice Phillips held that the language of the provision ("where [the broker] has dealt with the person who employs him as a principal…") did not appropriately describe dealings between a broker and an employer who places insurance both on its own behalf and on behalf of other interests.[15] Further, he held that, as a general principle of agency law, an agent could not create a lien beyond its own interest.[16]

4.10 In concluding that section 53(2) did not apply to composite insurance, Lord Justice Phillips was clearly mindful that this left a broker facing a gap in protection. Although not directly relevant to the case before him, he explained:

[12] *Eide UK Ltd v Lowndes Lambert Group Ltd ("The Sun Tender")* [1999] QB 199, at p 211.

[13] Now Toulson LJ of the Court of Appeal.

[14] See para 4.3 above.

[15] *Eide UK Ltd v Lowndes Lambert Group Ltd ("The Sun Tender")* [1999] QB 199, at p 213.

[16] Above, citing *Bowstead and Reynolds on Agency* (16th ed 1996), at para 7-087. Now see *Bowstead and Reynolds on Agency* (18th ed 2006), at para 7-087. Similarly, in Scots law, a broker may not exercise a general lien in respect of the balance of an agent's insurance accounts. Where, however, the agent's agency status is unknown to the broker, the broker is entitled to assume that it is transacting with a principal and to exercise its general lien. See Bell, *Commentaries* II, 116 to 117. See also A J M Steven, *Pledge and Lien* (2008), at para 17-47.

> Where, as is usual, a broker collects under the policy which he procured for the assured, the broker will normally have a right to set off the moneys received for a particular assured against any indebtedness of that assured. To this extent, if either market practice or contractual agreement places the broker in a position to insist on collecting under a policy, the broker will enjoy a degree of security. This case demonstrates, however, that in a case of composite insurance such security falls short of that which would be provided by a general lien over policy and proceeds.[17]

4.11 Lord Justices Waller and Chadwick both agreed with Lord Justice Phillips. The *Eide* case is therefore the most important recent case on section 53(2) and its limits with respect to composite insurance.

### ALTERNATIVE PROTECTION: BROKERS' CANCELLATION CLAUSES

4.12 In addition to the security provided by the lien in section 53(2), we understand that it is also common in the marine market for the policy to contain a broker's cancellation clause under which the broker is given the right to cancel the policy if he has not been reimbursed by the policyholder.[18] Further, these clauses include an undertaking by the insurer to repay to the broker that proportion of the premium which represents the unexpired part of the insurance cover.

4.13 Such a cancellation clause was included in the marine insurance policy at issue in *Heath Lambert Ltd v Sociedad de Corretaje de Seguros*.[19] The clause was drafted as follows:

> Notwithstanding anything contained in this policy to the contrary, [the broker], in addition to their lien on the policy, shall be entitled to cancel this policy in the event of any premium not having been paid to them when due and the underwriters hereby agree to cancel this policy on presentation at the request of [the broker] and to return any premium payable thereon in excess of a pro rate premium up to the date of the cancellation.[20]

4.14 The insurance policy in *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* included a similar cancellation clause.[21] The Court of Appeal agreed with the trial judge that the presence of this clause strongly indicated that section 53(1) was intended to apply to the policy since it was expected that the broker would pay the premium to the insurer.[22] The cancellation clause then provided the broker with protection in the event that the policyholder failed to reimburse the broker for the premium.

[17] Above, at p 214.

[18] See R Merkin (ed), *Colinvaux & Merkin's Insurance Contract Law*, at para B-0352/1.

[19] [2004] EWCA Civ 792; [2004] 1 WLR 2820.

[20] Above, at para 4.

[21] [1998] Lloyd's Rep IR 377; [1998] CLC 860, at p 862.

[22] Above.

4.15 Such cancellation clauses may give the broker an additional degree of protection, but in order to successfully "contract out" of section 53(1), we think that they must be incorporated into the main insurance policy between the insurer and the policyholder. This is because the cancellation of a policy by a broker will only be binding upon the policyholder where it is within the broker's express, implied or apparent authority.[23] Professor Merkin argues that the right to cancel the policy is unlikely to be within the scope of a broker's normal authority, and is therefore unlikely to be effective unless there has been some direct communication between the policyholder and the insurer.[24]

4.16 Consequently, we do not think that an agreement between the broker and the insurer alone would be sufficient to affect the policyholder's rights under section 53(1).[25] Under section 53(1), the insurer will probably be on risk from the date of inception, and any term that would allow the insurer to unilaterally cancel the policy must be incorporated into the main policy itself.

## CONCLUSION

4.17 The relative absence of case law and academic commentary on section 53(2) compared to section 53(1) suggests that the current law on the broker's lien is satisfactory. We have not encountered any serious problems with the operation of this provision and therefore do not think that it needs to be changed. However, the scope of section 53(2) could be clarified so that it is clear whether or not the same rules on the broker's lien apply to non-marine insurance.

4.18 At the end of Part 6, we ask for the views of consultees on the reform of section 53(2).

[23] See *Xenos v Wickham* (1866) LR 2 HL 296, where Lord Cranworth stated (at p 321) that "there is no suggestion that it is part of the ordinary duty or power of a broker to cancel agreements once validly and completely entered into". For more details on the different types of authority under which a broker may act, see paras 5.2 to 5.7 below.

[24] R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 15-41.

[25] For more explanation of TOBAs, the most common type of agreements between insurers and brokers, and their relationship to section 53, see paras 2.44 to 2.50 above.

# PART 5
# THE CURRENT LAW OUTSIDE SECTION 53

5.1 In this Part, we discuss the law relating to the broker's liability for the premium outside section 53. This mainly involves general principles of agency law. In Part 2, we took the view that section 53(1) is probably limited to marine insurance only. If this is correct, then for all other types of insurance, the relationship between brokers, policyholders and insurers is governed by normal agency law.

## GENERAL AGENCY PRINCIPLES: AUTHORITY AND LIABILITY

5.2 The law of agency is complex and wide-ranging. Many areas of agency law are beyond the scope of this paper, and so we will focus on the principles that are most relevant to any proposed reform of section 53. We begin by considering in outline the various forms of authority under which an agent may act on behalf of its principal. We then consider in what circumstances an agent, such as a broker, may be liable for the premium due under an insurance policy.

### Authority of agents

5.3 It is a general principle of agency law that the actions of an agent, acting within the scope of its authority, are attributed to its principal; even when such actions are detrimental to the interests of the principal. This can be seen from the 1954 case of *Zurich General Accident & Liability Insurance Co v Rowberry*, where an individual policyholder, Mr Rowberry, stated in his travel insurance proposal form that his destination was France but did not specify the particular airport he was travelling to.[1] Mr Rowberry intended to travel to Nice, but his agent accidentally informed the insurer that his destination was Paris. As a result, the policy only covered travel between London and Paris. Despite this mistake, the Court of Appeal held that Mr Rowberry was liable to pay the associated premium because "the proposal contemplated the nomination… by the proposing assured or his authorized agent, of a particular destination" and "the agents were acting plainly within the scope of their authority in nominating Paris".[2] The incorrect nomination was obviously detrimental to the policyholder's interests but since the mistake fell within the scope of the agent's authority, Mr Rowberry was bound by it.

5.4 This rule even extends to fraud carried out by agents. In an insurance context, this is illustrated by *Direct Line Insurance Plc v Khan*.[3] In that case it was held that a husband had put forward a fraudulent claim as an agent for his wife as well as himself. The Court of Appeal held that the innocent wife, Mrs Khan, was bound by her husband's actions. Lady Justice Arden said:

1 [1954] 2 Lloyd's Rep 55.

2 Above, by Sir Raymond Evershed MR at p 58.

3 [2001] EWCA Civ 1794; [2002] Lloyd's Rep IR 364.

Mr Khan's actions which constituted fraudulent exaggeration of both the defendants' insurance claims were actions which Mr Khan carried out partly on his own behalf and partly as agent for Mrs Khan within the scope of Mr Khan's actual or apparent authority from Mrs Khan. Mrs Khan was, therefore, bound by the consequences of those fraudulent actions… .[4]

5.5 The principles of agency law may therefore be of great importance in determining whether the broker or the policyholder is liable for the broker's actions. Various types of authority exist.[5] They may be summarised as:

(1) *Express authority*. This is given by express words of appointment, and the extent of the agent's authority depends on the true construction of those words.

(2) *Implied authority*. Two broad categories of implied authority are most relevant to insurance brokers:

(a) *Incidental implied authority*. This arises under English law where an agent is held to have implied authority to do acts which are incidental to the proper performance of its express authority.[6]

(b) *Usual implied authority*. An agent possesses, by implication, the authority to do all things necessary in the ordinary course of business for the efficient and proper performance of its duties. Such authority may derive from the practices or usages of particular markets. It can either be established by evidence or recognised by judicial notice.

(3) *Apparent (or ostensible) authority*. Even where there is no consensual agreement between the principal and the agent, an agency relationship may still arise. Where a person represents to a third party that they have an agent who is authorised to act on their behalf, that person will not be allowed to deny the agency later and will be bound by any acts of the agent. This form of authority is effectively a type of estoppel (or in Scots law, personal bar) against the principal.

(4) *Authority by ratification*. This occurs when the agent carries out unauthorised tasks on behalf of the principal, but the principal later authorises or ratifies the acts. Such ratification may be express or implied as a result of the course of dealings between the parties.

4 Above, at para 31.

5 For a full discussion of the types of authority, see *Bowstead and Reynolds on Agency* (18th ed 2006), ch 3. For a discussion of the comparable Scots law on the authority of agents, see Laura J Macgregor, *The Law of Scotland (Stair Memorial Encyclopaedia)* (Reissue), Agency and Mandate, paras 49 to 83.

6 For example, in *Bawden v London, Edinburgh and Glasgow Assurance Co* [1892] 2 QB 534 (CA), it was not disputed that an intermediary who incorrectly completed a proposal form was the agent of the insurer when he approached the consumer. The court also held that this gave him authority to negotiate and settle the terms of a proposal, including compiling the relevant form (through he did not have authority to conclude the insurance contract).

5.6 In many cases, brokers will act for the policyholder under express agreements, which set out what they have authority to do. This may include the authority to pay the premium on the policyholder's behalf. This means that any payment of the premium from the broker to the insurer would be deemed to be payment from the policyholder and would therefore discharge the policyholder's obligation to pay the premium.

5.7 Where the broker is not given express authority to pay the premium, we think that any of the other forms of authority set out above might be used instead. For example, it is quite possible that the usual customs of particular insurance markets may involve the broker paying on behalf of the policyholder. Brokers acting in such markets may then have implied authority to pay the premium based on these customs and practices.[7] Such authority might be implied unless the policyholder had specifically excluded it in an agency agreement with its broker.

## LIABILITY OF BROKERS OUTSIDE SECTION 53(1)

5.8 The primary role of an insurance intermediary, such as a broker, is normally to bring about a contract between its principal (the policyholder in most cases) and a third party (the insurer). The broker is not usually supposed to incur any liability to that third party in its performance of this primary role. The default position outside section 53 is, therefore, that a broker acting within the scope of its authority is not personally liable to the insurer for the premium. Rather, the policyholder is liable as the broker's principal.

5.9 *Colinvaux's Law of Insurance* sets out three exceptions to the general rule that a broker is not liable to the insurer:

(1) Where the broker *undertakes personal liability* on the contract. This is most likely where either the principal is undisclosed or where the broker signs the contract in a way that indicates it is accepting personal liability.[8]

(2) Where the broker has undertaken responsibility to the insurer in a manner which justifies the *imposition of a duty of care in tort or delict*.[9]

(3) Where the broker acts without the authority of its principal, and the principal chooses not to ratify the agreement, the insurer may have an action against the agent for *breach of warranty of authority*.[10]

[7] On the issue of implied authority in particular insurance markets, see the discussion of *Pacific and General Insurance Co v Hazell* [1997] BCC 400; [1997] LRLR 65, at paras 5.18 to 5.25 below.

[8] R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 15-09. Another example would of course be section 53(1) of the Marine Insurance Act 1906, which imposes such personal liability on brokers in respect of marine insurance premiums.

[9] Above. See generally *Customs and Excise Commissioners v Barclays Bank* [2006] UKHL 28; [2007] 1 AC 181.

[10] Above, citing the case of *Albion Fire and Life Insurance Co Ltd v Mills* (1828) 3 Wills & S 218.

5.10 From the first of these alternatives, it is clear that a broker could agree with the insurer that it will accept personal liability for the premium. This would then give the insurer a right of recovery against the broker. However, such an agreement would have to be in clear terms. It is also unlikely this sort of arrangement would preclude the insurer from also pursuing the policyholder for recovery, as the policyholder would still be primarily responsible for the premium under the terms of the insurance contract. This would put the insurer in a very strong position to recover the premium. However, if the broker wanted to agree to personal liability, it would be entitled to do so.[11]

**The distribution of insolvency risks outside section 53**

5.11 Where the broker is not personally liable for the premium, and unless they are authorised to receive premium payments on the insurer's behalf, then the fact that the policyholder has already paid the broker does not relieve the policyholder of its duty to pay the insurer. In circumstances where the insurer might be unable to recover the premium from the broker (if, for example, the broker has become insolvent), the policyholder remains liable to pay the premium directly to the insurer. This could result in the policyholder effectively paying the same premium twice (that is, to the broker and then, upon the broker's insolvency, to the insurer directly), and it would have to reclaim the first premium payment from the broker's liquidator. This state of affairs is, however, arguably more justified than the position under section 53, since the policyholder has control over whom it selects as its agent.

5.12 Further, and more importantly, many policyholders benefit from regulatory protection in the event of their broker's insolvency.[12]

[11] One way in which a broker may accept such personal liability is through a TOBA concluded between the broker and the insurer, in which the broker agrees to be personally liable for the premium regardless of whether it has received the money from the policyholder. For more details on TOBAs, see paras 2.44 to 2.50 above.

[12] FSA Principle 10 requires firms to arrange adequate protection for clients' money when they are responsible for it. Authorised firms carrying on insurance mediation activities must hold client money in accordance with the Client Assets Sourcebook (CASS). The Financial Services Compensation Scheme also provides financial compensation when authorised firms are unable, or likely to be unable, to satisfy claims against them. However, it applies mainly to claims from retail consumers and small businesses (save for compulsory insurance) for "protected contracts of insurance" which is any general insurance contract other than a contract falling within any of the following classes: aircraft; ships; goods in transit; aircraft liability; liability of ships; credit.

5.13 The requirements relating to holding client assets and client money are set out in the FSA Handbook, Client Assets Sourcebook (CASS).[13] Client money is money of any currency that a firm receives and holds for its clients. It can include premiums, claims money and premium refunds. The rules in CASS 5 give effect to the requirement in Article 4.4 of the Insurance Mediation Directive that all necessary measures should be taken to protect clients against the inability of an insurance intermediary to transfer premiums to an insurer or to transfer the proceeds of a claim or premium refund to the policyholder. A broker must arrange adequate protection for clients' assets when it is responsible for them.[14] The rules are designed to protect clients if a broker becomes insolvent while it is holding client money. Brokers are required to disclose to their clients how their money is to be handled.

5.14 CASS 5.1.7(2) explains how this objective is achieved when client money is involved:

> There are two particular approaches which firms can adopt which reflect options given in article 4.4. The first is to provide by law or contract for a transfer of risk from the insurance intermediary to the insurance undertaking (CASS 5.2). The second is that client money is strictly segregated by being transferred to client accounts that cannot be used to reimburse other creditors in the event of the firm's insolvency (CASS 5.3 and CASS 5.4 provide different means of achieving such segregation). CASS 5.1.5A R permits a firm subject to certain conditions to treat money which it collects as agent of an insurance undertaking as client money; the principle of strict segregation is, however, satisfied because such undertakings must agree to their interests being subordinated to the interests of the firm's other clients.

5.15 We note that the first sort of "risk transfer" approach referred to in this extract can be similar to the outcome of section 53(1), as section 53(1) passes the risk of recovering the premium from the policyholder to the insurer. In the "risk transfer" approach the insurer bears the risk for any losses arising as a result of the broker becoming insolvent before it has transferred money due to the insurer. One of the respondents to our 2006 Joint Scoping Paper felt that the position under section 53 was satisfactory, partly because of the risk transfer it achieves:

> We agree in principle with the provision that where a policy is effected through a broker the latter is directly responsible to the insurer for the premium. This approach would seem consistent with the FSA's approach on risk transfer. [an insurer.]

[13] CASS 5.1 to CASS 5.6 apply, subject to CASS 5.1.1 (2) and (3) and CASS 5.1.3 R to CASS 5.1.6 R, to a firm (see CASS 2.1) that receives or holds money in the course of or in connection with its insurance mediation activity.

[14] Insurance Mediation Directive, European Parliament and Council Directive of 9 December 2002 on insurance mediation (No 2002/92/EC).

5.16 The CASS rules require that client money passed to the broker by the policyholder must be held in a segregated bank account. The two different means of segregation set out in CASS are:

(1) holding client money in a statutory trust bank account (CASS 5.3.2R); or

(2) holding client money in a non-statutory trust bank account (CASS 5.4.6R).[15]

5.17 The effect of the CASS rules is that the policyholder's money (client money) should have been put in an appropriate trust account by the broker and, in the event of the broker's insolvency, client money held in each client account is treated as pooled, and is calculated and distributed according to the rules. Policyholders' claims to the accounts would take priority over any insurers' money validly being held in the accounts. For this reason, absent any risk transfer agreement, a policyholder will usually stand a better chance of recovering the premium from an insolvent broker. It therefore seems preferable for the default position to be that the policyholder, rather than the insurer, should bear the burden of recovering the premium.

**Brokers and the payment of premiums: a case study**

5.18 In Part 2, we discussed the case of *Pacific and General Insurance Co v Hazell*.[16] This provides a useful case study of how general agency principles might affect brokers acting in particular insurance markets. The case involved a broker who paid the premium for a reinsurance policy on behalf of a company in liquidation. The reinsurers cancelled the contract and returned the premium payments to the broker. The company's liquidator alleged that the reinsurance contract was still effective because the reinsurer had received the first premium (from the broker) and was entitled to look to the broker for all remaining instalments in accordance with a custom of the Lloyd's market.[17] Mr Justice Moore-Bick disagreed. Instead, he accepted the reinsurer's argument that the appointment of a provisional liquidator automatically revoked the authority of agents appointed on behalf of a company or under the authority of the directors.

5.19 In the court's view, this was a necessary consequence of an order which placed a provisional liquidator in control of the company's assets and operations. It was also consistent with the general rule that an agent's authority ceases when the principal becomes incapable of acting on its own behalf.[18] As a result of the broker's authority being revoked in this way, the payments to the reinsurer were not properly viewed as payments of premium at all. The broker could therefore recover them from the reinsurer.

[15] As referred to in CASS 5.3 and 5.4, the broker acts as trustee or, in Scotland, as agent.

[16] [1997] BCC 400; [1997] LRLR 65.

[17] Above, at p 402.

[18] Above, at p 408.

5.20 We explained in Part 2 that this case provides a strong indication that section 53(1) does not apply to non-marine insurance, because Mr Justice Moore-Bick's conclusion is entirely at odds with how that provision would operate. The broker was not personally liable for the premium and the reinsurer was entitled to cancel the insurance contract following non-payment by the policyholder.

5.21 On the scope of the broker's authority in a centrally operated insurance market (Lloyd's), Mr Justice Moore-Bick made it clear that the broker will normally have implied authority to pay premiums on behalf of the policyholder. This seems to have included both "incidental" and "usual" forms of implied authority:

> At the time in question settlement by the broker under the market procedures was already an established practice and in general an agent has implied authority to act in the execution of his express authority according to the usages and customs of the business in which he is employed.
>
> In the ordinary case (which of course this was, prior to the appointment of the provisional liquidator) I think the insured must be taken to have authorised the broker to pay premium on his behalf through the operation of [the normal Lloyd's] procedures; at any rate, I think that was so in this case where [the policyholder's managing director] must have been familiar with the practice. In my view this accords with the commercial realities of instructing a broker to place reinsurance at Lloyd's or in the London companies' market… .
>
> The expert witnesses in this case were all of one mind on this question, namely that in the ordinary way payment of premium by the broker by settlement in account is regarded by all concerned as payment on behalf of the insured. I think that is something the underwriter is entitled to take for granted as being within the broker's ordinary authority unless for some reason he is told otherwise.[19]

5.22 On the subject of whether the broker was personally liable for the premium payments it had made within the scope of its authority, we saw in Part 2 that Mr Justice Moore-Bick rejected the idea that the broker was liable by a custom of the non-marine insurance market:

> The evidence in this case does not support the conclusion that these market rules were intended to create legal relations between brokers and underwriters where none previously existed so as to render the broker personally liable for premium, either in conjunction with, or in place of, the insured… .

[19] Above, at p 405. It should be noted that Moore-Bick J also considered the question of authority by ratification, and concluded that the broker's payments had been reversed by the reinsurer before the policyholder's liquidator had purported to ratify them: see above, at pp 417 to 418.

> A party seeking to establish a binding custom is really seeking to demonstrate the existence of an implied term which is known to and accepted as part of the bargain by all those who regularly involve themselves in the trade or market in question. It is for that reason that the custom must be shown to be certain, uniform, notorious and reasonable, since if it fails any of these tests it cannot be a term which all those in the market would accept as invariably forming part of the legally binding terms on which they do business… The evidence in this case falls far short of what is required to prove a binding custom.[20]

5.23 Outside section 53(1), therefore, it would have only been by virtue of an implied term in the relevant contract that the broker would have been personally liable for the premium. In the absence of such an implied term, the broker was not liable to the insurer for the premium.

## THE BROKER'S LIEN OUTSIDE SECTION 53(2)

5.24 We addressed the question of the scope of a broker's lien both within and outside section 53(2) in some detail in Part 4 above. We concluded that the lien in section 53(2) may extend slightly further than the lien available to a broker under general agency principles in English law.[21] This is because the section 53(2) lien may be exercised in respect of the principal's general account, and is not limited to specific transactions.

5.25 In the *Pacific and General* case, Mr Justice Moore-Bick commented on the exercise of the broker's lien under general agency principles, illustrating how it operates outside section 53(2):

> I do not think that [the broker's] right to be indemnified by [the policyholder] depended on it continuing to have authority to pay premium on behalf of [the policyholder]… . In general an agent is entitled to be indemnified by his principal against liabilities and losses he incurs as a result of acts done by him at the request of his principal or with his authority… .

[20] Above, at pp 413 and 415.

[21] See paras 4.2 to 4.6 above. As noted in n 10 to para 4.6 above, Scots law recognises that a broker has a general lien exercisable over any property of the policyholder in its possession until the general balance due by the policyholder has been satisfied.

> In the present case [the broker's] right to be indemnified arose simply as a result of its having taken certain action at [the policyholder's] request or with its authority, namely, lodging documents with the bureaux in order to close the contracts, which in due course caused it to suffer loss by having its accounts debited. It would have been entitled to be indemnified by [the policyholder] against any such loss whether the payment, when it actually came to be made, was made on behalf of the policyholder or whether it was simply made without the authority of [the policyholder] under compulsion of the operation of the market systems which had been set in motion.[22]

## CONCLUSIONS

5.26 We have briefly examined the current law on the broker's obligations relating to payment of the premium outside section 53. In the absence of either this provision or some implied term in their contracts (which may be implied as a result of a proven market custom), brokers are not usually personally liable to insurers for premiums. Instead, the policyholder is normally liable for the premium.

5.27 However, brokers may often have express, implied or apparent authority to make premium payments on the policyholder's behalf. In the case of such authority, payment from the broker would be deemed to be payment by the policyholder, thus discharging the policyholder's obligation to the insurer. The broker will then be entitled to recover this payment from the policyholder and will have a lien over the policyholder's property (including the insurance policy and any proceeds received under it) in respect of the premium sum.

5.28 The broker may also accept personal liability to (or enter into a risk transfer arrangement with) the insurer under an appropriate contractual arrangement. This would result in a similar position to that under section 53(1), although it is unlikely that the broker's personal liability would automatically discharge the policyholder from its primary obligation to pay. This contrasts with the position under section 53(1).[23]

5.29 Finally, the broker has a lien over the policy and its proceeds in order to recover payments made on the policyholder's behalf, and this applies both under section 53(2) and under general agency principles (although the scope of section 53(2) might be slightly wider as it may be used in respect of the policyholder's general account with the broker).

[22] *Pacific and General Insurance Co v Hazell* [1997] BCC 400; [1997] LRLR 65, at pp 409 to 410.

[23] See the outcome of the *Universo* case under the custom codified in section 53(1), discussed above at paras 2.13 to 2.18 above.

# PART 6
# THE CASE FOR REFORM

6.1 In this Part we ask whether the law on the broker's liability for the premium should be reformed. We refer to the responses we received to our 2006 Joint Scoping Paper where relevant.

## SECTION 53(1) IS ANOMALOUS AND UNCLEAR

6.2 In Parts 2 and 3, we identified two distinct sets of problems with section 53(1) and the personal liability it imposes upon brokers:

(1) *The application of section 53 is anomalous and counter-intuitive.* In applying section 53(1), the courts have often seemed unsure whether or not to rely on the common law fiction. Consequently, they have sometimes reached conclusions which are at odds with both the plain language of the section and the intentions of the contracting parties as expressed in their contractual provisions.[1]

(2) *The scope of section 53 is unclear*. Is it limited to marine insurance only? Does it extend to non-marine business written at Lloyd's? What about non-marine business written *outside* Lloyd's? Does it apply in the companies' market which, like Lloyd's, has a central accounting system? Should it apply to all relationships between brokers and underwriters where such a central accounting system is used? None of these questions have had clear and final answers.[2]

6.3 It seems likely that section 53(1) is now limited to marine insurance only. If this is correct, then it constitutes a further anomaly in the law: why should the broker have personal liability for marine insurance but not non-marine insurance, particularly when both types of business may be conducted in the same market using the same accounting systems?

### Internal problems with section 53(1)

6.4 Of the two sets of problems noted above, the first may have been partly resolved by recent case law, most notably the *Allianz* case.[3] The courts are now more likely to ignore the common law fiction and instead focus on the language actually used in section 53. If the courts continue to follow this approach, unsatisfactory outcomes (such as the conclusion in *Prentis Donegan* that a freely negotiated automatic termination clause could never operate to discharge an insurer from liability) will be avoided and, for example, payment default clauses would operate as the contracting parties obviously intended.[4]

[1] See Part 3 above.

[2] See Part 2 above.

[3] See *Allianz Insurance Co Egypt v Aigaion Insurance Co SA* [2008] EWHC 1127 (Comm); [2008] 2 Lloyd's Rep 595, discussed at paras 3.21 to 3.26 above.

[4] See *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc* [1998] 2 Lloyd's Rep 326, discussed at paras 3.8 to 3.10 above.

6.5 However, in our view it remains possible that the common law fiction may be invoked and relied upon by courts in difficult or unusual cases. Whatever the plain language of section 53(1) suggests, the 1906 Act has been held to have codified the custom and (so the argument would run) codified the old common law fiction along with it. An argument of this nature was made relatively recently in *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret*, where Counsel submitted that "the judge was wrong to ignore the custom [and, by implication, the fiction that the policyholder had already paid the premium to the insurer] and pointed to the fact… that the section does not deal expressly with the relationship between the broker and the insured".[5]

6.6 Given that the Court of Appeal disagreed with Counsel on this point, the policyholder might in future be vulnerable to a claim from the insurer for the premium. Although the common law clearly provided that the policyholder was not liable to the insurer for the premium (as the Court of Appeal firmly held in the *Universo* case),[6] we noted above that this is not expressly set out in section 53(1).[7] If the "fiction of lending" was not codified and so does not survive in section 53, why should the rule in *Universo* receive different treatment?

6.7 In reality, we think that the two principles are sufficiently different that such a challenge would be unlikely to succeed.[8] However, it is unsatisfactory that any scope for an argument along these lines exists at all.

6.8 As such, we think the desired position should be set out clearly in statute. A large number of respondents to our 2006 Joint Scoping Paper agreed that the law on the broker's liability for premiums should be made clearer and simpler, with 72 of the 93 responses supporting a general review of section 53.

6.9 We think that the common law fiction underlying the custom on which section 53(1) was based should be discarded, even if the section is not otherwise reformed. As Judge Chambers QC noted in the *Allianz* case, "practically no one in the market is now aware of the fiction that enabled the insurer to look to the broker for payment". We think that the common law fiction has outlived its usefulness.

### *TOBAs and why they do not solve the problems of section 53*

6.10 In Part 2, we discussed "terms of business agreements" (TOBAs) currently in use between insurers and brokers. The use of TOBAs in the insurance market was raised by the International Underwriting Association in its response to our Joint Scoping Paper:

5 *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; [1998] CLC 860, at p 864.

6 *Universo Insurance Co of Milan v Merchants Marine Insurance Co Ltd* [1897] 2 QB 93, discussed at paras 2.13 to 2.14 above.

7 See para 2.3 and paras 2.15 to 2.16 above.

8 Above. See also the Australian case of *Con-Stan Industries of Australia Pty Ltd v Norwich Winterthur Insurance (Australia) Ltd* [1986] HCA 14; (1986) 160 CLR 226, where the court held that it was a "necessary corollary" of the broker's liability for the premium that the insurer could not recover the premium from the policyholder directly.

> A further reason for a review of section 53 is the use of TOBAs which apply risk transfer relating to the holding of client monies. The effect of allowing risk transfer is that the broker holds premium paid by the insured as agent of the insurer. Conversely, non-risk transfer TOBAs state that premium is held by the broker as the agent of the insured. Whilst, in our view, it is unlikely that risk transfer TOBAs breach the credit control requirements contained in section 53 of the MIA a consideration of the section in light of these contractual arrangements would be beneficial. [International Underwriting Association.]

6.11 We considered both types of TOBA in Part 2. We concluded that non risk transfer TOBAs do not appear to affect the operation of section 53(1). Unless section 53(1) was clearly excluded (that is, if the policy "otherwise agreed"), the broker would remain directly liable to the insurer for the premium and, in the event of the broker's insolvency, the insurer would have to rank as an unsecured creditor in order to recover any part of the premium. This position would seem to apply whether or not the policyholder had actually paid the premium to the broker. However, if the policyholder had not paid the premium, the broker's liquidator would, under section 53(1), be able to claim it from the policyholder in order to meet its liability to the insurer. This is exactly what happened in *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret*.[9]

6.12 By contrast, risk transfer TOBAs would appear to give the insurer slightly more protection if the broker becomes insolvent, because, assuming the broker had already received the premium from the policyholder, the broker would hold that premium as agent for the insurer possibly in a trust account (although the insurer's rights may be subordinated to the policyholder's rights if the premium is held with client money).

6.13 It is clear that TOBAs provide a significant degree of market flexibility, allowing insurers and brokers to decide the nature of their relationship and the extent of their liabilities. However, where section 53(1) applies to the insurance policy, we do not think that the problems of the current law can be solved by TOBAs alone. Even if a TOBA contained an express "contracting out" provision, it seems unlikely that it could entirely exclude section 53(1) because the only parties to a TOBA are the insurer and the broker. The policyholder may not even be aware that such an agreement exists. Consequently, even though a TOBA purporting to exclude section 53(1) may be able to affect the relationship between the broker and the insurer (so the broker might not be directly liable to the insurer for the premium), it would be unlikely to have any effect on the insurer's relationship with the policyholder. Thus the insurer would remain barred from claiming the premium from the policyholder directly. This would seem to leave the insurer in an even more vulnerable position than under section 53(1).

9 [1998] Lloyd's Rep IR 377; [1998] CLC 860. The case is fully discussed at paras 3.14 to 3.17 above.

## PROBLEMS WITH THE EXTERNAL SCOPE OF SECTION 53

6.14 The second set of problems identified above has not been solved by recent case law, although it seems unlikely that section 53 would now be held to apply outside the marine insurance market.[10] Even assuming that a broker's liability is definitely limited to marine business, this anomalous position was strongly criticised by those who responded to our Joint Scoping Paper in 2006. This criticism came from many quarters:

> This position is an anomaly and does not reflect the current workings of the market at least in the non-marine sector. The issue still raises doubt and remains the subject of dispute within the market. [Davies Arnold Cooper, a law firm.][11]
>
> It is anomalous that the broker is liable for the premium on marine insurance contracts but is not liable for the premium on non-marine insurance, and it is unsatisfactory that there remains uncertainty as regards marine reinsurance contracts. [AON Ltd, a broker.]
>
> There are anomalies within this section of the Marine Insurance Act, which is now clearly outdated. [Geraldine Wright, London Market broker.]

## REFORM IN AUSTRALIA

6.15 We explained above that section 59 of the Australian Marine Insurance Act 1909 was identical to section 53 of the UK Marine Insurance Act 1906.[12] Section 59 was, however, repealed following recommendations of the Australian Law Reform Commission ("ALRC") in 2001.[13] In its wide-ranging review of the Australian Act, the ALRC concluded that there was "no reason in principle why the conduct of the business of marine insurance (as distinct from the content of the contract) should be different from that of non-marine general insurance".[14]

[10] See paras 2.40 to 2.43 above.

[11] The Association of Insurers and Risk Managers (AIRMIC) took exactly the same view.

[12] See para 2.16 above.

[13] Section 59 was repealed by the Financial Services Reform (Consequential Provisions) Act 2001, s 2(6) and Sch 1, item 259.

[14] The Australian Law Reform Commission, Review of the Marine Insurance Act 1909: Report 91 (April 2001), at para 13.4.

6.16 Despite the repeal of section 59, modern Australian insurance law retains special provisions concerning premium payments when a broker is involved. The current position is set out in section 985B of the Corporations Act 2001.[15] This states that 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.[16]

The Act goes on to say that any agreement purporting to alter this effect is void.[17]

6.17 The effect of this section is essentially to impose a risk transfer arrangement on the parties to an insurance contract. In contrast to section 59 (in Australia) and section 53 (in the UK), brokers are not directly responsible for the premium under Australian insurance policies, even in the marine market. Instead, the policyholder is primarily liable to pay the premium and, unless the policyholder has paid the premium to the broker, the insurer may claim the payment from the policyholder directly. The unusual feature of this section is, however, that once the policyholder has paid the premium to the broker, the policyholder's liability to pay the insurer is deemed to be discharged. As soon as the premium has been passed to the broker, therefore, the insurer will be unable to advance any argument that it has not been paid the premium.

6.18 The ALRC recommended the above approach in its 1980 report on insurance agents and brokers:

> It should be made clear that the insurer is in law responsible for receipt of premiums by a broker. It is the insurer, not the insured, which agrees with the broker on credit terms and acquiesces in a broker's temporary treatment of premium money as his own. It is also the insurer, not the insured, which is in the better position to know the overall payment performance of a broker and to become aware of his impending insolvency… If convenience of accounting between insurer and broker should dictate the adoption of other procedures, it is the insurer, not the insured, which should be exposed to the additional risk.[18]

6.19 The Australian approach places the risk of the broker's insolvency on the insurer rather than on the policyholder. As the ALRC pointed out, an insurer is more likely to be aware of the broker's financial situation and may be in a better position to demand prompt payment from the broker.

[15] The provision was inserted into the Corporations Act 2001 by the Financial Services Reform Act 2001, s 2(5)(a) and Sch 1, item 1.

[16] Corporations Act 2001, s 985B(1).

[17] Above, s 985B(4).

[18] The Australian Law Reform Commission, Insurance Agents and Brokers: Report 16 (1980), at para 51. The report's recommendations led to the enactment of the Insurance (Agents and Brokers) Act 1984, s 14. The whole 1984 Act was repealed by the Financial Services Reform (Consequential Provisions) Act 2001, s 2(6) and Sch 1, item 245. The content of section 14 was, however, preserved and now appears in the Corporations Act 2001, s 985B.

6.20 We do, however, see disadvantages with imposing this sort of risk transfer regime on UK insurance contracts, particularly where the broker has a closer relationship with the policyholder than with the insurer. We think that the matter is best decided by the market, leaving insurers, brokers and policyholders free to work out the best arrangement between them. We have found no evidence of systemic problems relating to premium payments in the non-marine market, where section 53 does not appear to apply. We do not wish to introduce new rules applicable only to the marine market or interfere with satisfactory arrangements that have been agreed elsewhere.

## IS THE BROKER'S PERSONAL LIABILITY JUSTIFIED IN MODERN INSURANCE LAW?

### Support for the reform of section 53(1)

6.21 We note above that the equivalent of section 53(1) in Australia has now been repealed. We are not aware of any problems resulting from this. Several of the responses to our 2006 Joint Scoping Paper suggested that section 53(1) should be similarly repealed. In particular, some respondents doubted whether the broker's personal liability for the premium in section 53(1) reflected current practice in the non-marine market or even in the marine market itself, where the underlying custom originally developed:

> Section 53 is one of those idiosyncrasies of insurance law that is rooted in history, rather than being a reflection of modern day business practice. [Norton Rose, a law firm.]
>
> It is our experience that this provision is entirely at odds with market practice in the present day… . [Marsh & McLennan, a broker.]

6.22 Many respondents thought that it was unprincipled to automatically impose personal liability for the policyholder's premium on a broker, even in the marine market:

> There is no justification in 2006 for brokers having to bear the financial burden of paying an insured's premium to its insurers. Repeal [of section 53] would reflect the development of the market since 1906. [Willis Ltd, a broker.]
>
> There is no justification for brokers to remain liable by law for premium in marine business when they have no such liability in relation to non-marine business. It is open to the underwriters and intermediaries to agree otherwise if they choose. [Simon Scriven, a legal adviser to insurers.]
>
> The legal fiction surrounding premium payment should be removed. There is no reason why brokers should bear marine insurers' credit risk as a matter of principle. This section is unnecessary, outdated and is currently dealt with by way of contractual devices which are satisfactory. [Jardine Lloyd Thompson, a broker.]

6.23 Some respondents thought that the rationale underlying the custom, on which section 53(1) was based, no longer applies:

> Section 53(1) reflects a period where insurers had far less knowledge of the financial stability of the insured than the broker, thus forcing the broker to act as guarantor for the premium was considered a necessary measure. To a large degree this situation no longer exists. [International Underwriting Association.][19]

> The rule [in section 53] is an anachronism as the original basis for the rule (as we understand it being the uncertainty of the credit-worthiness of the insured) has now long since passed… . [AON Ltd, a broker.]

**Arguments for the retention of section 53(1) in the UK**

6.24 In contrast to the various calls for reform set out above, a number of respondents to our 2006 Joint Scoping Paper felt either that section 53 accurately reflected current practice, at least in the marine insurance market, or that it was right in principle for the broker to accept personal liability for the premium.

> The broker should remain directly responsible to the insurer for premium. [International Group of P&I Clubs.[20]]

6.25 Dame Elizabeth Gloster reached a similar conclusion, albeit with some apparent reluctance:

> In my view, legislative consideration should be given to the question whether there continues to be a need for statute to provide that the broker is personally liable to the insurer for the premium, or whether the matter should be left to express contractual provisions in the policy. I think that such a need probably does remain in the interests of market certainty, if nothing else.[21]

[19] The Association of British Insurers took a similar view.

[20] Traditionally, Protection & Indemnity ("P&I") Clubs were set up as mutual insurance associations, and would have been automatically excluded from section 53 by the operation of section 85(2) of the Marine Insurance Act 1906 ("the provisions of this Act relating to the premium do not apply to mutual insurance"). By contrast, many modern P&I Clubs are corporate entities and may now fall outside section 85 and within section 53. See further S J Hazelwood, *P & I Clubs Law and Practice* (3rd ed 2000), at pp 12 to 14, 45 to 47, and 121 to 122.

[21] E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 314.

6.26 One respondent suggested that brokers might wish to maintain the current divide between their clients and the insurer, and that the current system was set up to facilitate this:

> The practical reality of the London market is that brokers wish to be the exclusive channel of communications to *their* clients. Therefore they not only have the systems to collect the premium, but they also have the contacts from whom to make collections. Insurers do not – they are used to operating "in account" with brokers. The current system is therefore not an inefficient one though the discrepancy between liability for premium in one sphere, and not in another, does cause irritation. [Ince & Co, a law firm.]

6.27 This view is supported to some extent by the commercial context in which the broker operates, as Mr Justice Rix explained in the *Prentis Donegan* case:

> There are good commercial reasons for [the rule that there is no privity of contract between a sub-agent, such as a placing broker, and the policyholder]. It emphasises the importance of the contractual chain. It is natural for each agent in the chain to give credit to the party known to him, rather than to someone perhaps unknown. It reflects an agent's general desire to keep his client to himself. It reflects the professional or semi-professional relationships of agents and sub-agents.[22]

### The risks of insolvency

6.28 The risks of insolvency under section 53 may be unfairly distributed between the three parties. As Professor Merkin has written:

> Perhaps the most important consequence of the rule [in section 53(1)] is that if the broker becomes insolvent before the premium has been paid, the insurer cannot look to the assured for payment but must prove in the broker's liquidation. The rule is rooted in market practice, and has been reconciled by legal principle only by adoption of the fiction that the premium is deemed to have been received by the insurer and loaned back to the broker. A more realistic explanation is that the broker is acting as a principal in his own right or under some form of dual agency, and not merely as the agent for the assured.[23]

[22] *Prentis Donegan & Partners Ltd v Leeds & Leeds Co Inc* [1998] 2 Lloyd's Rep 326, at p 334.

[23] R Merkin in D R Thomas (ed), *The Modern Law of Marine Insurance (Volume 1)* (1996), at pp 282 to 283.

6.29 The operation of section 53(1) means that the risks of insolvency usually fall on either the insurer or the broker, and not on the policyholder. If the broker becomes insolvent, Professor Merkin rightly suggests that the insurer will be unable to claim the premium due from the policyholder, but will instead have to join the line of creditors in the broker's insolvency proceedings. Similarly, if the policyholder becomes insolvent, the broker will still be liable to the insurer for the full amount of the premium, and will have to claim an indemnity (so far as it is possible) from the policyholder's liquidator.[24]

6.30 Neither of these situations seems entirely fair, as several respondents to our 2006 Joint Scoping Paper made clear:

> Section 53(1) reflects a period where insurers had far less knowledge of the financial stability of the insured than the broker, thus forcing the broker to act as guarantor for the premium was considered a necessary measure. To a large degree this situation no longer exists. Furthermore, the risk to the insurance market overall has substantially increased as the number of brokers has consolidated. Though it is not an immediate problem, should one of the major brokers be unable to pass the premium on, insurance operations on a global scale would be severely compromised. [International Underwriting Association.]
>
> There is… the issue of the position on the insolvency of the broker, where the broker becomes insolvent without having collected the premium from the insured and without having paid it to the underwriter… . The issues are whether the underwriter can sue the insured for the premium and whether, if the insured pays the underwriter voluntarily, this discharges the broker's liability to the underwriter and the insured's liability to the broker. [Clyde & Co, a law firm.]

6.31 We foresee potential problems in situations where either a major broker or policyholder becomes insolvent. Where a large broker becomes insolvent, this may pose a risk to the insurance market. The consolidation of brokers means that one broker may be in possession of many premiums owed to several insurers in respect of policies for which the insurers are nevertheless on risk.[25] The insurers might be unable to recover these premiums from the broker's liquidator and, under section 53, would be unable to recover them from their policyholders. The result could be that insurers are liable for loss suffered by their policyholders in circumstances where the policyholders have not paid for the cover.

[24] However, a broker in this position would not appear to be liable for any "additional" premium payments. See the discussion of *The Litsion Pride* [1985] 1 Lloyd's Rep 437 at paras 3.4 to 3.6 above.

[25] The situation would be different if the insurance policy contained a premium payment warranty, as the insurer would be able to cancel the policy in the event that the broker did not pass on the premium. For further details, see the discussion of recent cases involving premium payment warranties, at paras 3.7 to 3.26 above.

6.32 Secondly, where a policyholder becomes insolvent, the broker remains personally liable to pay the premium to the insurer even though it may be unable to recover this sum from the policyholder's liquidator (or by using its section 53(2) lien over the policy). This leaves brokers exposed to the credit risk posed by policyholders. If a major policyholder becomes insolvent before paying substantial premium sums to the broker (or, worse, if several policyholders become insolvent at similar times without having paid their brokers), the broker would face a liability to the insurer without having any realistic chance of recovering this sum from anyone. This may be an impossible demand for a small broker to meet, and may possibly be anti-competitive.

6.33 Moreover, liquidators of either insolvent insurers or insolvent brokers may find that they are required to claim the premium from whoever they can, regardless of the commercial realities involved. This could be disastrous for long-term relationships between members of the industry. As Dame Elizabeth Gloster explained:

> There is some evidence to the effect that insurers are reluctant to invoke section 53(1) and that underwriters will hardly ever force the broker to fund his principal, the insured.… In any event, whatever the market rationale for the reluctance of insurers or brokers to operate section 53(1) may be, the fact is that the liquidators of an insolvent insurer or broker will have no option but to enforce premium or indemnity rights under the section.[26]

6.34 **We welcome consultees' views on whether section 53(1) reflects current market practice in either the marine or any part of the non-marine markets**.

6.35 **We ask whether there are any justifications for automatically imposing personal liability for premium payments on brokers in either the marine or non-marine markets**.

6.36 **We ask whether section 53(1) should be preserved only for marine insurance and, if so**:

(1) **whether such a divide between different types of insurance would continue to cause problems in practice, and what the nature of those problems would be**;

(2) **whether the desired result could be achieved contractually if section 53 were to be repealed and/or replaced**.

6.37 **We ask whether consultees agree that section 53(1) unfairly exposes insurers to the credit risk posed by brokers and exposes brokers to the credit risk posed by policyholders**.

6.38 **We ask whether there are any other reasons why section 53 should be retained**.

[26] E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 313.

6.39 One of the most important consequences of removing the risk from the broker will be that the risk posed by policyholders will fall instead on the insurer. In many cases, however, the insurer may lack any practical awareness of the extent of the risk involved with any given policyholder, particularly if the broker is reluctant to pass on information about its clients. This was one of the main reasons for the development of the custom that was eventually codified in section 53. One form of protection that an insurer may have against such credit risk is to include a payment premium warranty in the insurance policy. Under such a warranty, if the insurer is unable to recover the premium, it may cancel the policy. However, this type of protection may not always be available to an insurer, as we now discuss.

**The problem with premium payment warranties**

6.40 From our analysis of recent case law on section 53(1) in Part 3, it seems that the most difficult problems arise when the provision is applied in the context of premium payment warranties. Under these clauses, the policyholder warrants that premium instalments will be paid within specific time limits. In *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret*,[27] it was held that if such a warranty is breached, the insurer is automatically discharged from any further liability under the contract, but the policyholder remains liable to pay all the premiums on the due date.[28]

6.41 In Issues Paper 2, published in November 2006, we concluded that this appeared to be a harsh result.[29] We recommended that the law on warranties generally, including premium payment warranties, should be reformed so that general contract principles would apply to them. Under these general principles, it would still be open to an insurer to make payment by the due date a condition of the policy. If the policyholder breached such a condition, that would be considered a "repudiatory breach".

6.42 It would then be open to the insurer to accept the repudiation and terminate the contract. Until the repudiatory breach was accepted, the contract would continue and any claim would have to be paid. Once accepted, however, both parties' obligations would come to an end and a policyholder would not be liable for any payments arising after the termination (though the policyholder may be liable to pay damages for the insurer's loss of profits). We maintain our view that this is a fairer approach for warranties generally, and that, if implemented, it should cover premium payment warranties as well.[30]

[27] [1998] Lloyd's Rep IR 377; [1998] CLC 860.

[28] This was the effect of section 33(3) of the Marine Insurance Act 1906, which states that "subject to any express provision in the policy, the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date".

[29] Law Commission and Scottish Law Commission, Issues Paper 2: Warranties (November 2006).

[30] Above, at paras 7.77 to 7.78 and paras 7.140 to 7.149. See also Joint Consultation Paper, Insurance Contract Law: Misrepresentation, Non-Disclosure and Breach of Warranty by the Insured (2007) Law Commission Consultation Paper No 182; Scottish Law Commission Discussion Paper No 134, at paras 8.90 to 8.96.

6.43 The reform of warranties generally is, however, beyond the scope of this Issues Paper, and we limit our consideration here to how premium payment warranties should be dealt with where section 53 is involved. Although many of the problems with section 53(1) have arisen in the context of premium payment warranties, they do not bear sole responsibility. Similar problems arise with regard to additional or adjusted premium clauses. We are also concerned that the same logic could apply to "risk inception" clauses, if the policy states that the insurer will be on risk only from the date of payment. Therefore, we do not believe that simply abolishing premium payment warranties will solve the problems currently surrounding section 53.

6.44 We also think that insurers should be able to take advantage of premium payment warranties in appropriate situations, and that there is nothing inherently wrong with such clauses allowing the insurer to cancel the policy in the event of non-payment. Indeed, we think that they provide essential protection for an insurer when faced with a policyholder (or broker) who simply refuses to pay or where the policyholder (or broker) has become insolvent before paying the premium.

6.45 We do not therefore recommend the prohibition of such clauses. Rather, we consider how the onerous effects of these clauses might be mitigated by, for example, requiring advance notice to be given to the policyholder before an insurer relies on one.[31] In a situation where the policyholder does not realise that the broker has not yet paid the premium, this notice would give the policyholder the opportunity to pay the premium and thereby ensure that the insurance policy remains in force.

6.46 Such notification requirements already accompany some forms of payment default clauses. For example, the International Hull Clauses 2003 provide that the premium must be paid to the insurer within 45 days of risk inception (this period may be modified by agreement). If the insurer is not paid, it has the right to cancel the insurance by notifying the policyholder, through the medium of the broker, giving 15 days' notice. The policyholder then has the opportunity to pay the premium within those 15 days. If it does so pay, the cancellation will be revoked. If the premium remains unpaid, the cancellation will take effect.[32]

6.47 We think that such a notification requirement would provide important protection for a policyholder who has paid the premium, but whose broker has not yet passed it on to the insurer, as the broker could be hurried into paying. We understand that most payment clauses currently operate in this way, and are usually effective at ensuring the insurer receives the payment.

**The difficulty of contracting out**

6.48 Parties to a policy of marine insurance are theoretically free to contract out of section 53(1) and the custom it imposes upon them by using clear words to that effect. This is apparent from the wording of section 53 itself, which provides that the usage applies "unless otherwise agreed".

[31] See paras 7.18 to 7.21 below.

[32] See R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 8-16.

6.49 In practice, however, section 53(1) seems very difficult to exclude. In the *Chapman* case, Sir Brian Neill held that very clear words are required to displace the usual effect of section 53 and that merely inconsistent policy terms do not achieve this result:

> It seems to me that, if one recognises that the relationship between the parties in the ordinary case where the rule operates without question is between parties with independent rights and obligations, clear words are required to bring about a fundamental change in that relationship and in the status of the broker…
>
> The presence of [a premium warranty clause] clearly founds an argument that it is inconsistent with the operation of the general rule and is thus an indication of an agreement ousting the general rule. But the policy has to be read as a whole. The other clauses, including the broker's cancellation clause, clearly suggest that the ordinary rule is to apply. Reading the policy as a whole I am quite unpersuaded that the presence of this one discordant clause was intended to effect a change in the ordinary relationship between the parties.[33]

6.50 Moreover, even a very clear agreement between the insurer and the broker may not satisfy the "or otherwise" requirement in section 53(1), which seems to require an agreement, at least, between the insurer and the policyholder.[34] For this reason, we doubt whether premium payment warranties or brokers' cancellation clauses would be sufficient to "oust" section 53 in cases where they have been agreed only between the insurer and the broker (as where, for example, a premium payment warranty appeared only on the "slip" lodged at Lloyd's and not in the policy sent to the policyholder).

6.51 The same applies to TOBAs, to which the policyholder is not a party. Any provision agreed in a TOBA between the insurer and the broker would not extend to the policyholder. This seems to make it impossible for a TOBA to effectively oust section 53(1) under the current law.

[33] *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; [1998] CLC 860, at p 865. For this reason, Professor Merkin notes that the statement in the International Hull Clauses 2003 that "the Assured undertakes that the premium shall be paid" does not oust the operation of section 53(1). See R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 23-75, n 26.

[34] See E Gloster, "Who pays the piper – who calls the tune? Recent issues arising in the context of section 53 of the Marine Insurance Act 1906" [2007] *Lloyd's Maritime and Commercial Law Quarterly* 302, at p 313. See also *O'Kane v Jones (The Martin P)* [2003] EWHC 3470 (Comm); [2004] 1 Lloyd's Rep 389, by Deputy High Court Judge Richard Siberry QC at para 226.

6.52 We think that parties should be free to negotiate their contracts as they see fit. The difficulty faced by all three of the relevant parties in contracting out of section 53 seems to violate the important contract law principle of party autonomy. The difficulty with contracting out also carries the significant practical disadvantage of preventing the insurance market from reaching the best solution for itself and allowing the parties to adopt the most appropriate solution in any particular case (for example, a large broker might be able to shoulder the burden of personal liability whereas a smaller broker could not, and their contracts could be designed to reflect this). Under section 53, the benefits of flexibility are lost.

6.53 **Do consultees agree that the requirements of section 53 with respect to "contracting out" are unduly onerous and that parties should be free to negotiate their contracts as they see fit?**

**SECTION 53(2): THE BROKER'S LIEN**

6.54 We discussed section 53(2) and the current law surrounding the broker's lien on the policy in Part 4 above. We noted the relative absence of problems with the current law. We saw that, in Scots law, brokers are recognised as being among the limited categories of persons endowed with a general lien with the effect that brokers are entitled to detain the policyholder's property until the general balance of the account is settled.[35]

6.55 For marine insurance, we think that the provision operates satisfactorily and tentatively propose that it should be left as it is. It is not clear, however, whether, in English law, the broker's lien in non-marine insurance extends as far as the equivalent lien in marine insurance and, in particular, whether a non-marine lien would extend to the client's general account with the broker. We would be interested to find out consultees' views on the correct extent of both liens, and whether reform is desired to achieve this.

6.56 **We welcome consultees' views on whether the broker's lien under section 53(2) is satisfactory or whether it is in need of reform. We also welcome any information as to how, and how often, the lien is applied in practice**.

[35] See n 10 to para 4.6 above. See also Bell, *Commentaries* II, 115 and A J M Steven, *Pledge and Lien* (2008), at paras 17-39 to 17-47.

# PART 7
# PROPOSALS FOR REFORM

7.1 In this Part we consider how section 53 might be reformed, were such reform to prove necessary following consultation.

7.2 As we have not yet had the benefit of detailed responses from consultees, our views on proposals for reform of section 53 are provisional. With this in mind, we tentatively observe that, under the current law:

(1) *The scope of section 53(1) is unclear*.

(2) *The limited application of section 53(1) is anomalous*. Even if the provision is limited to the marine market only, we are unsure whether, or to what extent, it actually reflects market practice. Responses to our 2006 Joint Scoping Paper were divided.

(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*. Particularly in the context of premium payment warranties and additional premium payments, the courts have sometimes applied the common law fiction underlying the custom to reach outcomes which are at odds with the plain language of the provision.

(4) *Even in the marine market, it is unclear whether there is any justification for section 53(1)*. The original justification for the custom underlying the provision may no longer apply, even in the context of marine insurance. There does not appear to be any reason why brokers should be under personal liability for the premium owed by policyholders to their insurers.

(5) *The consolidation of brokers may pose a risk to the insurance industry*. For example, in the event of a large broker becoming insolvent there may be a risk that insurers would be unable to recover the premiums from their policyholders.

(6) *The risk of a policyholder's insolvency falls on the broker*.

7.3 **We welcome consultees' views on these observations. We also welcome views on whether there are any other perceived problems with section 53(1)**.

### DEFAULT POSITION: THE BROKER SHOULD NOT BE PERSONALLY LIABLE FOR THE PREMIUM

7.4 At this stage, we think that a broker should not usually owe a personal liability to the insurer for the premium. The default position should be that policyholders are liable for the premium payments due under their insurance policies. 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. In our view, this situation is justified since the policyholder receives the benefit of the insurance coverage and so it is the policyholder who should primarily be liable to pay for it.

7.5 In many cases, we think that a broker may have authority, whether express or implied, from the policyholder to pay the premiums on its behalf. This may often depend on the practice of the relevant insurance market.[1] In such a case, the broker would not be automatically liable to pay the premium, so the insurer would not normally be able to sue the broker for payment. Rather, the broker's payment of the premium would be treated as if it was payment from the policyholder. As we explained in Part 5, this would be the result under normal agency principles and we think it is the simplest and fairest solution for the modern insurance market. In the event that the policyholder became insolvent, however, the insurer would normally have to join the policyholder's other unsecured creditors in order to recover the unpaid premium.

7.6 We think both of these outcomes are fairer and easier to justify than the current law for two main reasons:

(1) Insurers may be protected against non-payment by a premium payment warranty or payment default clause – in the event that neither the broker nor the policyholder pays the premium, the insurer will be discharged from being on risk for any loss that would otherwise be covered by the policy.

(2) While small brokers may be unable to shoulder the potentially huge burden of a policyholder's insolvency, most insurers are more easily able to bear the credit risk posed by a policyholder. This is especially relevant if there is a payment default clause in the policy, because the insurer will not be on risk as a result of the non-payment (in contrast to the broker, who suffers through the burden of having to pay the insurer while not receiving the benefit of any insurance cover).

7.7 **We ask whether consultees agree that the default position should be that brokers are not personally liable for the premiums owed by policyholders to insurers**.

**Would the policyholder be exposed to double liability?**

7.8 Under our proposed default position, would the policyholder potentially be exposed to double liability where, for example, the policyholder has already paid the premium to the broker but the insurer nevertheless looks to the policyholder directly for recovery? This scenario is quite likely if the broker has become insolvent. It is true that the insurer would be able to sue the policyholder for the premium even if the policyholder had already paid it to the broker. However, we think there are fewer problems with this than where a broker is made to pay the insurer a premium which it may be unable to recover from the policyholder. This is partly because the policyholder should normally be in a position to recover the sum paid to the broker, even if the broker is now insolvent.

[1] See the discussion of *Pacific and General Insurance Co v Hazell* [1997] BCC 400; [1997] LRLR 65 at paras 5.18 to 5.25 above.

7.9 Brokers, as agents, owe fiduciary duties to their principals in a number of respects, particularly in their holding and managing of funds belonging to the principal. We discussed in Part 5 the requirement imposed by the Financial Services Authority (FSA) that brokers must hold client funds paid to them in a segregated bank account.[2] This may include any premium sum paid to the broker before it is passed on to the insurer. In the event of the broker's insolvency, the policyholder would have priority over the broker's other creditors in respect of that segregated account, making recovery of the premium both easier and more likely than if the insurer had to do it (which is the position under the current law in section 53(1)).

**Contracting out of the default position: a fairer solution?**

7.10 We accept, however, that in certain situations the parties may wish to arrange their affairs differently. For example, an insurer may not want to assume the credit risk of policyholders who are located abroad or who they suspect may be difficult to track down. In such cases, the insurer may agree with the broker that the broker will be personally liable for the premium or that risk transfer will occur on receipt of the premium by the broker (the broker being the agent of the insurer for this purpose). The broker would then be free to either accept or reject this liability, and could adjust its fees according to the degree of credit risk it would be undertaking. The result of this contractual agreement would be that the insurer could effectively choose between pursuing either the broker or the policyholder to recover the premium.

7.11 If insurers impose such liability on their brokers through contractual provisions, such as those contained in a TOBA,[3] we should also address the theoretical question of "double payment". That is, if the broker is contractually obliged to pay the premium to the insurer, but the policyholder has already done so; does the broker have to pay the insurer again? This question may be easily resolved, since brokers could simply demand that their contracts provide for their personal liability to be extinguished if the policyholder pays the premium.[4]

7.12 **We ask whether consultees agree that it should be possible to "contract out" of our proposed default position so that the broker could become contractually liable for the premium**.

7.13 Going one step further, it would be possible for all three parties to agree that the insurer would only be able to recover the premium from the broker and not from the policyholder at all. This would effectively replicate the current position under section 53(1). We accept that it might be difficult to conclude this sort of three-way contract in practice. Nevertheless, in particular circumstances, this result may be achieved.

[2] See paras 5.12 to 5.17 above.

[3] See our discussion of TOBAs under the current law in paras 2.44 to 2.50 above.

[4] It should be noted that, since the broker is the policyholder's agent, payment by the broker would be deemed to be payment *from the policyholder*, so the insurer would not thereafter be able to claim the premium from the policyholder directly.

### The effect of removing the broker's automatic liability for the premium

7.14 Altering the current default position of the broker's personal liability may not have a detrimental effect on the insurance market or on the insurer's security in particular. This view was supported by several of those who responded to our Joint Scoping Paper:

> When the broker's personal liability was suspended by the agreement… from August 1996 to August 2001 there were no difficulties we were aware of in conducting marine insurance in the absence of the brokers' personal liability. [AON Ltd, a broker.]

7.15 The agreement referred to was concluded in October 1997 between the Lloyd's Insurance Brokers' Committee, the Institute of London Underwriters and Lloyd's of London. Under this agreement, underwriters agreed not to hold brokers liable for premiums under section 53(1) unless the broker was in breach of any of the following three broad principles:

(1) Brokers and underwriters should not knowingly do business with clients likely to default;

(2) Brokers should inform all underwriters without delay if they acquire knowledge of a likely default; and

(3) Brokers should make every endeavour to collect monies owing and pass them to underwriters without delay. Underwriters should be supportive of these endeavours.[5]

7.16 Only if a broker was found to have been in breach of any of these three broad principles would the underwriter have the option to invoke section 53(1) and thus claim the unpaid premium from the broker. In return for this concession, the Lloyd's broking community agreed to make very significant contributions to the "Reconstruction and Renewal" plan at Lloyd's.[6] As we understand it, this agreement lapsed at the end of August 2001, and no business since then has been subject to it.[7] We think that the 1997 agreement could be viewed as demonstrating that section 53(1) is no longer an essential requirement in the marine insurance market.

7.17 **We welcome consultees' views on the effect of removing the broker's automatic liability for the premium. We are particularly interested in the perceived costs and benefits of such reform**.

[5] As far as we are aware, this agreement was never finalised in a formal written document. We have, however, been fortunate to see the exchange of letters in which the agreement was set out. For further details about this agreement, see Barlow Lyde & Gilbert LLP, *Insurance Law Handbook* (4th ed 2008), at pp 41 to 42. Professor Bennett has suggested that this agreement might not actually have been effective to exclude section 53(1) because it was not agreed between insurer and policyholder as the section requires. See H N Bennett, *The Law of Marine Insurance* (2nd ed 2006), at para 6.37. This provides a good example of how difficult it may be to "contract out" of section 53, as we discuss in paras 6.48 to 6.53 above.

[6] For more details on the "R&R" settlement plan, see R Merkin, *Colinvaux's Law of Insurance* (8th ed 2006), at para 13-41.

[7] See Barlow Lyde & Gilbert LLP, *Insurance Law Handbook* (4th ed 2008), at p 41.

### An obligation to notify the policyholder of non-payment?

7.18 A problem may arise where the policyholder is simply unaware that the insurer has cancelled the policy for non-payment, perhaps because the broker has not paid the premium. This could leave the policyholder without insurance cover. In *Heath Lambert Ltd v Sociedad de Corretaje de Seguros*,[8] the Court of Appeal concluded that, while the insurer could look only to the broker for payment, the operation of a premium payment clause meant that there was no "deemed payment" by the broker. The court recognised that this reasoning put the policyholder at the broker's mercy, because late or non-payment by the broker would defeat the policyholder's right to cover under the insurance policy even if the policyholder had already paid the premium sum to the broker.[9]

7.19 We ask whether all payment premium warranties should be read so as to include some form of obligation on the insurer (and possibly the broker as well) to give reasonable notice directly to the policyholder in addition to the broker, before cancelling the policy under such a payment clause. This would give the policyholder the opportunity to either ensure that the broker pays on its behalf or, alternatively, to pay the premium directly to the insurer.

7.20 We do, however, foresee at least one problem with this solution. The response of Ince & Co (a law firm) to our 2006 Joint Scoping Paper referred to the "practical reality of the London market… that brokers wish to be the exclusive channel of communications to their clients". We are concerned that brokers may be reluctant to pass on details of their clients to insurers. In any event, policyholders may negotiate to include specific notification provisions in their insurance policies if they wish.

7.21 **We ask whether the insurer and/or the broker should be under an obligation to notify the policyholder in the event that the premium has not been paid, and whether such notification should be required before the insurer exercises its rights under any premium payment warranty. Alternatively, should this be left to contractual arrangements between the parties involved?**

## REPEAL AND REPLACEMENT OF SECTION 53

7.22 In the event that our consultation indicates a willingness to reform the law on the broker's personal liability, we would need to consider how the desired reform can most easily be achieved. We now provisionally outline the two most likely options for reform, namely the simple abolition of section 53 or replacing it with a new legislative provision.

8 [2004] EWCA Civ 792; [2004] 1 WLR 2820.

9 Above, at pp 2829 to 2831. See also *J A Chapman & Co Ltd v Kadirga Denizcilik Ve Ticaret* [1998] Lloyd's Rep IR 377; [1998] CLC 860, where (at p 864) Sir Brian Neill explained the policyholder's argument that "the effect of this was that the assured would be under an obligation to pay his premiums to the broker alone but was liable to lose his insurance if the premiums were not transmitted by the broker to the underwriter. Such an arrangement could be described as 'commercially absurd'."

### Abolition of section 53(1)

7.23 Several of those who responded to our 2006 Joint Scoping Paper suggested that section 53(1) could simply be repealed. The aim of this would be to remove the broker's automatic liability for the premium. We think this outcome would be satisfactory but doubt whether simply repealing the provision could achieve this. As Stephen Goodacre (an insurer/broker) commented in his response to the Scoping Paper, the 1906 Act codified the common law and repealing parts of it would not necessarily alter the position at common law. This is particularly true of section 53(1), which as we have seen was based upon a long-established custom in the marine insurance industry.

7.24 We are therefore concerned that repealing section 53(1) might "revive" the common law custom and, worse still, the fiction that accompanied it. It would be unfortunate if, now that the courts have just begun to firmly reject application of the anomalous fiction to section 53, they were forced to apply it again by a revival of the common law.[10] Consequently, we tentatively conclude that if reform of section 53(1) is required, a new statutory provision would be needed in its place.

### Replacement of section 53

7.25 If a replacement provision is indeed required, its terms should reflect the broker's role in bridging the gap between the insurer and the policyholder. The new provision could simply state that a broker is not liable for the premium unless a contract between the insurer and the broker provides otherwise. This would allow insurers who fear the credit risks of dealing with an unknown policyholder to conclude an agreement as to liability with their brokers, and would allow those brokers to adjust their fees accordingly.

7.26 The replacement provision or regulation could place a limited number of obligations on any or all of the three parties, possibly including a requirement that the broker pass on the policyholder's contact information to the insurer and that the insurer must notify the policyholder of non-payment before exercising its rights under any premium payment warranty.

7.27 Moreover, if section 53(2) is considered to operate satisfactorily at present, we think that it should either be left in place or, if a new provision were to be drafted, re-enacted alongside it.[11]

7.28 **We ask whether consultees agree that section 53(1) should be repealed and replaced with a new statutory provision to make it clear that the broker is not automatically liable for the premium**.

7.29 **If so, we ask whether section 53(2) should be re-enacted alongside it**.

[10] Although section 16(1)(a) of the Interpretation Act 1978 provides that statutory repeal provisions do not "revive anything not in force or existing at the time", the situation with the common law and section 53 may be different, since section 91(2) of the Marine Insurance Act 1906 suggests that inconsistent rules of the common law may merely be "disapplied" while the Act is in force (consistent common law rules, by contrast, "continue to apply" alongside the 1906 Act).

[11] For more details on section 53(2), including why we think it operates satisfactorily at present, see Part 4 and paras 6.54 to 6.56 above.

### DOES SECTION 54 REMAIN RELEVANT?

7.30 We briefly discussed above the connection between sections 53 and 54 of the Marine Insurance Act 1906, and noted that the existence of section 54 cast doubt on whether the common law fiction was intended to survive in section 53. Section 54 states 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. We pointed out that the common law fiction would produce the same outcome, whether or not the policy included any such acknowledgment. We are not sure how regularly, if at all, marine policies nowadays include this sort of acknowledgement.

7.31 **We ask whether modern insurance policies ever include clauses acknowledging receipt of the premium, particularly if the premium has not actually been received by the insurer. We ask whether consultees think that section 54 has any relevance in modern insurance law**.

# PART 8
# LIST OF CONSULTATION QUESTIONS

8.1 We ask for comments on and responses to the following questions:

**CURRENT LAW AND PRACTICE ON SECTION 53(1)**

8.2 Does section 53(1) reflect current market practice in either the marine or any part of the non-marine markets? (Paragraph 6.34)

8.3 Are there any justifications for automatically imposing personal liability for premium payments on brokers in either the marine or non-marine markets? (Paragraph 6.35)

8.4 Should section 53(1) be preserved only for marine insurance? (Paragraph 6.36)

8.5 If so, would such a divide between different types of insurance cause problems in practice? What would the nature of those problems be? (Paragraph 6.36(1))

8.6 Alternatively, could the desired result be achieved contractually if section 53 were to be repealed and/or replaced? (Paragraph 6.36(2))

8.7 Does section 53(1) unfairly expose insurers to the credit risk posed by brokers and brokers to the credit risk posed by policyholders? (Paragraph 6.37)

8.8 Are there any other reasons why section 53 should be retained? (Paragraph 6.38)

8.9 Are the requirements of section 53 with respect to "contracting out" unduly onerous? Should parties be free to negotiate their contracts as they see fit? (Paragraph 6.53)

**THE CASE FOR REFORM OF SECTION 53(2)**

8.10 Is the broker's lien under section 53(2) satisfactory or is it in need of reform? (Paragraph 6.56)

8.11 We welcome any information as to how, and how often, the lien is applied in practice. (Paragraph 6.56)

**REFORM OF SECTION 53**

8.12 Do consultees agree that:

(1) The scope 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 consolidation of brokers may pose a risk to the insurance industry?

(6) The risk of a policyholder's insolvency falls on the broker? (Paragraph 7.2)

8.13 If consultees are aware of any other problems with section 53(1), we would like to be informed of them. (Paragraph 7.3)

**Proposed default position: brokers are not liable for the premium**

8.14 Should the default position be that brokers are not personally liable for the premiums owed by policyholders to insurers? (Paragraph 7.7)

8.15 Should it be possible to "contract out" of our proposed default position so that the broker could become contractually liable for the premium? (Paragraph 7.12)

8.16 We welcome consultees' views on the effect of removing the broker's automatic liability for the premium. We are particularly interested in the perceived costs and benefits of such reform. (Paragraph 7.17)

**Notification requirements and premium payment warranties**

8.17 Should the insurer and/or the broker be under an obligation to notify the policyholder in the event that the premium has not been paid? (Paragraph 7.21)

8.18 Should such notification be required before an insurer exercises its rights under a premium payment warranty? (Paragraph 7.21)

8.19 Alternatively, should such notification obligations be left to contractual arrangements between the parties involved? (Paragraph 7.21)

**Repeal or replacement of section 53**

8.20 Should section 53(1) be repealed? (Paragraph 7.28)

8.21 Should section 53(1) be replaced with a new statutory provision to make it clear that the broker is not automatically liable for the premium? (Paragraph 7.28)

8.22 If so, should section 53(2) be re-enacted alongside the new provision? (Paragraph 7.29)

**THE RELEVANCE OF SECTION 54**

8.23 Do modern insurance policies ever include clauses acknowledging receipt of the premium, particularly if the premium has not actually been received by the insurer? (Paragraph 7.31)

8.24 Do consultees think that section 54 has any relevance in modern insurance law? (Paragraph 7.31)