ALLOCATION OF RISK AND OBLIGATIONS TO INSURE - A Magic Roundabout?

by Martin Bakes

One of the main objects of contract wordings is to allocate risks between the parties. Often they also require parties to take out insurance to cover particular risks and to protect a number of different insureds. Over the years such arrangements have produced a plethora of litigation. This is an odd state of affairs because generally one of the purposes of such arrangements is to avoid litigation. Litigation has led to a number of judgments which seem difficult to reconcile with each other. The purpose of this note is to consider those judgments and to try to identify the legal principles which underlie them so that those who draft future contractual arrangements (and insurance policies which are intended to reflect those arrangements) might do so with greater confidence of avoiding litigation.

On its face, *Mark Rowlands Ltd. -v-Berni Inns Ltd. & ORS. [1986] 1 Q.B. 211* was a straightforward case concerned with the question of whether the tenant was liable to its landlord for fire damage to a building, part of which was the subject of the lease between them, such damage having been caused by the tenant's negligence. Not surprisingly the terms of the lease were crucial to the determination of the case. The lease did not contain a clear exclusion clause which might enable the tenant to escape responsibility. However it did contain provisions about the insurance of the property and about the consequences of a fire, at least in relation to payment of rent and reinstatement of the property. The landlord was obliged to insure the property (as to which the tenant was obliged to pay a proportion of the premium) and, in the event of fire, the landlord was obliged to use any money paid by insurers to reinstate the property. The tenant did not have to pay rent whilst the property was unfit for occupation. In practice (although irrelevant to the legal issues) the landlord took out insurance to cover the loss of rent. The Court of Appeal decided that the effect of these provisions was to relieve the tenant of any obligation to repair the property, by which must be understood any liability to the landlord for damages.

The result is a compellingly pragmatic one. This was obviously insurance which was taken out for the benefit of the tenant (as well as the landlord and other tenants of the building), given the obligation on the landlord to insure and the tenant's obvious interest in the reinstatement of the building. Furthermore, the tenant is responsible for payment of a proportion of the insurance premium (but, note, is not liable to pay this *to* the insurer). A fire insurer is liable under its policy irrespective of whether the fire is started (or spreads) as a result of negligence by its insured (or any other party) or by pure accident. In general a fire insurer will only escape liability if the insured either deliberately or recklessly causes the damage. The fire insurer, in *Mark Rowlands*, paid under its policy for the building to be repaired. In reality it was that insurer which, having paid, was now bringing the claim, pursuant to principles of subrogation in the name of the landlord against the tenant. To that claim the tenant had no direct contractual defence against the insurer because it was not a party to the

insurance policy. The court was therefore faced with the illusion of a straightforward claim by a landlord against a tenant and had to dispose of that claim on that basis whereas it was the relationship of those parties with the fire insurer (which had really suffered the loss) which was of crucial practical significance.

The bridge between illusion and reality was formed by the provisions in the lease relating to the obligation to insure against fire and the liability to reinstate. But what are the legal principles for this bridge? These provisions are not a clear contractual exclusion. Rather, they are a clear allocation of risk. The bargain between the landlord and the tenant was that the landlord would insure the property against the risk of fire. In the absence of such a provision the tenant might have done so. If it had, its insurer could not have sued it nor would its insurer have escaped liability by arguing that the tenant had negligently started the fire. By the lease the landlord had, in effect, told the tenant that it did not have to take out the insurance. As between the landlord and the tenant, the former had assumed the risk of damage to the building caused by fire. Contracts frequently allocate risk and an important function of the law is to respect and give effect to such an allocation whether expressed in terms of an obligation to insure, or in some other way.

Thus, in *James Archdale & Co. Ltd. -v- Comservices Ltd. [1954] 1 All E.R. 210* a contract to redecorate provided that the existing structures, works and unfixed materials were at the sole risk of the employer as regards loss or damage by fire and that the employer was to maintain a policy of insurance against that risk. A fire having occurred, the employer sued the contractor. The Court of Appeal held that the provision referred to above was a clear allocation of risk and, that risk having matured, it was to be borne by the employer and could not be visited upon the contractor in the event that the contractor's employee had negligently started the fire. The obligation to insure was important in the eyes of the Court of Appeal: it identified the source of the payment required to repair the premises. The notion of acceptance or allocation of risk was taken further by the Court of Appeal in *Norwich City Council -v- Harvey & ORS. [1989] 1 All E.R. 1180* in the context of a claim brought by building owners against felt-roofing sub-contractors which arose out of a fire started negligently by the sub-contractors which caused damaged to the plaintiff's building. The sub-contractors had been working on the building pursuant to a contract with the main contractors. The sub-contract provided (a) that the work was to be carried out in accordance with the main contract and (b) that the sub-contractors were engaged on the same terms and conditions as the main contract. But it also provided that no exclusions or limitations of liabilities are accepted unless separately agreed in writing "by the main contractors". The main contract contained a provision identical in all material respects to that considered by the Court of Appeal in *Archdale* to the effect that the building owner bore the sole risk of damage caused by fire to the existing building and the works.

The action was brought in negligence and the critical issue for determination was whether a duty of care had been owed. The defendants relied upon the provision in the main contract to argue that they had not owed a duty and, in essence, that argument was upheld by the court which found that, having regard to the fact that all parties had contracted on the basis that the plaintiffs would bear the risk of damage by fire, it would not be just and reasonable that they should owe a duty of care to the owners. Two matters should be noted. First there is no reference in the court's judgment to any reliance by the defendants on the terms of the main contract. Second, the court proceeded on the basis that the provision was sufficient to displace any claim in negligence against the sub-contractors even though it makes no reference to negligence. This principle, i.e. that a contractual provision allocating the risk of damage by fire to one party and requiring that party to insure against that risk, operated vis-a-vis another contracting party as an effective exclusion clause and vis-a-vis others engaged in the same enterprise as the other contracting party (usually as sub-contractors) to negate any duty of care that might otherwise be owed, remains good law. But judges have been very careful to allow a negligent party to escape liability only where another party has clearly accepted the risk of loss caused by such negligence.

In *National Trust -v- Haden Young (1994) 72 BLR 1*, a fire started negligently by the defendants employees caused damage to the plaintiff's property, Uppark House. The defendants had been engaged to carry out works to the house by MFB who in turn had been engaged by the plaintiff. The defendants sought to rely upon the terms of the contract between the plaintiff and MFB in the same way as the defendants had, with success in *Norwich -v- Harvey*. But in the *Haden Young* case they failed. For the reason why they failed, one must get to grips with the particular terms of the contract. But the first point to bear in mind is that the Court of Appeal's decision in *Haden Young* does not detract from the principle enunciated in *Norwich -v- Harvey*. The main contract was the JCT standard form for minor works as revised to January 1987. Clause 6.2 of the contract provided that the contractor would be liable for and indemnify the employer against damage to property (other than the Works) arising out of the Works caused by the negligence of the contractor or of any person engaged by him. Furthermore it required the contractor to take out and to cause any sub-contractor engaged by him to take out insurance in respect of such liability. Clause 6.3B provided that the employer should take out, in the joint names of the employer and contractor, insurance against loss or damage to the existing structure. The Court of Appeal held that the combined effect of these clauses was not to put the existing structures at the sole risk of the employer. Indeed, the clauses did not say this anywhere (unlike the contracts in *Archdale* and *Norwich -v- Harvey*), nor did the contract make the contractors liability under clause 6.2 subject to the loss or damage covered by the employer's obligation to insure under clause 6.3B. Furthermore the court did not consider that the assumption of an obligation to insure could, without more, throw the loss on one party when there are clear terms imposing a liability on the other party (i.e. clause 6.2). What then was the purpose of clause 6.3B? The

judge below (Otton J.) considered that the obligation to insure arose only in respect of damage not caused negligently by the contractor, thereby attempting to forge a consistency of approach between the two clauses not easily apparent from the words used. The Court of Appeal rejected this approach and accepted that there might be an overlap whereby the employer's recoverable damages against the contractor under clause 6.2 might be reduced by the amount recoverable under the insurance, "or vice-versa". The meaning of this is unclear and, in any event, notwithstanding the possible overlap, the court agreed with Otton J. that as between MFB and the National Trust, MFB was liable for the whole of the loss, apart from the damage to the Works. This decision has its difficulties. Apart from problems with the "overlap", the court did not address the significance of the requirement of insurance being in the joint names of the employer and the contractor, although it is difficult to see how this might have assisted the sub-contractor. The basic difficulty was that there was no clear allocation of risk by reference to the obligation to insure. The basic approach was to identify by reference to clause 6.2 the fact that the contractor was under a general and unlimited liability and to point out that clause 6.3B referred only to an obligation to insure and that this did not therefore exclude the general liability. But the emphasis on clause 6.2 is questionable. It merely recites that which would be the position as a matter of general law absent a contractual provision.

In *London Borough of Barking and Dagenham -v- Stamford Asphalt Co. Ltd. 1982 B.L.R. 25* the dispute between the parties was on all fours with the *Haden Young* case save that the defendant was the main contractor and it was admitted that the building owner plaintiff had not taken out insurance in accordance with clause 6.3B. The defendant contended that whilst it was liable under clause 6.2, it was entitled to set off the amount of such liability against what it should have been entitled to recover from insurers had the plaintiff taken out insurance in accordance with clause 6.3B. It should be noted, therefore, that the defendant did not attempt to argue that the overall effect of the contract was that the plaintiff should bear the risk of fire damage to the property. However the Court of Appeal did, inevitably, have to consider the interaction of clauses 6.2 and 6.3B in order to dispose of the case. In this regard the court held that the two clauses did not overlap. Clause 6.2 was concerned with the question of the contractor's liability and its effect was to make the contractor liable for fire damage to the property caused by its negligence, i.e. the admitted circumstances of this case. It was therefore concerned with a particular type of damage. Clause 6.3B was concerned with insurance covering a different type of damage, i.e. damage not caused culpably by the contractors. The court reached this conclusion because (a) the two clauses made no reference to each other (unlike the clauses in *Archdale* and *Norwich -v- Harvey*), (b) the matters dealt with in clause 6.3B (e.g. fire, explosion, storm, earthquake) are not normally the responsibility of the other contracting party and (c) it was unlikely to have been the commercial bargain that a liability should have been imposed on the contractor (clause 6.2) and then removed by the insuring obligation. The court was unquestionably doing its best to make sense of what appears, on the face of it, to be poor drafting. It is fair to say

that simply to provide that party A is obliged to obtain insurance in the joint names of parties A and B in the face of an acceptance by B of liability is a poor means of allotting responsibility to A rather than B, but each of the reasons given by the court for its conclusions is open to question. Thus, the fact that the clauses do not refer to each other is a means of distinguishing *Archdale* and *Norwich -v- Harvey* but it does not deal satisfactorily with *Berni Inns*. The Court of Appeal regarded *Berni Inns* as irrelevant because a number of the perils to be insured against under clause 6.3B did not result from negligence. But this does not give a fair picture of the reasoning in *Berni Inns* which was that a contract of fire insurance did not distinguish between fires started by pure accident and fires started by negligence. More to the point the court also distinguished *Berni Inns* on the ground that there was no provision in the lease in *Berni Inns* which imposed a liability on the tenant. The Court of Appeal also found that the contractor had no insurable interest in the building under the agreement. But the reasoning is difficult to follow. It appears to be based on the inconsistency between what would ordinarily be the position, i.e. that the insurer could not exercise rights of subrogation against its insured, and the fact that the contractor has accepted a liability under clause 6.2. What would have been the position if the plaintiff had (as it should have) taken out insurance in its name and in the contractor's name against the risk of fire damage? Either the insurer could have sued the contractor in the name of the building owner or it could not. Ordinarily one would have thought that it could not because an insurer cannot exercise rights of subrogation against its insured, and it would be an unusual fire policy which distinguished between fires caused by the negligence of one insured and those caused by other means.

The ability of an insurer to make a subrogated claim against an insured was the issue which confronted Lloyd J. in *Petrofina Ltd. -v- Magnaload Ltd. [1984] 1 Q.B. 127.* The plaintiffs alleged that the defendants had negligently damaged contract works which were in the course of erection when heavy lifting equipment collapsed on site. The defendants had been engaged to assist in the contract works but had no contractual relationship with the plaintiffs. Under the terms of the main contract the main contractor was obliged to insure the contract works and did so. The insurer paid for the damage and brought a subrogated claim against the defendants in the name of the plaintiffs. The defendant contended that they were insureds under the policy and that the insurers could not exercise rights of subrogation against them. The judge found that they were insureds. He also found that the risk which was the subject of the insurance was that of damage to property and that the defendants had an interest to the full value of the property on grounds of commercial convenience so that the defendants might, in principle, recover from insurers the full value of the property. Consequently the subrogated claim failed because it was circuitous. The decision did not apparently turn on the terms of the main contract, or those of any sub-contract, as they are not referred to in the judgment. The case turned simply on the relationship between the sub-contractors and the insurers. Applying *Petrofina* to the hypothetical situation referred to above, i.e. the facts of the *Stamford Asphalt* case

save that the building owner did take out property insurance, one might expect the simple answer to be that any claim made by these insurers would fail - assuming that the contractors had been named as insureds. On the face of it this looks odd. The employer seems to be able to break his duty to insure with impunity. But if he does insure, the insurer who stands in his shoes seems to be unable to recover from the party who would be liable absent the insurance. Before tackling this oddity and attempting some coherent rationalisation of the legal position two other cases, which add a gloss to *Petrofina*, have to be considered.

Petrofina did not turn on any consideration of the underlying contracts between the insureds. The fact that the sub-contractor was insured was sufficient to dispose of the case. But the judgment of the Court of Appeal in *Stone Vickers Ltd. -v- Appledore Ferguson Shipbuilders Ltd. [1992] 2 Lloyd's Rep. 578* makes it clear (as, in fairness Lloyd J. had made clear in *Petrofina*) that the underlying contracts must be scrutinised to determine whether the sub-contractor is, in fact, a co-assured. In *Stone Vickers* the plaintiffs had supplied, under contract, a propeller which was alleged to have been defective and, by counterclaim, were sued in respect of the costs associated with correcting the defects. The propeller had been used in the building of a vessel by the defendants and, whilst under construction, the vessel had been insured by the defendants. In fact the insurers had indemnified the defendants in respect of the sums counterclaimed although it was held that they had not, in fact, been obliged to do so. The plaintiffs contended that they had been insured under the policy and accordingly any subrogated claim would fail.

The defendants open cover did refer to sub-contractors, stating that insurers agreed to include sub-contractors as an additional co-assured for their respective rights and interests. The declaration made under that open cover in respect of the vessel under construction was made on 7th April 1982. The main contract was dated 8th April 1982. Of course the plaintiffs were not parties to that contract. The contract made reference to the propeller being a Stone Vickers propeller. It provided for the defendants to insure in the joint names of themselves and their clients the vessel whilst under construction. It was expected that the suppliers of the propeller would be the plaintiffs but in fact the plaintiffs did not tender for the contract until 19th April 1982. The sub-contract provided that the plaintiffs would make good any defects in the propeller and contained reciprocal indemnities in respect of loss caused by negligence. The Court of Appeal found that the plaintiffs had not been co-assureds under the policy having regard to the terms (and dates) of the policy and the contractual documents.

In *National Oilwell (UK) Ltd. -v- Davy Offshore Ltd. [1993] 2 Lloyd's Rep 582,* Colman J. was faced with a very similar, but factually more complex, set of issues. The plaintiffs had supplied a subsea wellhead completion system to the defendants and were the subject of a counterclaim in respect of alleged defects in the system and delay in delivery. As in *Stone Vickers*, the plaintiffs alleged that the counterclaim was

a subrogated claim made by insurers and that they, the plaintiffs, were co-assureds under the policy and thus the claim was circuitous. The policy covered sub-contractors (and the plaintiffs were sub-contractors). The sub-contract provided that the defendants were to purchase in the joint names of themselves and various other persons, including the plaintiffs, insurance on an all risks basis to cover the Works and materials in the course of manufacture until the time of delivery. The judge held that the extent of the insurance in favour of the plaintiffs was limited to reflect this obligation, i.e. there was cover only to the time of delivery. This was consistent with the terms of the sub-contract relating to the passing of property, i.e. property passed on delivery. The insurance policy also contained a waiver of subrogation clause and the judge found that its scope was limited to loss which was the subject of the limited cover given to the plaintiffs. Furthermore the restriction on the obligation to insure, as found by the judge, was held to limit the operation of the allocation of risk principle as enunciated in *Berni Inns*.

From these two decisions it is clear that one cannot rely on the circuity principle without recourse to the underlying documents and the policy, in order to determine (a) whether the party claiming to be insured is, in fact, an insured: and (b) the extent of the insurance provided to that party. The discussion of the *Stone Vickers* and *National Oilwell* decisions followed a question raised about the combined principles of *Petrofina* and *Stamford Asphalt* and in particular the absurdity (as perceived) that, where there is an obligation to insure, the party so obliged seemed to be able to breach that obligation with impunity and yet if he discharged that duty the insurer standing in his shoes would not be able to bring a subrogated claim against the other party. It can now be seen that this should rarely arise. The obligation to insure should reflect the allocation of risk: the insurance that is actually obtained should be limited to that which party A was obliged to take out. But this reflects a perfection which is not always achieved by the draftsman. In the *National Oilwell* case, the policy provided for the interests of other assureds to be covered throughout the entire policy period *unless specific contracts contained provisions to the contrary*. The sub-contract between the plaintiffs and the defendants did contain a provision to the contrary in that the defendants were only obliged to obtain insurance up to the time of delivery. There was, therefore, consistency between the policy and the contract. In *Haden Young* and *Stamford Asphalt* there were no policies before the court (in the latter case it was admitted that no policy had been taken out) but it would be surprising if a policy, had one been taken out, would have been sufficiently restrictive in its application and applied only in cases of damage not caused by the negligence of the contractor. The suggestion in those cases, that the contractual arrangements might be consistent with such a policy, is highly questionable. In some cases there might be an inconsistency between the terms of the underlying contract and the insurance policy (although, to date the courts have managed to avoid such a conclusion) and, in that event, it is probably right that insurers should lose their right to bring a subrogated claim in circumstances where absent an insurance policy a

good claim would lie against the contract breaker. After all the insurer's claim depends not on the original breach but on whether the party in breach has been unjustly enriched. Where it is also an insured in respect of that damage it is difficult to see why it should be said to have been unjustly enriched at insurers' expense.

The following general principles can be identified (with some trepidation):-

1. The court will give effect to a contractual allocation of risk such that if the risk occurs the party who has agreed to bear it ("the risk bearer") will have no claim against any other contracting party (*Berni Inns* and *Archdale*) or any other party participating in the same venture who has done so on the basis that the risk bearer has assumed that risk (*Norwich -v- Harvey*).

2. The allocation of risk is frequently achieved by the risk bearer agreeing to insure against the risk. But this will not be sufficient to achieve an allocation of risk in the face of contractual terms which are inconsistent with such an allocation (*Haden Young* and *Stamford Asphalt*). Apart from an obligation to insure, other indications of an allocation of risk are (a) providing that damage to particular property is at the sole risk of a contracting party, (b) making a contracting party's liability for damage subject to an obligation on the other party to insure and (c) providing that any insurance taken out pursuant to an obligation to insure must include a waiver by the insurer of any subrogation rights against any other contracting party or any other party participating in the same venture.

3. An insurer cannot, by exercise of subrogation rights, claim against its insured in respect of loss which it has agreed to cover for that insured. But it is important to determine (a) whether the party is, in fact, an insured and (b) that it is indeed an insured in respect of the loss which is the subject of the claim.

The recent judgment of the House of Lords in *British Telecommunications* plc *-v- James Thomson and Sons (Engineers) Ltd [1999] 1 W.L.R. 9* is consistent with those principles. The defendant sub-contractors sought to have the claim against them struck out. It was alleged that they had negligently started a fire whilst carrying out building works. They contended that they did not owe a duty of care to the plaintiffs by reference to the terms of the main contract (to which they were not a party). Under the main contract the plaintiffs had been obliged to take out insurance against the risk of fire damage to existing structures. Such insurance had either to recognise *nominated* sub-contractors as insureds or waive rights of subrogation against such sub-contractors. But the defendants were not nominated sub-contractors. Technically (and the main contract distinguished between the two types of sub-contractors) they were domestic sub-contractors. Accordingly there was no obligation on the part of the plaintiffs to cover them under the fire policy and, in those circumstances, it was just that they should owe a duty of care to the plaintiffs.The main contract provided generally that the main contractor would be liable for damage caused by negligence on its part or on the part of any person

engaged by him in connection with the works. But that liability (and commensurate obligation to indemnify the employer) was *subject to* the employer's obligation to insure. The use of the expression "subject to" distinguishes this case from *Haden Young* and *Stamfod Asphalt*. Furthermore the House of Lords, by implication, accepted that an obligation to obtain a waiver of subrogation would be a factor in determining whether there had been a true allocation of risk. The Court of Session had found that the absence of an obligation on the part of the employer to obtain a waiver of subrogation so far as a domestic sub-contractor was concerned was not important because it only bore upon the insurer's rights against the domestic sub-contractor but said nothing about the rights of *BT* against the sub-contractor. But with respect, this was a false point because the authorities clearly show that the obligation to insure and all aspects of the obligation are relevant to determining whether there is a liability under the contract or in tort (e.g. *Berni Inns*).

The cases in this area are confusing and sometimes seem difficult to reconcile but it is submitted on this analysis and by reference to the principles set out above there is a thread of consistency running through them, albeit that, on the facts of the various cases, that thread has seemed, at times, to come close to breaking point.

The lesson for the future is that there is no substitute for clarity of intention and of expression. The commercial justification for a consistent approach to insurance and questions of liability is that it should lead to a cost saving in insurance premia. It should also avoid the distraction of litigation. But it does require the parties, their lawyers, their brokers and insurers all to understand what is to be achieved and give effect to that understanding. To that end, co-operation and not confrontation should be the watchword in their negotiations.

Martin Bakes, Herbert Smith