RIGHTS OF THIRD PARTIES AGAINST INSURERS

By Anthony Menzies

The Contracts (Rights of Third Parties) Act 1999 came into force on 11th November 1999, although the Act only applies automatically to contracts concluded on or after 11th May 2000. In most cases, therefore, annual policies renewed today will become subject to the Act for the first time. The purpose of this article is to review again the implications of the Act on various classes of insurance business and in particular to dispel some common misconceptions which have developed in the market since the Act came into force.

Introduction

The Act is intended to reform the law of contract generally, so there is nothing in it specific to insurance. Its purpose is to overcome problems arising under the common law doctrine of privity of contract, the effect of which is that a person, who is not a party to a contract, cannot enforce it, even though the contract may be expressly for his benefit. The doctrine has been seen by many as an unwelcome complication in the modern world of multi-party legal relationships and during recent decades it has been gradually eroded, either by statute or precedent, in most other common law jurisdictions. For some, the reform of the English law was long overdue.

The main provisions of the Act have been widely described but, in short, the Act entitles a person, who is not a party to a contract (a "third party"), to enforce a term of the contract in his own right if (a) the contract expressly provides that he may, or (b) a term of the contract "purports to confer a benefit" on him. In order to take advantage of the Act, the third party must be either expressly identified in the contract by name, or as a member of a class or as answering a particular description, although he need not be in existence when the contract is entered into.

Position of the Loss Payee

It is a feature of many classes of direct insurance that, in the event of a claim, the indemnity is to be paid to a named third party, typically a financing bank or mortgagee of the insured property. In some cases, the bank may take an express assignment of the policy or may be named as an insured for its own interest as mortgagee, in which case it has no need to invoke the Act to be able to pursue a claim in its own right. A bank whose interest exists solely as loss payee, on the other hand, is in a different position. Under the old law, the bank would be barred by the doctrine of privity from suing insurers directly, unless it could make out an argument that the reference to the bank's interest in the policy amounted to an equitable assignment of

the policy or its proceeds (as in *Colonial Mutual General Insurance Co Ltd -v- ANZ Banking Group (New Zealand) Ltd* [1995] 2 Lloyd's 433). It is doubtful whether a bare loss payee clause in the standard form would have this effect, in which case the bank would be reliant upon the co-operation of the insured to sue on its behalf. The Act has removed this complication since the bank can now enforce the clause in its own name without the need to demonstrate that it is an assignee of the policy.

From insurers' perspective, the risk exists (at least in theory), that they will have to pay the claim again in the event that the policy proceeds have already been paid to the insured in defiance of the loss payee clause. In practice, however, it is likely that insurers in such a situation could rely upon section 5 of the Act, which is intended to protect the paying party from exposure to double liability by virtue of the third party's right to sue directly under the Act. Under section 5, the court may reduce any amount payable to the third party to reflect payments already made under the contract. Nevertheless, insurers should now be more careful than ever to ensure either that the proceeds are directed to the loss payee in the first place or that an appropriate release is obtained from him.

Group Medical Insurance

Another example of the effect of the Act is to be found in the case of group medical insurance, such as that contracted by an employer for the benefit of its workforce. An employee would now be entitled, by virtue of the Act, to pursue a claim directly against the insurer and would not be reliant upon his employer bringing a claim for his benefit. Again, insurers would be advised to obtain releases from both the named insured and the claimant in order to avoid any risk of facing a second claim.

Energy and Construction Risks

Multi-party policies covering energy or energy construction risks are often cited as prime examples of contracts which may be affected by direct rights of action, and yet on closer analysis the effect of the Act on such contracts is less extensive than imagined. Typically, these policies confer cover on a host of different companies, including not only the named main insured but also its subsidiaries or affiliates, project managers, contractors and sub-contractors. It is important to bear in mind, however, that the benefit in each case may well be conferred in the capacity as an insured or co-insured under the policy. On this basis, the sub-contractor has become a party to the contract of insurance, albeit through the mechanism of the main insured acting as his agent at the time of taking out the policy. It follows that the sub-contractor is not, in truth, a third party at all and so has no need for the Act. Similar

considerations often arise in hull insurance, where the owner's policy will typically extend to insure the managers of the vessel for their own interest.

Marine Cargo Insurance

Marine cargo insurers are already well accustomed to receiving claims from third party buyers who were strangers to the original insurance contract, but who claim as endorsees of a cargo insurance certificate tendered to them by the named insured under a c.i.f. sale. Once again, the consignee buyers are not third parties in a strict sense. Rather, they have become, by endorsement of the certificate, insureds in their own right. Accordingly, if the buyers suffer loss, they will be entitled to claim against insurers directly as assignees of the relevant policy, or otherwise as a principal party, being a person for whom the main insured had "instructions to insure". Again, the buyers have no need for the Act and so it does nothing to change their position.

Waiver of Subrogation Clauses

It is common in many classes of insurance for there to be a provision that, upon paying a claim, insurers will not exercise rights of subrogation otherwise available to them against named companies or individuals or groups. Under the old law, as stated in *Midland Silicones Ltd -v- Scruttons Ltd* [1961] 2 Lloyd's Rep 365 and subsequent authorities, the general position was that a person had to be a party to a contract before they could invoke in their own name any waiver or limitation of liability in that contract as a defence to a claim brought against them. In the insurance context, therefore, a sub-contractor who sought to rely upon a waiver of subrogation had to demonstrate that he was a co-insured under the policy. As mentioned, this will often mean showing that the main insured had acted as the sub-contractor's agent in obtaining the benefit of the insurance on the sub-contractor's behalf, perhaps as an undisclosed principal. The complication with the agency approach is that it does require evidence of an undertaking on the part of the main insured to act as agent for the sub-contractor and of course the latter's authority for him to do so, or at least subsequent ratification. In the cases of *Stone Vickers Ltd -v- Appeldore Ferguson Shipbuilders Ltd (the "Charles Darwin")* [1992] 2 Lloyd's Rep 578 and *National Oilwell (UK) Ltd -v- Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582, therefore, the court had to review the contractual relationship between the principal insured (who had arranged the policy), as the main contractor, and the sub-contractor, in order to determine precisely what agreements and instructions existed under the works contract(s) between them. In the *Stone Vickers* case, the court found that there was no agreement by the main insured to procure any insurance for the sub-contractor. In *National Oilwell*, by contrast, it was clear that the sub-contractor was insured under

the policy to some limited extent but the court found that the benefit of the insurance derived by the sub-contractor did not include the risks which had, in fact, given rise to the subrogated claim. Accordingly, in both cases the waiver of subrogation defence failed.

According to the language in which the new Act is drafted, it is likely that the court will look only at the terms of the insurance policy and nothing else. If the policy purports to confer the benefit of a waiver of subrogation on a class of third parties and the defendant is a member of that class then on the face of it he can rely upon the waiver, even if he never gave instructions to the insured to procure the benefit of the insurance on his behalf and/or would otherwise be a complete stranger to the insurance contract. He need not be a co-insured under the policy and (as regards corporate bodies) might not even have existed at the time the contract of insurance was concluded. The *Stone Vickers* and *National Oilwell* decisions may well have gone the other way had the Act applied at that time, a result which, perversely, could have been contrary to the actual intentions of the parties as reflected in the works contract.

Reinsurance

As with direct insurance, the effects of the Act upon the reinsurance industry are largely tangential. Take the case of a cedant under a quota share treaty, for example, who obtains "common account" excess of loss cover for the benefit of himself and his quota share reinsurers. In most cases, the XL cover is expressed to be for the benefit of the reinsured and his QS reinsurers, in which case each should properly be viewed as an XL reinsured in its own right and not as a "third party" for the purposes of the Act. It is common practice that the claim under the XL contract is presented by the reinsured alone, who will then account to his QS reinsurers. Should the cedant become insolvent in the meantime, it is doubtful whether the QS reinsurers could re-present claims already paid to the cedant under the XL contract for their respective proportions, since the cedant would normally be deemed to have acted as agent of the QS reinsurers in collecting from XL. That position is unlikely to have been changed by the Act.

Of more significance, perhaps, is the position of a "cut through" clause in a contract of reinsurance, by which it is acknowledged that the insured has the right to bring a claim directly against reinsurers. The problem, of course, is that the insured as the beneficiary of the clause is not a party to the reinsurance and so in the past may have

faced problems of privity of contract in relying upon it. His position under the Act is now considerably simplified.

Excluding the Act

One unusual feature of the Act is that it specifically permits the parties to agree at the outset to exclude its provisions entirely, with the effect that no third party may claim rights under the relevant contract. The parties are even entitled to revoke third party rights subsequently, although not if the third party beneficiary of the right has in the meantime communicated his assent to the contract or it is known, or it can be reasonably foreseen, that the third party has or would rely upon it. This principle accords with the existing equitable doctrine of estoppel, to the effect that a person may not renege on a promise which has been relied upon by another to his detriment, even though that promise may lack contractual force.

The right to exclude the effect of the Act is one which has been taken up with some enthusiasm in the commercial insurance industry. Both the Joint Cargo and Joint Hull Committees, for example, were quick to devise standard exclusion wordings and similar provisions are now to be found in other classes of insurance. In some cases, the industry's concerns about the effects of the Act are justified but in other areas the concerns may be of less significance, for the reasons mentioned.

Liability Insurance

Perhaps the greatest misconception about the Act, however, concerns liability insurance. There is a widely held view in the market that the Act in some way alters the position under the Third Party (Rights Against Insurers) Act 1930 ("the 1930 Act"), by, for example, extending the right of claimants against an insured under a liability policy to pursue the claim directly against liability insurers. The perception is that, for example, a third party claimant against a P&I Club member could invoke the Act to pursue his claim directly against the Club. This misunderstanding is perhaps to be expected, given that the two Acts have similar sounding names. In reality, however, they deal with very different situations. The new Act applies in cases where a benefit is conferred on the third party by a provision *in the contract of insurance*. It almost certainly has no application to the situation where the direct claim arises against insurers not as a result of anything in the policy but rather by virtue of rights conferred by statute, as in the case of the third party claimant suing under the 1930 Act.

In its report published in June 1996, the Law Commission specifically asked itself the question whether it should take the opportunity, in drafting the Contracts (Rights of

Third Parties) Bill, to reform the 1930 Act at the same time. The conclusion it reached was that it should not. It took the view that the issues arising under the 1930 Act were discrete and that they required separate treatment, which they have since received in the form of a Law Commission report published in 1998. A draft Bill amending the 1930 Act is expected from the Commission any time now, and this will attempt to tackle some of the thorny issues surrounding the 1930 Act, which the Commission has already highlighted. Principal amongst these is the fact that, under the current régime, the third party claimant has no direct rights against liability insurers unless and until the claim against the insured has been established, if necessary by pursuing that claim to judgment. In the meantime, the claimant has no right to information concerning the insured's liability cover, either as to policy limits under the insurance or even whether such cover is available to respond to his claim at all. The Commission has identified this area as ripe for reform, as it has the circumventory effect of the so-called "pay to be paid" clause, which was famously upheld by the House of Lords in "*The Fanti*" and "*The Padre Island*" (No. 2) [1990] 2 Lloyd's Rep 191 but not in *Charter Re v Fagan [1996]* 2 Lloyds Rep 113. Given the stated intention of the Commission to remove what it sees as manifest iniquities faced by third party claimants suing under the 1930 Act, one might expect that the forthcoming legislation will not be quite so obliging to those parties who prefer to contract out of it. This is almost certainly true as regards the various procedural obstacles which the claimant currently faces, but it seems the "pay to be paid" clause might yet survive to some limited extent. In an interview given to Shipping and Transport Lawyer International, the Law Commissioner, Diana Faber, has hinted that the Commission might hold back from outlawing "pay to be paid" provisions in marine insurance contracts, the rationale being that the reform of marine insurance law should, wherever possible, be left to international bodies. Only where marine claims relate to death or personal injury would the clause be rendered ineffective by the new legislation, and to this extent the new Act would simply reflect the existing common (though, in the writer's experience, not universal) practice amongst P&I Clubs and fixed premium P&I insurers not to seek to invoke the defence in relation to such claims.

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