# Legal Expenses Insurance: beware of insolvent insureds

*by Nick Stanbury*

At common law, the successful third party claimant against a person insured under a contract of liability insurance will take a chance that the insured may become formally insolvent before the insurance claim is settled. If insolvency intervenes, the insurance monies belong to the insolvent estate (and thus to the creditors in general) and the unsatisfied third party must prove in the insolvency as an unsecured creditor for his loss; with luck, he may receive a modest dividend. As can be seen, the creditor as a whole could benefit from a 'windfall' boost to the estate derived from a potentially large insurance settlement, at the direct expense of the injured third party. This obvious injustice was confirmed in the late 1920's and, to rectify this, the Third Parties (Rights Against Insurers) Act 1930 ('the Act') was passed, the effect of which is to reverse the position at common law and to provide the third party with a right of statutory subrogation, entitling him to stand in the shoes of the insolvent insured and to receive his indemnity direct from the insurer, by-passing the insolvency. It is no coincidence that the advent of compulsory motor insurance was contemporaneous with the Act; there would have been little point in requiring insurance against liabilities to third parties if the third party claim could be defeated by the insolvency of the motorist.

## Does the Act apply to legal expenses insurance?

The Act although short and straightforward, has some obvious limitations and uncertainties which are ripe for review, if only because the world has changed since 1930 when, for example, legal expenses insurance was not only illegal but probably not even contemplated. At first sight, the Act might appear to be relevant in the context of LEI when the insured becomes insolvent before his 'appointed representative' (i.e. the solicitor or other suitably qualified person appointed by the insured in accordance with the policy) has been paid in full out of the available insurance indemnity. There is a liability (albeit contractual) to the appointed representative as a third party and that liability is insured. It would seem that the unpaid appointed representative would be entitled to invoke the

Act and to recover his outstanding fees direct from the LEI insurer. However, life is not quite that simple: it is necessary to establish first whether LEI is truly within the ambit of the Act and, if this is so, whether the appointed representative can otherwise meet the requirements of the Act that govern his right to receive insurance indemnity. Each of these issues requires careful consideration.

**What is LEI?**

In the Act, section 1(1) states that 'Where under any contract of insurance [the insured] is insured against *liabilities to third parties* which he may incur... his rights against the insurer under the contract in respect of the liability shall... be transferred to and vest in the third party to whom the liability was so incurred' (*emphasis added*). Clearly, the insurance must be against 'liabilities to third parties' and a conventional contract of 'liability insurance' would fulfil this definition, e.g. an insurance within Class 13 (General Liability) 3, the business of that Class being defined as 'Effecting and carrying out contracts of insurance against risks of the persons insured incurring *liabilities to third parties...*'. However, LEI is not per se a liability insurance, if only because it is specifically Class 17 (Legal Expenses) 3 business, defined as being '...against *risks of loss* to *the persons insured* attributable to their incurring legal expenses (including costs of litigation)'. The words italicised seem clearly to suggest that LEI is essentially a contract of first party pecuniary loss insurance, intended to reimburse the insured for an expense which he has necessarily incurred. This distinction is further supported by the regulations 4 which (at the time LEI became recognised) granted to those insurers already authorised to write pecuniary loss (as distinct from liability) insurance automatic authorisation to write Class 17 LEI.

It may of course be that the coincidence of the phrase 'liabilities to third parties' is no more than that and it is certainly arguable that a pure *contractual liability* to a third party is within that term. Nevertheless, the position of the insured must be relevant; under LEI, the insured's obligation is to pay his appointed representative's proper fees in consideration of having the benefit of agreed professional advice and/or representation. This is a direct and fundamental liability of the insured as a term of the contract itself and can be distinguished from the more remote and less quantifiable liability (to the solicitor or some other

party) arising from some breach of the contract, or arising in tort but based on the contractual relationship, or arising in tort independently of the contract. In other words, is the foreseeable and controllable obligation to make a payment voluntarily accepted under contract to be equated with the un-looked for and potentially unavoidable liability and tort for which insured indemnity is, as a matter of public policy, to be recoverable by the plaintiff notwithstanding the defendant's insolvency? Why should the Act protect the unpaid appointed representative when it is unlikely that *mutatis mutandis* the unpaid repairer of a damaged motor vehicle or the unpaid supplier of a replacement for stolen property would be able to invoke the Act, even though the person with whom they had contracted was insured against such a loss?

At the time of writing, the application of the Act to LEI has not been directly considered judicially, although it is likely to be an issue in a case currently listed for appeal 5. Pending such judicial decision (and any subsequent review of the relevant legislation, *see below*), the writer is firmly of the opinion that the Act *cannot* be invoked by the unpaid appointed representative whose fees are ultimately insured, provided of course that there is no direct contractual obligation of the insurer to the appointed representative to pay the fees or to guarantee their payment. At this point, it is as well to remind ourselves that LEI is a contract between the insurer and the insured which does no more than to indemnify the insured for his specified legal expenses. The appointed representative makes a separate contract for professional services with the insured, to whom he is entitled to look for his fees even though they should be funded by the insurer. In normal circumstances, there will be no contractual relationship between the insurer and the appointed representative and, indeed, the insurer would be well advised to make clear to the appointed representative that the risk of unpaid fees and costs is a matter solely between the appointed representative and his client, i.e. the insured. It is of course open to the appointed representative to seek suitable security for costs from his client and it may well be advisable to do so.

**What if the Act does apply?**

There is one situation relevant to LEI in which there can be little doubt that the Act can be invoked. LEI invariably provides an indemnity in respect of the costs awarded in favour of a genuine third party, i.e. the successful litigant with whom

the insured has been in dispute, as distinct from the appointed representative engaged by the insured. This is a true 'liability to a third party' established by operation of law and in respect of which recovery direct from the insurer can be effected by invoking the mechanism prescribed in the Act. The same would apply in respect of any award of damages in favour of a third party which, somewhat exceptionally, is sometimes insured under LEI, e.g. an award in the industrial tribunal. Such an award is clearly a liability within the contemplation of the Act; indeed, this element of indemnity in reality arises from an element of liability insurance given in parallel with LEI under a single contract.

As stated above, the third party seeking to invoke the Act effectively steps into the shoes of the insolvent insured and it is important to remember that the third party has no better rights under the contract of insurance than does the insured himself. This means that if, for example, the insured has failed to make his claim for indemnity in accordance with the terms of the LEI contract in that regard (perhaps by notifying a claim or circumstance too late, or, indeed, making no notification at all), the insurer may never incur an obligation to indemnify the insured, so cannot be called upon to indemnify the third party either. Of particular relevance is the obligation of the insured to demonstrate that a legal liability has actually arisen; until liability is established there is of course no loss for which an insurance indemnity may be available. The third party is not entitled to know of the existence or terms of the contract of insurance until such liability is established so may need to consider carefully whether it is worth the trouble and expense of proving liability but being unable to recover in the event because either there is no insurance to which the Act applies, or there is such insurance but the insured has failed to comply with its terms. (It should be noted that the third party would be entitled to fulfil the terms of the contract of insurance, to the extent that the insured has not done so, and may thereby obtain indemnity notwithstanding some neglect or default on the part of the insured but the chances are that, by the time this writer rises, it will be too late to exercise it.) It is unlikely that an appointed representative would be ignorant of the existence or terms of LEI in this situation and should therefore be aware of what steps need to be taken to secure or preserve indemnity, but it will still be necessary to monitor the situation and to fulfil the insured's obligations under the contract as and when they arise.

At common law, the right to receive indemnity arises when the loss is established, which in the case of legal expenses means that the obligation to pay these has been incurred. In the absence of clear words to the contrary (which will rarely be found in LEI), indemnity is not deferred, e.g. until the legal expenses have actually been paid out by the insured. However, if the contract did include a 'pay to be paid' clause, this would undoubtedly prevent an effective recovery under the Act because the insured, being insolvent, would have no funds to meet the liability in person and thence to recover that outlay from the insurer.

Of greater practical importance is the common situation in which the LEI claim has been made and admitted and the appointed representative's work has been completed and the only remaining task is for the appointed representative to obtain the settlement monies from the insurer. Regardless of the insured's solvency, it is usual for the LEI contract to require the insured to satisfy the insurer that the work has been completed and that the billed costs have been properly incurred; it is common practice to require the insured to certify the bill to this effect before the insurer will pay the appointed representative. If the insured is unable or unwilling to provide this approval, the insurer can legitimately refuse settlement. If the insured is insolvent, it is quite likely that he will refuse to co-operate, but as his rights and obligations under the LEI contract then pass to the office holder acting in the insolvency, it will be open to the appointed representative to seek the office holder's co-operation in discharging this and any other obligation remaining under the contract. (A similar situation will arise if the insured dies, in which case the personal representatives can act for him.)

**A case for reform**

If, as is suggested, the Act does not avail the unpaid appointed representative in obtaining payment when is LEI-insured client becomes insolvent, there is little that the appointed representative can do if he has not made other arrangements to secure his entitlement to recover fees and expenses which are properly chargeable. It is by no means unknown for appointed representatives to assert a right of direct indemnity by the insurer notwithstanding the insolvency, and sometimes the insurer will provide it. In such cases, the possibility that the Act might apply, or the nature of its mechanism is often either ignored or misunderstood! If the Act cannot be invoked, it is clear that any payment made

direct to the appointed representative is potentially a preference in the insolvency and could be set aside, with the possibility that the insurer could be required by the officeholder to make a further payment into the insolvent estate. Sometimes, an officeholder will purport to direct the insurer to meet the appointed representative's demand directly, which (whether or not the Act has been considered) is undoubtedly a breach of duty on the part of the officeholder, who must bring into account all debts due to or by the insolvent. Whilst a 'direction' of this nature by an officeholder undoubtedly should be resisted, the insurer who obeyed it could no doubt plead estoppel if there was subsequently a demand for further payment to be made into the estate. The only safe course is for the insurer to insist on making such payments as are otherwise due under the contract direct to the officeholder; the difficulty then can be that the officeholder may not be readily identifiable or may simply fail to request the settlement monies in accordance with the contract, even if prompted by the unpaid appointed representative - and it is hardly incumbent upon the insurer to insist that the officeholder or anyone else fulfils outstanding obligations.

It will thus be seen that it is not unusual for an insurer who is willing and able to settle an outstanding LEI claim to be unable to do so because of an intervening insolvency and the inability of the unpaid appointed representative to obtain direct payment by invoking the Act. Unless the Act is held to apply to LEI as it undoubtedly does to conventional liability insurances, the only remedy would appear to lie in amendment of the Act, which is in any event open to criticism on other grounds. Whilst those insurers writing LEI might have mixed feelings in the matter, the need to review the Act has been quite widely recognised and is currently the subject of scrutiny by the Law Commission. It is understood that consultation with interested parties on a number of issues, including those set out in this article, is likely to take place during 1977; undoubtedly, The Law Society and other representative bodies will wish to make observation, whether driven primarily by self-interest or otherwise. LEI insurers, being honourable people, will continue to feel uncomfortable if they continue to enjoy unintended unjust enrichment as a result of the uncertainty surrounding the Act and will doubtless also join in the debate, albeit vociferously.

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