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Third Party Claims against P&I Clubs and the “pay to be paid” Rule

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Summary

The “pay to be paid” Rule is a fundamental component of Protection & Indemnity (hereinafter referred to as “P&I”) insurance policies, which requires a Club Member to discharge his liabilities to the injured third party before he can be indemnified by the P&I Club. If the Club Member cannot compensate the third party as a result of insolvency, the third party is denied full satisfaction of his judgment against the Member. The Third Parties (Rights against Insurers) Act 1930 transfers to the injured third party the rights of the insolvent insured against the insurer in relation to the insured’s liability; however the Club is entitled to rely on the “pay to be paid” Rule against the third party, which will effectively defeat the third party’s claim.

This thesis analyses the “pay to be paid” Rule in English law and its relationship with the aforementioned statute as well as the impact of the new Third Parties (Rights against Insurers) Act 2010 on the Rule. The approaches taken by a number of States in the U.S.A. to the “pay to be paid” Rule and measures adopted in International Maritime Organization (hereinafter referred to as “IMO”) Conventions relating to direct action against insurers are also considered in this thesis. The thesis will conclude by exploring the future of the “pay to be paid” Rule and determining whether the P&I Clubs should still be permitted to rely on this Rule in relation to third party claims where a Club Member is insolvent.

1 Introduction

1.1 Background

The “pay to be paid” Rule has been a central feature of P&I insurance for as long as the P&I Clubs have existed. The Rule requires a Club Member to firstly discharge his liability to a third party before he can seek indemnification from the Club. Where the Member is unable to pay the third party due to the former’s insolvency, the third party requires an alternative course of action; otherwise he faces an unsatisfied judgment.

The Third Parties (Rights against Insurers) Act 1930 was passed with the intention of transferring the rights of the insolvent insured against their insurers to third parties to whom the insured has incurred a liability. On the face of it, it seems that a third party would be able to utilise the statutory transfer of rights to bring an action against the P&I Club. In a claim by a third party however, the Club can rely on defences available to it were the Member to have brought an action against the Club. One of these defences is the “pay to be paid” Rule. If the Member is insolvent therefore and cannot pay the third party, it would appear that this failure to pay the third party would prevent the third party from pursuing the Club.

1.2 Purpose

The objective of this thesis is therefore to scrutinise the “pay to be paid” Rule and determine whether P&I Clubs should still be allowed to rely on this Rule in relation to third party claims where a Club Member is insolvent. In order to achieve this objective, this thesis will examine the importance of the Rule to P&I Clubs and its impact on third parties where a Club Member is insolvent. Additionally, this author will analyse the Third Parties (Rights against Insurers) Act 1930 (hereinafter referred to as “the 1930 Act”) as well as its relationship with P&I Club Rules in general. This author will establish whether or not the “pay to be paid” Rule is compatible with the 1930 Act.

In addition to exploring alternative methods of satisfying the third party’s judgment, this author will analyse the Third Parties (Rights against Insurers) Act 2010 (hereinafter referred to as “the 2010 Act”), with particular focus on the “pay to be paid” principle and assess what impact this new legislation and the existing case law jurisprudence will have on the future of this Rule. Furthermore, this author will analyse the approaches of a number of States in the U.S. to the “pay to be paid” Rule for comparative purposes as well as the attitude of the international community to the Rule, expressed through various IMO liability Conventions. In the latter stages of the thesis, this

author will assess the effect of IMO Conventions on the Rule and ascertain whether reliance on the Rule by P&I Clubs is justifiable.

1.3 Method

This author adopts a traditional, dogmatic legal approach. The thesis will be of a descriptive and analytical nature. In order to fulfil this method, the following sources have been used: Convention law, domestic legislation, case law, legal textbooks, journal articles, P&I Club Rules, official U.K. preparatory works, and websites of international organisations and law firms.

This thesis will also be of a comparative nature. Thus, in order to fulfil this method, this author has used: legislation from the United States of America, U.S. case law and U.S. journal articles.

1.4 Delimitation

This thesis will focus on the “pay to be paid” Rule under English law. In spite of this, the thesis will contain a chapter examining the “pay to be paid” Rule in the United States for comparative purposes and therefore American legislation and cases will be cited. Additionally, since both the 1930 and 2010 Acts concern the rights of third parties against insurers generally, non-P&I cases will frequently be used as authority. An American case has been used to demonstrate a point regarding the circumvention of the “pay to be paid” Rule, but it is not cited as authority for the substantive English law.

Moreover, not every aspect of the two Acts will be discussed due to the sheer amount of law that would necessarily have to be reviewed; therefore only the “pay to be paid” Rule will be analysed in depth.

2 The “pay to be paid” Rule

2.1 Indemnity Insurance

The principle of “pay to be paid” is an integral component of most P&I Club Rules¹. The Rule is a fundamental feature of indemnity insurance, marine or otherwise. In essence the Rule requires the insured to firstly pay a third party’s claim, before he is entitled to be indemnified by the insurer. This pre-payment is generally a condition precedent to the insured’s right of recovery from the Club.

Thus, the “pay to be paid” Rule and indemnity insurance in general differs significantly from liability insurance. In the latter type of insurance, the insurer undertakes to cover the insured for a variety of liabilities contained within the insurance policy and they will pay out if it is established that the liability falls within the policy. Unlike indemnity insurance therefore, no prior payment to the aggrieved party is necessary before the insured can recover from the insurer².

2.2 The “pay to be paid” Rule in P&I Club Rules

2.2.1 Background

The “pay to be paid” Rule is incorporated into the Rules of the majority of P&I Clubs, so there must be a good reason behind their presence in the Rules. There are alternative forms of paying out insurance, for example the P&I Clubs could pay the third parties directly or the Clubs could firstly compensate the Member who would subsequently pay the third party. It is therefore appropriate for the purposes of ascertaining how important the Rule is to Clubs, to discuss why the “pay to be paid” Rule is the preferred approach.

Sumption Q.C. submits in *The Fanti and The Padre Island*³ that prior payment is required to prevent Club Members making a profit by receiving payment from the Club and subsequently failing to pay the third party⁴. It

¹ See for example Rule 5A U.K. P&I Club; Rule 5(1) Britannia P&I Club; Rule 3(1) London P&I Club

² Hazelwood, S.J. *P&I Clubs: law and practice* (3rd edition) 2000, London: Lloyd’s of London Press at p. 351

³ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti) and Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island")* (No.2) [1991] 2 A.C. 1

⁴ *ibid* at pp. 33-34

was noted though that this cannot happen where the Club Member is in the process of being wound up as insurance proceeds form part of the general assets of insured, which will eventually be distributed amongst the creditors.

On the other hand, counsel for the West of England P&I Club in the aforementioned case submitted that the reason for the inclusion of the “pay to be paid” Rule is that due to P&I Clubs being mutual insurance associations, each Member must be able to rely on the financial integrity of others, as Members are themselves both insurers and the insured. By making a Club Member pay first to the third party, other Members are assured of the authenticity of the third party claim and need not be worried about the Member manipulating Club funds⁵.

The reasoning behind the inclusion of the “pay to be paid” Rule is therefore uncertain; it may even be an amalgam of the two explanations expressed above. Regardless of what the reasoning is however, the Rule allegedly plays a fundamental role in the Club’s operation in any event.

2.2.2 The “pay to be paid” Rule: an example

A typical example of a “pay to be paid” Clause can be found in Rule 3(1) of The London P&I Club’s Rules⁶. This states that: “[i]f any Assured shall incur liabilities, costs or expenses for which he is insured, he shall be entitled to recovery from the Association out of the funds of this Class, PROVIDED that actual payment (out of monies belonging to him absolutely and not by way of loan or otherwise) by the Assured of the full amount of such liabilities, costs and expenses shall be a condition precedent to his right of recovery”.

2.2.3 Extent of Liability

Moreover, with regard to the extent of the Club’s liability, Rule 5(1) of the North of England P&I Club’s Rules stipulates that the Member is “entitled to recover out of the funds of the Association the amount of such liability, costs or expenses provided by these Rules”⁷. It is therefore evident from this Rule that the Club will only pay out to the Member what the Member has paid out to the third party. This is another key element of an indemnity insurance policy.

⁵ *ibid* at p. 36

⁶ Available online at <http://www.londonpandi.com/files/rules/pandi/5RULES.pdf> (retrieved on 22/04/2010)

⁷ <http://www.nepia.com/cache/files/4388-1265909909/North-RuleBook-PI-2010.pdf#zoom=70> (retrieved on 22/04/2010)

Rule 5(1) of the North of England P&I Club's Rules continues by stating that "when such Member is entitled to limit his liability, the liability of the Association shall not exceed the amount of such limitation"⁸. Consequently, a U.K shipowner can limit his liability for the benefit of both himself and the Club in accordance with the limits set forth in the Convention on Limitation of Liability for Maritime Claims 1976, which is given the force of law in the United Kingdom by s. 185(1) of the Merchant Shipping Act 1995.

2.3 Waiver of the "pay to be paid" Rule

Conversely, the Committee of the relevant P&I Club may decide to exercise its discretion afforded to it by the Club's Rules and waive the requirement of pre-payment by the Member⁹. By employing this method in situations where it is likely that the Member will be ordered by a court of law to pay out to the third party, the Club can avoid the outcome of an unfavourable decision against the Member by arranging an out-of-court settlement with the aggrieved third party¹⁰.

Another example of Clubs waiving the pre-payment requirement is when they issue letters of undertaking in order to obtain the release of arrested entered vessels. These will generally provide that the Club will assume responsibility for the maritime claim, rather than the Member¹¹.

Furthermore, there are occasions where the Club will assume control in relation to a claim against a Member and settle it independently with the claimant, as in the case of *Court Line Ltd v. Canadian Transport Co Ltd*¹². The Club may do this for reasons of convenience or because the claim is substantial, but it must be borne in mind that the Club's actions are discretionary. Consequently, by assuming control of the handling of a claim or even issuing a letter of undertaking, the Club can still choose whether or not to pay the claim directly to the claimant¹³. As Brandon J. said in *The Rena K*¹⁴, Members have no legal right to insist on the Club paying directly to the claimant and that the Club has an unfettered discretion to decline to make such payment.

⁸ *ibid*

⁹ See for example Rule 5(1) of the Britannia P&I Club:
<http://www.britanniapandi.com/en/rule-books/class-3/index.cfm> (retrieved on 22/04/2010)

¹⁰ Hazelwood, *supra* note 2, at p. 352

¹¹ *ibid*

¹² *Court Line Ltd v. Canadian Transport Co Ltd* (1939) 64 Ll. L. Rep. 57 at p. 60 *per* Scott L.J.

¹³ Hazelwood, *supra* note.2 at p. 352

¹⁴ *The Rena K* [1978] 1 Lloyd's Rep. 545 at p. 554 *per* Brandon J.

2.4 Discharge of the Member's Liabilities

Where the Member must firstly discharge his liabilities before being indemnified by the P&I Club, there has been some debate surrounding the way in which Members pay out to third parties. In the American case of *Arthur Liman v. American Steamship Owners*¹⁵, the insured's trustee in bankruptcy discharged the liabilities of the bankrupt insured. The United States District Court held that the liabilities did not have to be discharged with the Member's own funds and accordingly gifts or loans from third parties could be used to pay off the relevant debts¹⁶.

This controversial decision concerned various P&I Clubs, as in their view this ruling contradicted the "pay to be paid" principle, which is a fundamental element of indemnity insurance, and it effectively allowed a Member to claim directly against the Club without having firstly paid off their debts to third parties¹⁷. Thus a bankrupt Member for example, could circumvent the "pay to be paid" Rule and seek indemnification from the Club.

Fuelling the fires of discontent amongst the P&I Clubs was Slade J.'s *obiter* in the English case "*The Allobrogia*"¹⁸. Slade J. suggested in his judgment that it is conceivable that the liquidators of an insolvent Member could pay off the Member's liabilities using borrowed money and the resultant indemnification would be used to reimburse the lenders. This method of payment would in theory satisfy the condition precedent to the Member's right of recovery according to the judge¹⁹.

In response to these decisions, P&I Clubs countered by amending their right of recovery Rules. Thus, when describing the payment of liabilities by the Member, a number of Clubs inserted phrases similar to or with the same effect as "*provided that actual payment (out of monies belonging to him absolutely and not by way of loan or otherwise)*"²⁰. In this way, it was hoped that the ambiguity in the Club Rule which resulted in the decision in *Liman* and the *dicta* of Slade J., would be eliminated.

¹⁵ *Arthur Liman v. American Steamship Owners Mutual P&I Association* [1969] A.M.C. 1669

¹⁶ *ibid* at p. 1673

¹⁷ Hazelwood, *supra* note.2 at p. 353

¹⁸ *Re Allobrogia Steamship Corp* [1979] 1 Lloyd's Rep. 190

¹⁹ *ibid* at p. 197 *per* Slade J.

²⁰ Rule 3(1) of The London P&I Club

3 Third Parties (Rights Against Insurers) Act 1930

3.1 Background to the Act

As a general rule under the common law doctrine of privity, if an insured party is liable towards a third party under the former's insurance policy, the third party only has a claim against the insured²¹. If the insured is insolvent however, this severely jeopardises the third party's right to payment, even if the third party has obtained a judgment entitling him to full payment from the insured.

This particular predicament arose in two cases in 1928²². It was held by the Court of Appeal that although the third party had obtained a judgment against the insolvent insured for the payment of damages, the third party had no claim in law or in equity against the insurance company or the liquidator for the payment of the insurance monies. Consequently, the proceeds of the insurance policy were to form part of the general assets of the insolvent company, which would be proportionately distributed amongst the third party and other unsecured creditors.

In order to rectify the situation and provide third parties to whom the insolvent insured is liable with a more equitable solution, the U.K. Parliament decided to take legislative action. The result was the Third Parties (Rights Against Insurers) Act 1930. The objective of this Act is clearly revealed in the long title: "*An Act to confer on third parties rights against insurers of third-party risks in the event of the insured becoming insolvent, and in certain other events*".

3.2 Salient Features of the 1930 Act

According to s.1(1), the Act states that upon the bankruptcy or winding-up of the insured, his contractual rights against his insurer in relation to any third party liability covered by the insurance policy incurred prior to or after the insolvency, will transfer to and vest in the third party to whom the liability was incurred. Additionally, it is stated in s.1(3) that any insurance contract made between the insurer and insured which purports directly or

²¹ Rose, F.D. *Marine Insurance: law and practice* (2004) London; Singapore: Lloyd's of London Press at p. 133

²² *Hood's Trustees v. Southern Union General Insurance Co of Australasia Ltd* [1928] Ch. 793; *In Re Harrington Motor Company Limited* [1928] Ch. 105

indirectly to avoid the contract or alter the rights of the contracting parties upon insolvency will have no effect.

The extent of the insurer's liability in respect of the third party is defined by s.1(4), which provides that the insurer is under the same liability to the third party as he would have been to the insured. Thus, if the insurer's liability to the insured is less than the liability of the insured to the third party, the third party will have to commence separate proceedings against the insured for the balance²³.

The duty of the insured to provide the third party upon request with information relating to whether or not rights have been transferred to the third party under the 1930 Act is contained within s.2. Furthermore, s.3 stipulates that after the commencement of bankruptcy or winding-up proceedings and after liability has been incurred to a third party, the insured cannot make a settlement with the insurer which will defeat the transferred rights.

3.3 Operation of the 1930 Act

3.3.1 Insolvency

In order for the 1930 Act to be operative, the insured must be insolvent in accordance with s.1, which specifies numerous procedures which constitute insolvency for the purposes of the Act. A statutory transfer of rights essentially requires an individual to be bankrupt, whereas the most significant instance in which this Act applies to a company, is where it is subject to a winding-up order.

3.3.2 Liability

3.3.2.1 Establishing Liability

In addition to being declared insolvent, the third party must establish and quantify liability in relation to the insured before being able to bring an action directly against the insurers. This is what the Court of Appeal decided in *Post Office v. Norwich Union Fire Insurance Society Ltd*²⁴. The court held that liability had to be established by judgment of Court, arbitration award or by agreement between the parties otherwise the third party cannot sue the insurer directly. It was further held in *Law Society v. Shah*²⁵ that an admission of the third party's claim against the bankrupt

²³ s.1(4)(b), 1930 Act

²⁴ *Post Office v. Norwich Union Fire Insurance Society Ltd* [1967] 1 Lloyd's Rep. 216

²⁵ *Law Society v. Shah* [2009] Ch. 223

insured by the trustee in bankruptcy would be sufficient for establishing liability, even though the claim may not be accurately quantified²⁶.

Moreover, it was also held in *Cox v. Bankside Members Agency Ltd*²⁷ that the insurer's obligation to pay only arises once liability is ascertained and quantified; however, the rights of the insured in relation to the insurer transfer to the third party upon the bankruptcy or winding-up of the insured. Until the establishing and quantification of liability against the insured, Philips J. at first instance held that these transferred rights are “*inchoate or contingent*”²⁸.

3.3.2.2 Liabilities incurred by Dissolved Companies

Problems arise however if the company is dissolved. Pursuant to the House of Lords in *Bradley v. Eagle Star Insurance Co Ltd*²⁹, since an action cannot be brought against a dissolved company, the appellant could therefore not establish and quantify liability. To rectify this situation, the third party must apply to the Companies Court to restore the company to the Companies Register under s. 1029(2)(f) of the Companies Act 2006. The third party must make this application within six years of the company's dissolution, although there is no limit where the third party's claim against the company relates to personal injury. Upon restoration to the Companies Register, the third party could then commence proceedings against the regenerated company³⁰.

3.3.2.3 Voluntarily-incurred Liabilities

The 1930 Act is not particularly clear in relation to what liabilities it covers; it merely stipulates that liabilities incurred by the insured in the capacity as an insurer under another contract of insurance are outwith the ambit of the Act³¹. Reinsurance contracts are therefore not covered by the 1930 Act.

The Act is silent on other liabilities however. In the case of *Tarbuck v. Avon Insurance Plc*³², a solicitor brought an action against the insurer of a bankrupt client in order to recover unpaid legal fees. The client had procured legal expenses insurance with the abovementioned insurer. Unfortunately for the solicitor, Toulson J. construed liabilities under the Act narrowly and consequently held that liabilities should be limited to liabilities that have arisen by operation of the law, such as those resulting

²⁶ *ibid* at p. 239 *per* Floyd J.

²⁷ *Cox v. Bankside Members Agency Ltd* [1995] 2 Lloyd's Rep. 437

²⁸ *ibid* at p. 443 *per* Philips J.

²⁹ *Bradley v. Eagle Star Insurance Co Ltd* [1989] A.C. 957

³⁰ *Arnould's Law of Marine Insurance and Average* (17th edition), 2008, London: Sweet & Maxwell at p. 268

³¹ s.1(5), 1930 Act

³² *Tarbuck v. Avon Insurance Plc* [2002] Q.B. 571

from a breach of contract or a tort. In his opinion, liabilities voluntarily undertaken by the insured are outwith the scope of the 1930 Act³³.

The decision in *Tarbuck* was applied in *T&N Ltd v. Royal & Sun Alliance Plc*³⁴ in which the court held that non-payment of a contract debt was a liability voluntarily incurred by the insured. For this reason, the court held that this liability fell outwith the scope of the 1930 Act.

The Court of Appeal in *Re OT Computers Ltd*³⁵ had a very different view of the matter. Longmore L.J. held that liabilities should not be restricted to “*tortious liabilities and contractual liabilities akin to tortious liabilities*”³⁶. He also expressed his views on *Tarbuck* and *T&N Ltd*, albeit *obiter*, saying that there is no reason why liabilities under the Act should not apply to all contractual liabilities, whether for damages or for a contractual debt³⁷. Accordingly, Longmore L.J. held that the Act applied generally to liabilities and so liabilities that are voluntarily incurred would be covered.

3.3.2.4 Multiple Third Parties

If there are several third parties who have claims against the insolvent insured, priority is determined by the order in which the parties establish and quantify liability³⁸. The amount of insurance available therefore will diminish upon the ascertainment of liability and so it is quite possible in these situations that some third parties will establish liability, only to discover that the insurance monies have been exhausted by other third party claimants.

3.3.3 Anti-Avoidance

Despite the seemingly broad nature of s.1(3), which seeks to prevent contracts between the insurer and insured in relation to the insured’s liability to third parties being altered or avoided upon the insolvency of the insured, it has been judicially interpreted as invalidating provisions that have a detrimental effect on the third party’s rights in the event of the insured’s insolvency³⁹. It is therefore to be construed purposively⁴⁰.

Regarding s.3, which precludes the insurer and insured reaching a settlement after the insolvency of the insured and after liability has been incurred by

³³ *ibid* at 577 *per* Toulson J.

³⁴ *T&N Ltd v. Royal & Sun Alliance Plc* [2003] EWHC 1016 (Ch)

³⁵ *Re OT Computers Ltd* [2004] Ch. 317

³⁶ *ibid* at para. 14 *per* Longmore L.J.

³⁷ *ibid* at para 19 *per* Longmore L.J.

³⁸ *Cox v. Bankside Members Agency Ltd* [1995] 2 Lloyd’s Rep. 437 at p. 467 *per* Saville J.

³⁹ *Re Allobrogia Steamship Corp* [1979] 1 Lloyd’s Rep. 190 at p. 198 *per* Slade J.

⁴⁰ Bennett, H. *The Law of Marine Insurance* (2nd edition), 2006, Oxford: Oxford University Press, at p. 615

the insured which will defeat or affect the transferred rights, it has been held that agreements made after liability has been incurred, but before the commencement of bankruptcy are perfectly valid⁴¹.

3.3.4 Information

The duty to provide necessary information upon request of the third party after the insolvency of the insured is contained in s.2 and the application of this provision has been far from consistent. In *Nigel Upchurch v. Aldridge*⁴² for example, the court believed that no rights were transferred to the third party before liability was established and thus only when liability was established would the third party be entitled to information under s.2. Similarly, in *Woolwich Building Society v. Taylor*⁴³ the court held that prior to liability being established against the insured, it was impossible to tell whether the insured was liable to the third party. In the court's opinion, only once liability is established can the right to information be triggered.

These cases produced a highly unsatisfactory outcome. As one commentator observes, a third party could instigate costly and time-consuming legal proceedings against a party he believes to be liable to him, yet discover upon the establishment of liability that the party is neither insured nor has the funds to satisfy the judgment⁴⁴.

Common sense fortunately prevailed in *Re OT Computers Ltd*⁴⁵ which overruled the authorities of *Nigel Upchurch v. Aldridge* and *Woolwich Building Society v. Taylor* in respect of information. The Court of Appeal held that contingent rights were transferred upon the insolvency of the insured and at this point the third party could exercise its s.2 right to information. There was therefore no need to firstly establish the liability of the insured.

3.3.5 The Insurer's Defences

The Act does not confer upon the third party every right of the insured under the insurance policy; the rights transferred to the third party are only those relating to the liability incurred by the insured to the third party⁴⁶. In

⁴¹ *Normid Housing Association Ltd v. Ralphs & Mansell* [1989] 1 Lloyd's Rep. 265

⁴² *Nigel Upchurch Associates v. Aldridge Estates Investment Co Ltd* [1993] 1 Lloyd's Rep. 535

⁴³ *Woolwich Building Society v. Taylor* [1995] 1 B.C.L.C. 132

⁴⁴ Bennett *supra* note 40 at p. 626

⁴⁵ *Re OT Computers Ltd* [2004] Ch. 317

⁴⁶ *Murray v. Legal & General Assurance Society* [1970] 2 Q.B. 495

the words of Lord Denning M.R., the aggrieved third party “*steps into the shoes*” of the insured upon the statutory transfer⁴⁷.

As a result, the third party cannot be in a better position than the insured⁴⁸, which means that all the defences the insurer was entitled to under the policy against the insured can be relied upon against the third party. As Harman L.J. memorably stated, the third party cannot “*pick out the plums and leave the duff behind*”⁴⁹.

Consequently, the Commercial Court held in *Avandero (UK) Ltd v. National Transit Insurance Co Ltd*⁵⁰ that the third party’s claim against the insurer was subject to the limitation of liability provisions in the insurance policy. Moreover, it was held in *Cleland v. London General Insurance Co Ltd*⁵¹ that non-disclosure by the insured entitles the insurer to repudiate liability under the insurance policy.

Further examples of the insurer invoking their defences to liability include where the insurer repudiated liability where the insured breached a condition precedent⁵² and where the insurer is entitled to reject a claim where the notification of such claim is late⁵³. It was also held at first instance in *Cox v. Bankside Members Agency Ltd*⁵⁴ that insurers could set-off defence costs that were owed to them by the insured against the third party.

What can be inferred from this is that whilst the rights relating to the third party liability are transferred to the *bona fide* third party, the actions of the insured in relation to the insurance policy still affect the subsequent transfer. As a result, if the insured has breached a condition or has failed to disclose material information, the insurer can avoid the policy, thus preventing the third party from receiving any statutory transfer.

3.3.6 Limitations

Time is a crucial factor that the third party must always bear in mind when contemplating bringing proceedings against the insured and hopefully the insurer. It is stipulated in s.5 of Limitation Act 1980 that an action founded on contract cannot be brought before the courts after the expiration of six years from the date on which the cause of action arose. The cause of action for the purposes of the statutory transfer according to Popplewell J. in

⁴⁷ *Post Office v. Norwich Union Fire Insurance Society Ltd* [1967] 1 Lloyd's Rep. 216 at p. 219 *per* Lord Denning M.R.

⁴⁸ *ibid* at p. 222 *per* Salmon L.J.

⁴⁹ *ibid* at p. 220 *per* Harman L.J.

⁵⁰ *Avandero (UK) Ltd v. National Transit Insurance Co Ltd* [1984] 2 Lloyd's Rep. 613

⁵¹ *Cleland v. London General Insurance Co Ltd* (1935) 51 Ll. L. Rep. 156

⁵² *George Hunt Cranes Ltd v. Scottish Boiler & General Insurance Co Ltd* [2003] 1 C.L.C.

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⁵³ *Alfred McAlpine Plc v. BAI (Run-Off) Ltd* [2000] 1 Lloyd's Rep. 437

⁵⁴ *Cox v. Bankside Members Agency Ltd* [1995] 2 Lloyd's Rep. 437 at p. 451 *per* Philips J.

*Lefevre v. White*⁵⁵ is the judgment that establishes and quantifies liability against the insured. In view of the fact that the third party “steps into the shoes” of the insured when the transfer of the contractual rights takes place, the third party is also subject to this six year limitation⁵⁶.

In the case of *Lefevre v. White*⁵⁷, the insured issued a writ against the insurer claiming an indemnity within six years of the third party’s judgment against him, but he was made bankrupt a day after. By the time the third party brought fresh proceedings against the insurer, the six years had elapsed. The court held that the third party could not replace the insured in his initial action and that his only option was to commence fresh proceedings against the insurers. Unfortunately for the third party, he was time-barred from doing so in the eyes of the court.

On the other hand, it was held in “*The Felicie*”⁵⁸ that although the third party could not continue the bankrupt insured’s proceedings, the third party could commence separate proceedings against the insurer after the six year limitation period had expired. In spite of both these decisions, the relevant court may order a new party to be substituted for an existing party under Part 19 of the Civil Procedure Rules⁵⁹.

3.3.7 Waiver of the Insurer’s Rights

It is also possible for the insurer to waive their rights under the insurance policy, for example the right to avoid the contract. Where there has been a breach of a condition by the insured, the contract is voidable and so the insurer can choose whether to avoid or affirm the contract. In general, where the insurer elects to affirm the contract, he must unequivocally communicate this affirmation to the insured in order to constitute a legally valid waiver⁶⁰. If the insured is insolvent however, it may be the case that the insurer must communicate this affirmation of the contract to a third party to whom the insured is liable.

Following the decision in *Bradley v. Eagle Star Insurance Co Ltd*⁶¹, the court in *Spriggs v. Wessington Court School Ltd*⁶² held that since the third party only has contingent rights in relation to the insurer prior to the establishing and quantification of liability against the insolvent insured, any waiver of the policy must be communicated to the insured, as the insured is

⁵⁵ *Lefevre v. White* [1990] 1 Lloyd's Rep. 569

⁵⁶ *ibid*

⁵⁷ *ibid*

⁵⁸ *London Steamship Owners Mutual Insurance Association Ltd v. Bombay Trading Co Ltd (The Felicie)* [1990] 2 Lloyd's Rep. 21

⁵⁹ *Arnauld, supra* note 30 at p. 271

⁶⁰ *Spriggs v. Wessington Court School Ltd* [2004] EWHC 1432 (QB) at par. 17 *per* Stanley Burnton J.

⁶¹ *Bradley v. Eagle Star Insurance Co Ltd* [1989] A.C. 957

⁶² *Spriggs v. Wessington Court School Ltd* [2004] EWHC 1432 (QB)

the only party with an enforceable right against the insurer⁶³. Thus an unequivocal communication of affirmation to a third party where the insured was still solvent or where the liability to the insured had not yet been established or quantified by the third party, would not constitute a waiver of rights⁶⁴.

Furthermore, it was held in *Spriggs* that communication to the relevant party is not the only way of affirming the contract; the insurer may act in a manner inconsistent with avoidance by accepting payment of a premium or by paying out a claim⁶⁵.

An alternative form of waiver emerges where the insurer makes an unequivocal representation to a third party, who subsequently relies on this representation. The insurer will be precluded from contending his liability under the policy in these circumstances. This is waiver by estoppel⁶⁶. An example of such a representation is provided by Stanley Burnton J. in *Spriggs*: if a third party incurs expenditure as a result of an assurance from the insurer that the insurance cover is valid, the insurer will be estopped from disputing his liability under the policy⁶⁷. The estoppel only applies though to the particular claim by the third party to whom the representation was made and so the insurer can dispute his liability in relation to claims from parties who were not exposed to the representation⁶⁸.

⁶³ *ibid* at pars. 28-30 *per* Stanley Burnton J.

⁶⁴ *ibid* at par. 32 *per* Stanley Burnton J.

⁶⁵ *ibid* at par. 45 *per* Stanley Burnton J.

⁶⁶ *Arnauld*, *supra* note 30 at p. 274

⁶⁷ *Spriggs v. Wessington Court School Ltd* [2004] EWHC 1432 (QB) at par. 46 *per* Stanley Burnton J.

⁶⁸ *ibid*

4 The 1930 Act and P&I Clubs

4.1 Applicability of the 1930 Act to P&I Clubs

From the moment the 1930 Act came into force, the applicability of the Act to P&I Clubs has been a much debated issue. There was initial uncertainty as to whether or not P&I insurance amounted to “contracts of insurance” under s.1(1) of the 1930 Act, due to the mutual nature of P&I insurance whereby a Club Member is indemnified by contributions from other Club Members. It was held in *Wooding v. Monmouthshire and South Wales Mutual Indemnity Society Ltd*⁶⁹ and subsequently in “*The Allobrogia*”⁷⁰ that despite the unique nature of P&I insurance, contracts between the P&I Club and the Member were “contracts of insurance” within ordinary legal terminology and thus P&I insurance fell within the ambit of s.1(1).

Furthermore, there was a concern that third parties would not be entitled to a transfer of rights under the 1930 Act where foreign Club Members were liable to them. Although the English Admiralty Court has worldwide jurisdiction⁷¹, which allows third parties to establish and quantify liability, it was unclear whether a foreign company could be wound up in the English courts⁷². If the foreign Club Member could not be wound up in an English court, then the insolvency requirement of the 1930 Act would not be satisfied and thus no transfer of rights would take place.

This problem was overcome by the decision in *Re Compania Merabello San Nicholas SA*⁷³ in which the court held that a foreign company could be wound up in English courts under ss.398 and 399 of the Companies Act 1948⁷⁴ in certain circumstances, even if it had never had a place of business in England and Wales. The most pertinent points are: that there must be an asset or assets within the jurisdiction; that such assets may be of any nature; that such assets in some way confer a benefit upon the creditor; and that if there is no reasonable possibility of a benefit accruing to the creditors from the making of a winding-up order, jurisdiction will be excluded⁷⁵.

Thus it was held in that case that an insured company’s right of action against the insurer could constitute an asset if it was payable in England and therefore a winding-up order instituted in English courts would be

⁶⁹ *Wooding v. Monmouthshire and South Wales Mutual Indemnity Society Ltd* [1939] 4 All E.R. 570

⁷⁰ *Re Allobrogia Steamship Corp* [1979] 1 Lloyd’s Rep. 190 at p. 194 *per* Slade J.

⁷¹ Supreme Court Act 1981 (c.54), s.20(7)

⁷² Hazelwood, *supra* note 2 at p. 312

⁷³ *Re Compania Merabello San Nicholas SA* [1973] Ch. 75

⁷⁴ Now regulated by ss.220 and 221 of the Insolvency Act 1986 (c.45)

⁷⁵ *Re Compania Merabello San Nicholas SA* [1973] Ch. 75 at pp. 91-92 *per* Megarry J.

justifiable⁷⁶. If the right of action is the insured company's sole asset, the action must have a reasonable possibility of success, otherwise there would be no benefit for the third party⁷⁷. Following on from *Merabello*, the court in *Eloc-Electro*⁷⁸ held that the insured company need not have any assets within the jurisdiction; the possibility that a benefit may accrue in favour of the third party upon the winding-up of the company would be sufficient grounds for founding a winding-up order. It was consequently held that a benefit derived from an outside source as a result of the winding-up order was sufficient for founding jurisdiction.

4.2 Club Defences

The Club Rules have also proved to be a source of conflict. When a third party makes a claim against the Club after having an insolvent Member's rights transferred to it by virtue of the 1930 Act, the Club can rely on any of the defences that it would have been entitled to rely on were it the Member that made the claim⁷⁹. Whether these defences can be relied on or not has frequently been debated in the courts over the last eighty years.

It has been held for example, that only rights relating to the liability of the insured to the third party are transferred to the third party and therefore liabilities of the insured to the insurer which do not relate to such liability cannot be transferred to the third party⁸⁰. Consequently, if the Club Rules do not state that the payment of premiums is a condition precedent to recovery, it follows that any unpaid premiums cannot be set-off against a third party's claim⁸¹. Conversely, if the Rules, as they often do⁸², expressly stipulate that the Club can set-off unpaid premiums against the Member's indemnity, it can be inferred that this Rule is equally applicable as against the third party.

Moreover, it was held in *The Padre Island (No. 1)*⁸³ that the third party would be subject to an arbitration clause in the policy, which requires disputes regarding P&I cover to be referred firstly to the Committee and then if need be to arbitration. Additionally, it was held in *The "Vainqueur Jose"*⁸⁴ that a Club Rule that requires a Member to notify a claim against him to the Club within a certain period of time can be enforced against a third party who is claiming against the Club under the 1930 Act. As a

⁷⁶ *ibid* at pp. 88-90 *per* Megarry J.

⁷⁷ *Re Allobrogia Steamship Corp* [1979] 1 Lloyd's Rep. 190 at p. 196 *per* Slade J.

⁷⁸ *Re Eloc Electro-Optieck and Communicatie BV* [1982] Ch. 43

⁷⁹ s.1(4), 1930 Act

⁸⁰ *Murray v. Legal & General Assurance Society* [1970] 2 Q.B. 495

⁸¹ *ibid*

⁸² Rule 5(3) of the Britannia P&I Club

⁸³ *Socony Mobil Oil Co Inc v. West of England Ship Owners Mutual Insurance Association (London) Ltd (The Padre Island) (No.1)* [1984] 2 Lloyd's Rep. 408

⁸⁴ *CVG Siderurgicia del Orinoco SA v. London Steamship Owners Mutual Insurance Association (The "Vainqueur Jose")* [1979] 1 Lloyd's Rep. 557

result, if the claim is not notified within this period, the Club can reject the third party's claim.

A Club Rule stipulating that the Club will not be liable for claims arising before or after a Member ceases to be protected by the Club due to the non-payment of calls, was held by the Court of Appeal to be a penalty clause⁸⁵. This Rule would therefore not preclude the third party from recovering its debt from the Club.

4.3 The “pay to be paid” Rule and the 1930 Act

Perhaps the most controversial Club Rule to be examined by the courts regarding a third party claim is the “pay to be paid” Rule. As mentioned above, the “pay to be paid” Rule requires Members of P&I Clubs to firstly pay off a third party's claim before seeking an indemnification for the third party liability from the Club. Additionally, it has been demonstrated that in the event of the insured's insolvency a third party to whom the insured has incurred liability can proceed directly against the insurer by virtue of the 1930 Act.

However, since the insurer can rely on the defences available to him under the policy against the third party, if the insured fails to fulfil a condition of the contract, this adversely affects the third party's claim. Consequently, if the insured fails to pay the third party owing to his insolvency, he is not entitled to indemnification. It appears therefore that a third party would not be able to proceed against the Club as according to case law breach of a condition precedent to the right of recovery can defeat a third party claim.

The first case to seriously examine the impact of the 1930 Act on the “pay to be paid” Rule was “*The Allobrogia*”⁸⁶ in 1979. In this case Slade J. considers whether s.1(3) of the 1930 Act nullifies the Rule, as this section invalidates any provision that directly or indirectly purports to avoid the contract or alter the rights of the insured upon the occurrence of either bankruptcy or a company being wound-up. According to Slade J., a provision that has the substantial effect of avoiding the contract or altering the insured's rights is nullified by this section⁸⁷. Does the “pay to be paid” Rule have such an effect?

Slade J. held on this point that if compliance with the “pay to be paid” Rule was still possible after the insolvency of the company, then the Rule would

⁸⁵ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti) and Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island") (No.2)* [1989] 1 Lloyd's Rep. 239

⁸⁶ *Re Allobrogia Steamship Corp* [1979] 1 Lloyd's Rep. 190

⁸⁷ *ibid* at p. 197 *per* Slade J.

not have the substantial effect of avoiding the contract or altering the rights of the Member. On the other hand, if the insolvency of the company rendered performance of the condition precedent impossible, then it is “*strongly arguable*” that the Rule would be invalidated by s.1(3)⁸⁸.

4.4 *The Fanti and The Padre Island*

In the late 1980s, the English courts had to confront the issue again. In *The Fanti*⁸⁹, the court held at first instance that since the contractual rights in connection to the liability had been transferred to the third party, the onus was on the third party to satisfy the “pay to be paid” clause. In the opinion of Staughton J., this was “*impossible or at least futile*”⁹⁰. He further held that the “pay to be paid” Rule breached s.1(3) of the 1930 Act, as it indirectly altered the rights of the parties upon insolvency. As a result, he held that the clause had no effect⁹¹.

That same year, another case with similar facts was brought before the Commercial Court. In *The Padre Island*⁹² Saville J. held that since the insured could not claim indemnification from the Club, neither could the third party as they could not be placed in a better position than the insured by the statutory transfer. He also held that the insured had a contingent right to be reimbursed upon paying off the third party and that such a right was totally unaffected by the winding-up order against the insured. Accordingly, the “pay to be paid” Rule did not breach s.1(3) of the 1930 Act.

In summary, on the subject of the “pay to be paid” issue, Saville J. took completely the opposite view from Staughton J. in *The Fanti*.

The appeals for these two cases were brought together before the Court of Appeal⁹³. The court held that the prior payment by the third party was impossible to perform and therefore it should have no effect. On the other hand, it was also held that s.1(3) of the 1930 Act did not nullify the “pay to be paid” Rule. In the view of the court, the Rule did not have the substantial effect of avoiding the policy or altering the rights of the parties upon the winding-up of the insured. It was stated that the ability to exercise these rights was affected by the winding-up in that it is harder for the insured to

⁸⁸ *ibid* at p. 198 *per* Slade J.

⁸⁹ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti)* [1987] 2 Lloyd's Rep. 299

⁹⁰ *ibid* at p. 306 *per* Staughton J.

⁹¹ *ibid* at p. 309 *per* Staughton J.

⁹² *Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island") (No.2)* [1987] 2 Lloyd's Rep. 529

⁹³ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti)* and *Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island") (No.2)* [1989] 1 Lloyd's Rep. 239

pay the third party. These rights remained unaffected therefore, save the fact that these rights had now been transferred to the third party.

The joined case was subsequently appealed to the House of Lords⁹⁴. The House of Lords held that on the ordinary and natural construction of the “pay to be paid” Rule, it was a condition precedent to the right of recovery for the Club Members. Although the House of Lords recognised that there is an equitable principle that allows the court to order the insurer to pay directly to the third party or to the insured, it could not however prevail over the “pay to be paid” Rule, due to the express and clear wording of the Clause⁹⁵.

The House of Lords also ruled that the “pay to be paid” Rule did not purport to avoid the contract or vary rights of parties in the event of insolvency. It was stated that this Rule is not solely applicable to when the insured is being subject to a winding-up order; it is equally applicable both before and after such an order. From a practical perspective, the Rule will be more difficult to satisfy after a winding-up order, but crucially the legal rights are unaffected by such an order⁹⁶.

Finally, the House of Lords held that a third party cannot have transferred to him better rights than that of the insured under the insurance policy. Thus, since the insured had not satisfied the condition precedent to the right of recovery, the insured cannot recover anything from the Club and neither can the third party after the statutory transfer. In other words, the Club had a good defence against the insured, which could similarly be used in relation to the third party⁹⁷.

Nevertheless, before concluding his judgment Lord Goff stated that it was not inconceivable that P&I Clubs would reject a claim from a third party regarding death or personal injury, where the insolvent Club Member had not satisfied the “pay to be paid” Rule. Even though the Clubs in this case provided their assurances that in these circumstances the Committee would waive the requirement of prior payment, Lord Goff suggested that if the Clubs were to exploit this Rule in relation to these types of claims, then Parliament would take legislative action to remedy this⁹⁸.

⁹⁴ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti) and Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island") (No.2)* [1991] 2 A.C. 1

⁹⁵ *ibid* at p. 28 *per* Lord Brandon

⁹⁶ *ibid* at p. 29 *per* Lord Brandon

⁹⁷ *ibid* at pp. 29-30 *per* Lord Brandon

⁹⁸ *ibid* at p. 39 *per* Lord Goff

5 Third Parties (Rights Against Insurers) 2010

5.1 Entry into Force

The Third Parties (Rights against Insurers) Act 2010 became law on the 25th March 2010⁹⁹ and it expressly repeals the 1930 Act¹⁰⁰. The 2010 Act has been formulated in order to rectify the various inefficiencies of the 1930 Act. According to Lord Bach in the Second Reading of the House of Lords, the primary objective of the Act *“is to create a more straightforward and cheaper route to compensation for people who find themselves caught up in a dispute with someone who is insolvent. To achieve this objective the Bill simplifies and modernises the procedure to be followed, not the substantive law underlying it”*¹⁰¹.

5.2 Establishing Liability

As noted by Lord Bach above and as stated in the preamble, the 2010 Act aims to transfer the rights of an insolvent insured to a third party to whom the insured is liable and it does so by virtue of s.1(2). The first significant modification is seen in s.1(3), which stipulates that a third party may bring proceedings against the insurer without having first established the insured’s liability, although the second part of the sentence adds that the transferred rights cannot be enforced against the insurer until liability has been established.

This section operates in conjunction with s.2(2), which provides that a third party can bring an action against the insurer to obtain one or both of the following declarations: a declaration as to the insured’s liability to the third party; or a declaration as to the insurer’s potential liability to the third party. Together, these sections provide the third party with the option to pursue the insurer directly, which means that if the third party so chooses, he can avoid the often time-consuming and costly obstacle of commencing a separate action against the insured to establish and quantify his liability. The third party will still have to establish and quantify the liability of the insured in order to convert his contingent rights into enforceable rights, but now it is possible to do so in just the one proceeding.

⁹⁹ <http://services.parliament.uk/bills/2009-10/thirdpartiesrightsagainstinsurers.html>
(retrieved 02/04/10)

¹⁰⁰ Schedule 4, 2010 Act

¹⁰¹ HL Deb 7 December 2009, GC41

In view of the fact that the third party can bring an action against the insurer directly, the third party no longer has to restore a defunct company to the Companies Register for the purpose of bringing an action against them to establish and quantify liability. This is certainly a most welcome addition for the third party, as it saves time and money.

5.3 Insolvency

Sections 4-7 of the 2010 Act specify who or what constitutes a relevant person for the purposes of the Act; in other words, these sections set forth situations in which a person, company or trust can be considered to be insolvent. This list of natural and legal persons who are insolvent in the eyes of the Act is far more extensive than the insolvent persons enumerated in the 1930 Act¹⁰². A much wider range of insolvent persons was required in the 2010 Act due to the fact that insolvency and company law have evolved immensely since the 1930s and new entities such as limited liability partnerships have emerged in this period. Accordingly, the revised list is designed to reflect such changes and include new entities that were previously excluded from the ambit of the 1930 Act.

5.4 The Insurer's Defences

5.4.1 The General Rule

Where a third party is bringing an action against the insurer in order to obtain a declaration of the insured's liability under s.2(4) of the 2010 Act, the insurer can rely on any defence that the insured would have been entitled to rely on had the third party brought the action against them. In addition to this, the 2010 Act maintains the general rule that an insurer can utilise any of the defences he would be entitled to rely on if it were the insured who brought the action against him, in an action brought against the insurer by the third party. This rule though, is subject to the three exceptions contained within s.9.

5.4.2 Exceptions to the General Rule

First of all, s.9(2) states that anything done by the third party which if done by the insured would have fulfilled a condition in the policy, is to be treated as done by insured. An example of the type of scenario envisaged by the legislators when creating this exception is where an insolvent insured fails

¹⁰² s.1(1), 1930 Act

to notify the insurers of a claim being brought against him within the prescribed time limit in the insurance policy¹⁰³. By virtue of this section, a third party can notify the insurer of this claim within this same time period and thus fulfil a contractual condition. The insurer would therefore not be able to reject the claim from the third party because of failure by the insured to notify in time.

The second exception declares that transferred rights are not subject to a condition that the insured must provide information or assistance to the insurer if this condition cannot be fulfilled because the individual has died or the company has been dissolved¹⁰⁴. The following subsection provides that a condition requiring the insured to provide information or assistance to the insurer does not include a condition requiring the insured to notify a claim to the insurer¹⁰⁵.

5.4.3 The “pay to be paid” exception

The final exception is found in s.9(5), which states that transferred rights are not subject to a condition requiring prior discharge by the insured of their liability to third parties. This exception is qualified somewhat by s.9(6), which provides that in cases of marine insurance, this exception only applies insofar as the liability of the insured relates to death or personal injury.

5.4.4 The Rationale Behind the s.9(6) Qualification

The U.K. Government based the new legislation on recommendations made in The Law Commission and Scottish Law Commission Report 2001 (hereinafter referred to as the “2001 Report”)¹⁰⁶, which followed a Consultation Paper produced in 1998¹⁰⁷. In this 2001 Report, the majority of consultees supported reforming the law relating to the “pay to be paid” Rule. A number of consultees noted that the P&I Clubs often paid claims directly to the third party and that legislation would be required to protect third parties in respect of death and personal injury claims, as the Club

¹⁰³ See Explanatory Notes, Third Parties (Rights against Insurers) Bill [HL], as introduced in the House of Lords on 23rd November 2009 [HL Bill 17], p.7, available online at <http://www.publications.parliament.uk/pa/ld200910/ldbills/017/en/2010017en.pdf> (retrieved 15 May 2010)

¹⁰⁴ s.9(3), 2010 Act

¹⁰⁵ s.9(4), 2010 Act

¹⁰⁶ Law Commission and Scottish Law Commission Report 2001 on Third Parties - Rights Against Insurers (Law Com. No. 272) (Scot Law Com, No. 184), July 2001, Cm 5217, SE/2001/134

¹⁰⁷ Consultation Paper on Third Parties (Rights against Insurers) Act 1930 (1998), Law Com No. 152; Scot Law Com No. 104

practice of not relying on the “pay to be paid” Rule in these instances was insufficient protection for third parties¹⁰⁸.

In contrast, opponents of reform stated that the Rule was essential for the operation of P&I Clubs and that outlawing the Rule could drive the Clubs out of the United Kingdom. It was also submitted that since marine liability insurance was being discussed on the international level, it would therefore be unwise to reform this area of law at national level¹⁰⁹.

After examining both points of view, the Law Commissions made their proposals for reform. They generally sided with the proponents for reform and recommended abolishing the defence of “pay to be paid” in general. An excerpt from the judgment of Bingham L.J. in the Court of Appeal in *The Fanti and The Padre Island*¹¹⁰ was cited in substantiation of their decision:

The clubs’ obligation to the member was to pay, but to pay only, a member who had suffered actual loss (by payment to the third party). Upon transfer, the clubs’ obligation would still be to pay, and to pay only, a third party who had suffered actual loss (although not in this instance by payment out).

The Commissions agreed that the third party was not gaining greater rights than the insured and so the “pay to be paid” Rule was not in their opinion in conflict with the 1930 Act. As a result, they crafted a Draft Bill that would protect the third party from the consequences of an insured’s insolvency, one of which is the inability of the insured to discharge his liability to an injured third party.

Conversely, it was stated that since international negotiations regarding marine liability insurance were currently taking place, the Commissions were reluctant to recommend new provisions which may be at a variance with forthcoming international regulation¹¹¹. For this reason, the Commissions did not extend the prohibition on insurers employing the “pay to be paid” Rule defence in an action by a third party to contracts of marine insurance.

However, due to the serious nature of personal injury and death claims and numerous concerns regarding the inadequate protection of the third party in these claims, the Commissions decided to address this particular issue. Thus, rather than relying on flimsy promises from the Clubs that they will not rely on the defence of prior payment where such claims are involved, the Commissions recommended that Clubs cannot rely on the “pay to be paid”

¹⁰⁸ 2001 Report, p. 61

¹⁰⁹ *ibid*

¹¹⁰ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti) and Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island") (No.2)* [1989] 1 Lloyd's Rep. 239 at p.250 *per* Bingham L.J.

¹¹¹ 2001 Report, p. 62

Rule where claims of this nature are brought against them by third parties¹¹².

5.5 Information

As a consequence of s.11 and Schedule 1, the third party is entitled to information concerning the contract of insurance under which the insured is allegedly liable to the third party. This information may be obtained from the insured person or company, or even from another party altogether who is able to provide information regarding the insurance policy¹¹³. This allows a third party to obtain information from a key source of information that was overlooked by the 1930 Act – the insurance broker.

The recipient of a notice requesting information normally has 28 days to respond¹¹⁴. If a third party requires information relating to a defunct company, they can request information from persons related to that defunct company under paragraph 3 of Schedule 1. Consequently, unlike the state of affairs under the 1930 Act, a third party need not restore a company to the Companies Register in order to obtain information regarding the contract of insurance.

The third party is therefore able to acquire information much more easily under the 2010 Act and the Act clearly specifies what information must be provided to the third party upon request. It is no longer in any doubt that the third party does not need to establish and quantify liability first before being entitled to request information relating to the relevant insurance policy. Now that a third party can obtain information relating to the insured's liability relatively soon after the liability arises, the third party can therefore decide before going to court whether or not it is worth proceeding against the insured or the insurer.

5.6 Limitation

Where a third party brings proceedings against the insurer under s.2(2)(a) whereby they are seeking a declaration of the insured's liability, the third party is entitled to commence these proceedings after the period of limitation relating to that liability has expired, provided that an action against the insured is already in progress¹¹⁵. In other words, if a third party has already commenced proceedings against the insured to establish his liability, ss.12(1) and (2) prevent him from being time-barred from

¹¹² *ibid*

¹¹³ Schedule 1, paragraph 1, 2010 Act

¹¹⁴ Schedule 1, paragraph 2, 2010 Act

¹¹⁵ ss.12(1) and (2), 2010 Act

commencing a subsequent action against the insurer and receiving a declaration from the court of the insured's liability.

5.7 Jurisdiction

With regards to jurisdiction, s.18 of the Act provides that the Act will apply irrespective of whether or not there is a foreign element to the claim. As a result, the application of the Act is not dependent on: whether liability was incurred in or under the law of England and Wales; the place of residence of either of the parties; whether the contract of insurance is governed by the law of England and Wales; or the place where the sums due are payable under the Act¹¹⁶.

The effect of this provision is that third parties can now bring an action against foreign-based insurers in English courts. There is no longer any confusion as to whether the third party can pursue an insured company incorporated overseas and the provision also dispenses with the requirement that a claim must be payable in England in order for an English court to establish jurisdiction¹¹⁷.

5.8 Voluntarily-incurred Liabilities

The 2010 Act expressly includes liabilities which have been voluntarily incurred by the insured. There had been considerable judicial uncertainty as to whether or not liabilities incurred willingly by the insured would be covered by the original 1930 Act¹¹⁸. The 2010 therefore eliminates that uncertainty and the third party can now proceed against the insurer for claims relating to expenses voluntarily incurred, such as legal expenses or health fees.

¹¹⁶ s.18, 2010 Act

¹¹⁷ *Re Compania Merabello San Nicholas SA* [1973] Ch. 75

¹¹⁸ See *Tarbut v. Avon Insurance Plc* [2002] Q.B. 571; cf *Re OT Computers Ltd* [2004] Ch. 317

6 Direct Action in the United States of America

6.1 Overview

In the United States, marine insurance is governed at State level as opposed to federal level¹¹⁹. As a result, there is great disparity between the laws of the fifty States¹²⁰, particularly in respect of direct action against insurers. The different approaches taken by the State Legislatures in relation to this issue and the “pay to be paid” Rule will therefore be examined for comparative purposes.

6.2 The Louisiana Direct Action Statute

6.2.1 Salient Features

Several U.S. States have passed direct action statutes which essentially allow a third party to proceed directly against the insurer of an insured party who is liable to the third party¹²¹. The third party may be entitled to direct action after a judgment has been obtained against the insured or if the insured is insolvent. There are even occasions where neither of these conditions is necessary¹²².

One of the most famous statutes is the Louisiana Direct Action Statute, which is generally viewed as being the most favourable towards third parties¹²³. Enacted in 1918, the Louisiana Legislature were at that time addressing the growing practice of insurers inserting “no action” (pay to be paid) clauses into insurance policies¹²⁴. The consequence of such clauses in situations where the insured was insolvent was that the injured third party received no compensation.

Instead of outlawing “no action” clauses, the Statute provides that the right of direct action will exist in an insurance policy regardless of whether or not there is a provision in the policy which forbids direct action and that the

¹¹⁹ Foster, N. *Marine Insurance: Direct Action Statutes and Related Issues* (1998-1999) 11 U.S.F. Mar. L.J. 261 at p. 264

¹²⁰ *ibid* at p. 265

¹²¹ Hazelwood, *supra* note 2, at p. 319

¹²² See Louisiana: LSA-R.S. 22:1269 (West 2009). Formerly La. Rev. Stat. Ann. § 22:655, hence the majority of case law refers to this provision rather than its identical successor.

¹²³ Foster, *supra* note 118 at p. 270

¹²⁴ Shariff, V. *Grubbs v. Gulf International Marine Co.: The Louisiana Supreme Court Declares the Direct Action Statute Applicable to Marine P&I Insurance* (1994) 68 Tul. L. Rev. 1653 at p. 1654

insolvency of the insured will not release the insurer from liability¹²⁵. Moreover, a judgment establishing liability is not required before a third party can bring a direct action against the insurer¹²⁶. It has been held that the right of direct action exists even if no prior judgment has been obtained against the insured and regardless of whether or not he is insolvent¹²⁷.

Rather than the insurer joining the insured as a co-defendant, the Louisiana Direct Action Statute permits the third party to proceed directly against the insurer alone, albeit only in certain circumstances, for example if the insured is bankrupt, insolvent or deceased¹²⁸. Additionally, it has been held by the Court of Appeal of Louisiana that a third party may not have a right of action against the insured, but in spite of this they can sue an insurer directly if they can establish that the insured is legally responsible for the injury sustained¹²⁹. In other words, if the insured has a valid defence against the third party claim, the third party can pursue the insurer directly if they can establish the liability of the insured.

6.2.2 Scope

Regarding scope, the right of direct action will only be effective if the insurance policy was written in Louisiana, if the policy was delivered in Louisiana or if the accident took place in Louisiana¹³⁰. It can be inferred therefore that even if a Louisiana citizen was involved in the incident, as a third party he would have no right of direct action if one of the above requirements was not fulfilled.

6.2.3 Louisiana and P&I insurance

The Louisiana Direct Action Statute *prima facie* applies to liability insurance policies only¹³¹. Liability insurance is distinguishable from indemnity insurance by virtue of the fact that the insurer becomes liable as soon as the liability of the insured is established. In contrast to indemnity insurance therefore, no actual loss must be suffered by the insured before the insurer pays out under liability insurance¹³².

As stated above, P&I insurance is indemnity insurance with the “pay to be paid” Rule at its core, and it would therefore appear that it is excluded from

¹²⁵ La. Rev. Stat. Ann. § 22:1269(B)(2)

¹²⁶ *Edwards v. Fidelity & Cas. Co.*, 123 So. 162 (La. Ct. App. 1929)

¹²⁷ *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541 (5th Cir. 1983)

¹²⁸ La. Rev. Stat. Ann. § 22:1269(B)

¹²⁹ *Futch v. Fidelity & Cas. Co.*, 136 So. 2d 724 (La. Ct. App. 1961)

¹³⁰ La. Rev. Stat. Ann. § 22:1269(B)(2) and *Landry v. Travelers Indem. Co.*, 890 F.2d 770 (5th Cir. 1989)

¹³¹ La. Rev. Stat. Ann. § 22:1269

¹³² Foster, *supra* note 118 at p. 266

the ambit of the Statute. It has been held however by the Louisiana courts that liability insurance encompasses indemnity insurance¹³³. Moreover, P&I insurance in particular has been held to be a liability policy in a number of cases¹³⁴. The decisions by these courts have been criticised by courts in other States¹³⁵.

6.2.4 “Ocean marine” insurance

Even if P&I insurance is considered liability insurance, it may still be excluded by §851¹³⁶. There has been considerable debate concerning the wording of §851, which stipulates that the Statute does not apply to “ocean marine” insurances¹³⁷. In the case of *Cushing v. Maryland Cas. Co.*¹³⁸, the Fifth Circuit Court of Appeal held that the Louisiana Legislature had no intention to deny the right of direct action to third parties covered by marine policies, although the court failed to take into consideration the effect of §851 in reaching its conclusion.

Conversely, a Louisiana District Court held in 1990 that the Statute must be read as a whole and whilst the Legislature had initially expressed their intention to include marine insurance policies, it had subsequently expressed contrary intent by including §851¹³⁹. Consequently, it was held that ocean marine insurances, which include P&I policies, were excluded from the ambit of §851 and so third parties did not have a right of direct action against marine insurers.

The confusion surrounding §851 deepened when the opposite decision was made by the Louisiana Court of Appeal in the case of *Hae Woo Youn v. Maritime Overseas Corp.*¹⁴⁰. Here it was held that the general language of this exclusionary provision did not supersede the more specific wording of §1269, which allows a third party to proceed directly against all liability policies. Thus, since the court believed that P&I policies were liability policies, the third party could proceed directly against the P&I Club under the Statute.

The Supreme Court of Louisiana finally got a chance to address this issue in *Grubbs v. Gulf International Marine Co.*¹⁴¹. The court reviewed the history

¹³³ *Olympic Towing Corp. v. Nebel Towing Co.* 419 F.2d 230, 237 (5th Cir. 1969)

¹³⁴ See for example: *American Sugar v. Vainqueur Corp.* [1970] A.M.C. 405 and *Hae Woo Youn v. Maritime Overseas Corp.* 605 So.2d 187

¹³⁵ *Miller v. American Steamship S.S. Owners Mutual Protection & Indemnity Co.*, 509 F. Supp. 1047 – S.D.N.Y. (1984)

¹³⁶ Formerly La. Rev. Stat. Ann. § 22:611; the majority of case law therefore refers to this provision, rather than its identical successor.

¹³⁷ La. Rev. Stat. Ann. § 22:851 (A)

¹³⁸ *Cushing v. Maryland Cas. Co* 198 F.2d 536

¹³⁹ *Delaune v. Saint Marine Transportation Co.* 749 F.Supp. 1463

¹⁴⁰ *Hae Woo Youn v. Maritime Overseas Corp.* 605 So.2d 187

¹⁴¹ *Grubbs v. Gulf International Marine Co* 625 So.2d 495 (La.1993)

of the direct action statute, which dated back to 1918 and noted that this statute and other insurance laws were consolidated in 1948 into an insurance code. The insurance contract part of this new code encompassed much more than just the direct action statute, which was inserted into the code almost verbatim and it included the predecessor of §851. Thus, even though the original act applied to all liability policies between 1918 and 1948, the inclusion of §851 created a potential restriction.

The court held though that the Legislature had not shown any intention to restrict the scope of §1269 with the exception of §851. If the Legislature had truly wanted to restrict the scope of §1269, they would have taken legislative action following the decision in *Cushing v. Maryland Cas. Co.* Additionally, the language of §851 implies that it only applies to certain sections and it was held in *Giannouleas v. Phoenix Maritime Agencies Inc.*¹⁴² that the Direct Action Statute was not one of these. Consequently, the court concluded that due to the absence of legislative action, which indicated intent on behalf of the Legislature that it did not want to restrict the scope of §1269, and the language of §851, that the Statute permits all injured persons to have a right of direct action against all liability insurers, including P&I Clubs.

6.2.5 The Insurer's Defences

According to §1269(C), the insurer is entitled to all the defences he would be able to use against the insured. Conversely, case law has revealed that defences personal to the insured cannot be used by the insurer¹⁴³. Personal defences are granted to members of a specific class and prohibit a right of action where a cause of action would otherwise have existed¹⁴⁴. To use an example from case law, interspousal immunity applies to all married persons; hence all tort litigation between spouses during marriage is forbidden¹⁴⁵. Other examples of personal defences include governmental immunity¹⁴⁶, employee immunity¹⁴⁷ and insanity¹⁴⁸.

Moreover, the courts have held that the insurer may not be able to deny liability where the insured has failed to give suitable notice of a claim¹⁴⁹. The rationale behind this decision is that the Statute confers upon the third party a substantial right at the time of the incident and it would be contrary to public policy for this right to be defeated due to the actions of another party. It was alluded to in *West v. Monroe Bakery* that an insurer could

¹⁴² *Giannouleas v. Phoenix Maritime Agencies Inc.* 621 So.2d 1131 (La. App. 1st Cir. 1993)

¹⁴³ *Descant v. Administrators of the Tulane Educational Fund*, 639 So. 2d 246 (La. 1994)

¹⁴⁴ *ibid* at p. 250

¹⁴⁵ *Edwards v. Royal Indemnity Co.* 182 La. 171 (La. 1935)

¹⁴⁶ *Brooks v. Bass*, 184 So. 222 (La. Ct. App. 1938)

¹⁴⁷ *Liberty Mut. Ins. Co. v. State Farm Mut. Auto. Ins. Co.*, 579 So. 2d 1090 (La. Ct. App. 1991)

¹⁴⁸ *von Dameck v. St. Paul Fire & Marine Ins. Co.* 361 So.2d 283 (La. App. 1st Cir. 1978)

¹⁴⁹ *West v. Monroe Bakery* 46 So. 2d 122 (La. 1950)

successfully employ the defence of late notification if he himself were deprived of a substantial right¹⁵⁰.

It was further held in *Albany Insurance Co. v. Bengal Marine, Inc.*¹⁵¹ that the insured's failure to pay his deductible does not mean that the insurer can escape liability. The court once again relied upon the wording of §1269(A), which states that the insolvency of the insured does not release the insurer from liability. As a result, if the insured cannot pay his deductible on account of his insolvency, the insurer cannot reject liability.

With regards to limitation of liability, it was held in *Olympic Towing Corp. v. Nebel Towing Co.*¹⁵² that limitation was a defence personal to the insured, as it was only available to a certain class of persons, namely shipowners. This part of the judgment was overruled by the Fifth Circuit Court of Appeals in *Crown Zellerbach Corp. v. Ingram Industries*¹⁵³ as limitation is only available to certain shipowners in certain circumstances and therefore it cannot be considered a personal defence of the insured. The P&I Club in question could therefore rely on the limitation of liability defence in an action by a third party.

6.3 The New York Direct Action Statute and its Progeny

New York's Direct Action Statute operates in a very different manner from its Louisiana counterpart and the majority of States adhere to this model¹⁵⁴. The Statutes of these States require third parties to firstly obtain a judgment against the insured before they are entitled to direct action against the insurer¹⁵⁵. In addition to this, it is commonly provided that the judgment must be unsatisfied as a result of the insolvency of the insured before the third party can pursue the insurer¹⁵⁶. Moreover, the Statutes generally do not permit an insurer to join the insured in the initial proceedings¹⁵⁷, which means that two distinct proceedings are usually required under these types of Direct Action Statute.

Where an injured party's claim arises from death or personal injury however, if the insurer has disclaimed liability due to late notification, the injured party can proceed directly against the insurer without having first obtained a judgment against the insured¹⁵⁸.

¹⁵⁰ *ibid* at p. 130

¹⁵¹ *Albany Insurance Co. v. Bengal Marine, Inc.* 857 F.2d 250 (5th Cir. 1988)

¹⁵² *Olympic Towing Corp. v. Nebel Towing Co.* 419 F.2d 230 (5th Cir. 1969)

¹⁵³ *Crown Zellerbach Corp. v. Ingram Industries* 783 F.2d 1296 (5th Cir. 1986)

¹⁵⁴ Foster, *supra* note 118 at p. 281

¹⁵⁵ See for example N.Y. Ins. Law § 3420(b) (Mckinney 2010)

¹⁵⁶ See for example Pennsylvania: Pa. Stat. Ann. tit. 40, §117(Purdon, 2010)

¹⁵⁷ *State Farm Fire & Cas. Co. v. Reuter*, 700 P.2d 232 (Or. 1985)

¹⁵⁸ <http://www.stblaw.com/content/publications/pub719.pdf> (retrieved 06/05/2010)

On the other hand, similar to the Louisiana Direct Action Statute, the New York Statute provides in §3420(a)(1) that no liability policy may be issued in the State unless it contains a provision stipulating that the insolvency of the insured will not release the insurer from liability under the policy. Consequently, if the insured does not satisfy the relevant judgment, the insurer will not be able to deny liability. In other words, if the “no action” clause is not complied with, the third party will still be able to pursue the insurer.

When the third party commences a separate action against the insurer, he is deemed to be standing in the shoes of the insured¹⁵⁹. Consequently, the third party’s rights against the insurer are no greater than those of the insured under the policy and so the insurer may utilise any defence it would have been entitled to rely on had it been the insured who had brought an action against them¹⁶⁰. On the other hand, the insurer cannot rely on defences that are personal to the insured¹⁶¹.

With regards to late notification of claims, New York’s Direct Action Statute has recently been amended so that it is now more aligned with other States. It now provides that late notification does not entitle the insurer to reject the claim, unless he is prejudiced by the insured’s failure to provide timely notice¹⁶².

In terms of limits of recovery, it was held by the Supreme Court of Alabama that the third party cannot recover more than the amount of coverage provided in the insurance policy between the insurer and insured¹⁶³.

A crucial difference between the New York Statute and the Louisiana Statute is the coverage in respect of P&I insurance. Whilst Louisiana courts have ended years of confusion by declaring that P&I insurance is covered by the Direct Action Statute, the New York legislation has excluded P&I policies from its ambit¹⁶⁴. One commentator has observed that this exclusion exists in order to protect New York’s marine insurers¹⁶⁵.

The New York Direct Action Statute is therefore narrower in scope than its Louisiana equivalent. Courts in this State and States with similar Direct Action Statutes have refrained from blurring the distinction between indemnity and liability policies and unlike Louisiana, P&I policies have been construed as indemnity rather than liability policies.

¹⁵⁹ *Saxon v. U.S. Fidelity & Guar. Co.*, 153 A. 596 (N.J. 1931)

¹⁶⁰ *Hermance v. Globe Indemnity Co.* 221 A.D. 394, 223 N.Y.S. 93

¹⁶¹ *Bonde v. General Sec. Ins. Co. of Can.*, 285 N.Y.S.2d 675 (N.Y. Sup. Ct. 1967)

¹⁶² <http://www.stblaw.com/content/publications/pub719.pdf> (retrieved 06/05/2010)

¹⁶³ *Dumas Bros. Mfg. Co. v. Southern Guar. Ins. Co.*, 431 So. 2d 534 (Ala. 1983)

¹⁶⁴ See Foster, *supra* note 118 at p. 285 and *Ahmed v. American S.S. Mut. Protection & Indemnity Ass’n*, 640 F.2d 993 (9th Cir. 1981)

¹⁶⁵ See Foster, *supra* note 118 at p. 286

6.4 Direct Action in Other States

As stated above, the variation in the attitudes of States towards direct action is considerable. Wisconsin's Direct Action Statute follows the Louisiana model, in view of the fact that it does not require insolvency of the insured before a third party can proceed directly against the insurer and it provides that the third party need not join the insured in proceedings against the insurer¹⁶⁶. California on the other hand, has adopted legislation that is more akin to the New York Statute, as their Direct Action Statute requires judgment against the insured before the third party can recover from the insurer¹⁶⁷.

Florida has not adopted a Direct Action Statute, but it does recognise a third party's right of action against the insurer in its case law¹⁶⁸. Various other States allow direct action, but in very restricted circumstances¹⁶⁹. Several other States such as Alaska, Arizona and Illinois completely reject the notion of the third party's right of direct action¹⁷⁰. Curiously, public policy is the principal reason why some States forbid direct action against the insurer - it is claimed that if juries were to discover that the tortfeasor was insured, there is a possibility that they will award a larger verdict to the injured third party¹⁷¹.

¹⁶⁶ Wis. Stat. Ann. § 632.24 (West 2010)

¹⁶⁷ Cal. Ins. Code § 11580(b)(2) (West 2009)

¹⁶⁸ Foster, *supra* note 118 at pp. 286-287

¹⁶⁹ See for example New Mexico: *Raskob v. Sanchez*, 970 P.2d 580 (N.M. 1998); Illinois: *Richardson v. Economy Fire & Cas. Co.*, 467 N.E.2d 317 (Ill. App. Ct. 1984), *rev'd*, 485 N.E.2d 327 (Ill. 1985)

¹⁷⁰ Alaska: *Evron v. Gilo*, 777 P.2d 182 (Alaska 1989); Arizona: *Nationwide Mut. Ins. Co. v. Arizona Health Care Cost Containment Sys.*, 803 P.2d 925 (Ariz. Ct. App. 1990)

¹⁷¹ See for example the Illinois case of *Zegar v. Sears Roebuck and Co.* 570 N.E.2d 1176

7 Direct Action and International Conventions

7.1 The International Convention on Civil Liability for Oil Pollution Damage 1992

The IMO has developed a number of liability conventions over the years which are aimed at making the shipowner strictly liable for certain misdemeanours and providing adequate compensation to those who have suffered damage from such transgressions. The most notable of these conventions is the International Convention on Civil Liability for Oil Pollution Damage 1992 (hereinafter “CLC 1992”), which makes the shipowner strictly liable for oil pollution damage from tankers¹⁷².

The CLC 1992 also creates a system of compulsory liability insurance for tankers carrying in excess of 2,000 tonnes of oil as cargo¹⁷³. Where pollution damage occurs, the shipowner is liable to the injured party in accordance with Article III. The injured third party need not bring the claim against the offending shipowner though; Article VII(8) allows the third party to bring a claim directly against the insurer who covers the shipowner’s liability for pollution damage.

For ease of reference, the entire text of Article VII(8) will be reproduced below:

Any claim for compensation for pollution damage may be brought directly against the insurer or other person providing financial security for the owner’s liability for pollution damage. In such case the defendant may, even if the owner is not entitled to limit his liability according to Article V, paragraph 2, avail himself of the limits of liability prescribed in Article V, paragraph 1. He may further avail himself of the defences (other than the bankruptcy or winding up of the owner) which the owner himself would have been entitled to invoke. Furthermore, the defendant may avail himself of the defence that the pollution damage resulted from the wilful misconduct of the owner himself, but the defendant shall not avail himself of any other defence which he might have been entitled to invoke in proceedings brought by the owner against him. The defendant shall in any event have the right to require the owner to be joined in the proceedings.

Article VII(8) elaborates on the direct action procedure by stating that even if the pollution damage resulted from the shipowner’s wilful misconduct¹⁷⁴, the insurer can still rely on the liability limits contained in Article V(2).

¹⁷² Article III, CLC 1992

¹⁷³ Article VII, CLC 1992

¹⁷⁴ Defined by Article V(2) as a “personal act or omission, which was committed with the intent to cause such damage, or recklessly and with knowledge that such damage would probably result”

Furthermore, the insurer can rely on any of the defences that the insured shipowner could employ in an action against an injured party. The insurer cannot however draw on any of the defences it would have been able to use against the insured in an action by a third party, with the exception of wilful misconduct. Finally, the insurer can compel the shipowner to be joined in the proceedings.

It is relevant to note though that if the insurer relies on the defence of wilful misconduct, the insurer may avoid the policy and therefore not pay out at all to the injured third party. If this is the case or if the third party fails to obtain full satisfaction of their claim from the insurer who has limited their liability in accordance with the CLC, the third party is entitled to compensation under the 1992 Fund Convention¹⁷⁵ and the 2003 Supplementary Fund Protocol¹⁷⁶ if the third party has still not been able to obtain full and adequate compensation under the Fund Convention. Thus, the injured third party is extremely well protected in the event of oil pollution as it has recourse to two Funds if direct action against the insurer does not yield full compensation.

The overall outcome of Article VII(8) is that in cases of oil pollution damage the injured party has the discretion to directly pursue the insurer who covers the shipowner's liability for such damage. Liability for oil pollution damage is customarily covered by P&I Clubs¹⁷⁷ and so the vast majority of the insurance procured by the relevant shipowners will be from the Clubs. The CLC 1992 therefore permits a third party to proceed directly against a P&I Club.

What are the consequences therefore of the third party having a right of direct action under the CLC 1992? There are several key points to be remarked upon. Firstly, there is no insolvency requirement. Secondly, there is no requirement that the third party establishes and quantifies the liability of the insured shipowner before pursuing the insurer. Finally, if the insurer cannot rely on any of his policy defences except for wilful misconduct, is it to be assumed that the "pay to be paid" Rule is dispensed with?

The Merchant Shipping Act 1995 (hereinafter referred to as "MSA 1995"), which implements the CLC 1992¹⁷⁸, clarifies the situation. According to s.165(5) of the Act, the Third Parties (Rights against Insurers) Act 1930¹⁷⁹ does not apply in relation to contracts of insurance that are compulsory under the CLC 1992. It is therefore apparent that there is no overlap between the CLC 1992 and the 1930 Act. Consequently, the MSA 1995

¹⁷⁵ Article 4, International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage 1992

¹⁷⁶ Article 4, Protocol 2003 to the International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage 1992

¹⁷⁷ See Rule 19(13) North of England P&I Club; Rule 9.15 London P&I Club; and Rule 19(12) Britannia P&I Club

¹⁷⁸ ss. 152-171, Merchant Shipping Act 1995

¹⁷⁹ This section will clearly be amended shortly to take into account the enactment of the 2010 Act.

nullifies the “pay to be paid” Rule in respect of claims for oil pollution damage from injured third parties.

7.2 Other IMO Conventions

The inclusion of articles providing for direct action against insurers is an increasingly popular trend in IMO Conventions. As well as featuring in the CLC 1992, virtually identical provisions appear in: the International Convention on Civil Liability for Bunker Oil Pollution Damage 2001 (Bunkers Convention 2001)¹⁸⁰; the International Convention on Liability and Compensation for Damage in connection with the Carriage of Hazardous and Noxious Substances by Sea 1996 (HNS Convention 1996)¹⁸¹; the Athens Convention Relating to the Carriage of Passengers and their Luggage by Sea 2002 (Athens Convention 2002)¹⁸²; and the Nairobi International Convention on the Removal of Wrecks 2007 (Nairobi Convention 2007)¹⁸³.

Out of these, only the Bunkers Convention 2001 is currently in force¹⁸⁴, although an earlier version of the Athens Convention 2002 is still in force, but it does not contain a direct action provision¹⁸⁵. The MSA 1995 treats the direct action provision in the Bunkers Convention in exactly the same way as its CLC counterpart; that is to say, the 1930 Act will not apply to insurance policies that are mandatory under the 2001 Convention¹⁸⁶.

Since bunker oil falls within the scope of P&I coverage¹⁸⁷, the Bunkers Convention also allows a third party to proceed directly against a P&I Club. Moreover, if the three other aforementioned Conventions were to enter into force, P&I coverage would encompass the various types of liabilities addressed by these Conventions¹⁸⁸. Whether or not these Conventions will ever enter into force is still to be seen, but if they do and the U.K. ratifies them, P&I Clubs will be subject to an increasing number of direct actions. Thus, the protection that the “pay to be paid” Rule supposedly affords to the Clubs will be severely diminished.

¹⁸⁰ Article 7(10), Bunkers Convention 2001

¹⁸¹ Article 12(8), HNS Convention 1996

¹⁸² Article 4*bis*(10), Athens Convention 2002

¹⁸³ Article 12(10), Nairobi Convention 2007

¹⁸⁴ www.imo.org (retrieved 16/04/10)

¹⁸⁵ Protocol to Athens Convention 1976

¹⁸⁶ s. 165(5)

¹⁸⁷ See Rule 19(13) North of England P&I Club; Rule 9.15 London P&I Club; and Rule 19(12) Britannia P&I Club

¹⁸⁸ See for example Britannia P&I Club, Rules 19(2), 19(12) and 19(13)

8 Analysis

From the foregoing discussion, it has been demonstrated that the “pay to be paid” Rule is an integral component of P&I insurance in England. It has a long and chequered history and its operation has been far from straightforward. This turbulent history is illustrated by the disputes centring on the way in which a Member discharges its liability and countless clashes with the 1930 Act.

It has been held in the House of Lords that the “pay to be paid” Rule is not negated by the 1930 Act¹⁸⁹, despite it being a clear hindrance to a third party’s recovery. Thus, whenever a Club Member becomes insolvent and has incurred a liability to a third party, rights can be transferred under the 1930 Act but they are in practice unenforceable.

From a third party’s perspective, this is obviously a highly undesirable outcome. The reasoning behind the enactment of the 1930 Act was to protect third parties in the event of a liable party’s insolvency. If an insolvent Club Member cannot pay a third party, the third party fails to be protected by the 1930 Act. The third party therefore becomes an ordinary creditor in respect of the general assets of the insolvent party – the exact type of predicament that the 1930 Act aims at avoiding.

It is well-established that the third party cannot be in a better position than the insured and that if the insured cannot recover from the insurer, neither can the third party. This maxim protects the insurer, as a supposed inequity would occur if as a result of the insured’s insolvency he were to be in a worse position than he would be in under normal circumstances.

It therefore seems to be the case that law-making in this area is a delicate balancing act with the protection of insurers on one scale and the protection of injured parties on the other. As the law stands third parties are adversely affected by the “pay to be paid” Rule, thus if any action was taken to rectify the situation, it would be to the third parties’ advantage. Since the P&I Clubs would be deprived of the “pay to be paid” Rule in this hypothetical scenario, it would consequently be prudent to assess how important the Rule is to P&I Clubs and whether the Clubs could function without it.

The financial probity argument put forth in *The Fanti and The Padre Island* essentially suggests that the Rule features in P&I policies to ensure that Club Members only pay out in situations where the authenticity of the claims is beyond doubt. Thus, the Members will only pay out if the claim is genuine, which protects both the Club and the Members from paying out fraudulent claims.

¹⁸⁹ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti) and Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island")* (No.2) [1991] 2 A.C. 1

This method also prevents Members abusing the insurance system, either by keeping part or all of the insurance pay-out for themselves. Such impropriety is not inconceivable, especially if a Member is struggling financially. As a result, since the Members contribute to the Club fund through payment of their calls, they are accordingly concerned as to how the fund is distributed, particularly if the calls have to increase the following year due to large pay-outs.

Conversely, as it was demonstrated above, P&I Clubs can waive the “pay to be paid” Rule. The discretion of the P&I Club Committee to waive the Rule is often found within the Rules and it is used in a variety of circumstances. These situations range from out-of-court settlements if the Member is in danger of an unfavourable court decision, to the issuance of letters of undertaking if an entered vessel is arrested to where the Club takes the place of the Member where the claim is considerable in size.

The “pay to be paid” Rule is therefore not strictly applied in every instance and in two of the situations outlined above, it appears that the P&I Club interferes with the claim in order to avoid a detrimental outcome for the Club. It can be inferred that when the stakes are high, the Club takes it upon itself to ensure that the pay-out is kept as low as possible by disregarding the requirement of prior payment.

Consequently, in relation to small claims, of which there could be dozens in any one year, the Rule seems to apply without exception in order to prevent Members from manipulating Club funds, but in relation to large claims, the application of the Rule is less strict. The Rule is therefore important in providing an effective defence to the P&I Club, even if it is waived for larger claims, but in those situations the Club is only intervening with the best interests of itself and its Members in mind.

On the other hand, it has been observed that this Rule may not be crucial in the everyday administration of the Club and that a high quality of Club membership and management would be more beneficial to the Club¹⁹⁰. This is obviously an ideal scenario for any insurer-assured relationship. This author submits though that from a Club’s perspective, the Rule is very effective in practice and it is evident that the Clubs are reluctant to dispose of this Rule any time soon. Put simply, losing the Rule would remove a vital buffer against false claims from third parties and manipulation of Club funds by Members.

From a Member’s standpoint, if they truly believe that the Rule is the best way in which to guarantee that fellow Members do not abuse the indemnification system, then the Rule is indeed an indispensable element of P&I policies.

¹⁹⁰ Mance, J., *Insolvency at Sea* [1995] L.M.C.L.Q. 34 at pp. 45-46

In the light of the fact that the P&I Clubs and Club Members seem to favour the inclusion of the Rule into P&I policies, this does not bode well for the injured third parties in the event of the insolvency of a Club Member. It has already been demonstrated how the failure by a Member to satisfy the “pay to be paid” condition will be fatal to a third party claim.

Failure to satisfy a claim suggests that the Member has not paid in full. However, if the insolvent Member has only paid the third party a portion of the claim, it was initially uncertain whether the Member would be entitled to indemnification. The drafters of the 1930 Act had not envisaged such a possibility and so the Act is silent on partial payment of the claim. On the other hand, Club Rules now frequently state that the Member must pay his liabilities in full before he can be indemnified¹⁹¹. Accordingly, anything less than full satisfaction of the claim will not entitle a Member to indemnification.

This Club Rule therefore neutralises the scheme envisaged by Mance, whereby a Club Member could pay part of his liability to the third party, before recovering the amount of such payment from the Club and using this indemnification to pay the third party again. The Member could employ this method repeatedly until the third party is paid in full and the Member itself has been fully indemnified¹⁹².

Since the insolvent Club Member will be out of pocket if he only partially pays the third party claim, it can be deduced that a Member would rather either pay the third party in full or not pay out at all. In these two scenarios the Member will not be worse off, because if it pays the third party in full he will be indemnified and if he fails to pay, the third party will elect to proceed against the insurer, although in its current state the law will prevent the third party from being successful.

Where the Member is insolvent therefore, it is in the interests of the third party to devise a strategy to circumvent the “pay to be paid” Rule in order to ensure that the Member pays in full. A scheme of this nature appeared in the American case of *Arthur Liman v. American Steamship Owners*¹⁹³ and was contemplated by Slade J. in “*The Allobrogia*”¹⁹⁴. Both situations entailed the Member borrowing money to discharge the liability, which satisfies the third party’s claim and fulfils the Member’s condition precedent to indemnification.

P&I Clubs felt that discharging liabilities in this way contravened the principle of indemnity¹⁹⁵ and regrettably for the third parties, Clubs responded to such schemes by requiring liabilities to be discharged through

¹⁹¹ See for example Rule 3.1.1 of London P&I Club

¹⁹² Mance, *supra* note 187 at p. 47

¹⁹³ *Arthur Liman v. American Steamship Owners Mutual P&I Association* [1969] A.M.C. 1669

¹⁹⁴ *Re Allobrogia Steamship Corp* [1979] 1 Lloyd's Rep. 190 at p. 197 *per* Slade J.

¹⁹⁵ Hazelwood, *supra* note 2 at p. 352

the Member's own funds and not through loans. Consequently, if a scheme is to be devised, it cannot entail a loan to the Member.

Perhaps the third party would therefore be wiser to arrest a ship belonging to the Member as security for their claim. This is possible by commencing an action *in rem* under ss. 20(2) and 21(4) of the Supreme Court Act 1981. Arresting a vessel is a pre-judgment action aimed at providing security to the injured party, so that if the liable party fails to satisfy the judgment, the judgment can be satisfied through the sale of the vessel.

The arrest may also serve as a device to bring the shipowner to court to defend the claim. In this scenario, the shipowner will want to release the ship for obvious commercial reasons and in order to do so he can ask his P&I Club to issue a letter of undertaking. Accordingly, if a ship is arrested, the Club may well waive the "pay to be paid" Rule and issue a letter of undertaking, which will guarantee that the Club will pay out if the Member is found liable. An added bonus of arresting the ship is that the ship or letter of undertaking will be immune from "*the consequences of any future events affecting the financial solvency of the Member*",¹⁹⁶. Consequently, where the third party elects to arrest a vessel of the Member, the insolvency of the Member will not be an unassailable obstacle to the third party's claim.

Indeed, it is suggested by Mance that the practical implications of *The Fanti and The Padre Island* will result in arrests by third parties becoming a more common occurrence¹⁹⁷ and this author agrees to an extent with this view based on the preceding discussion. However, the efficacy of arrest very much depends on the jurisdiction in which the Member's vessel is located. Furthermore, if the P&I Club does not provide a letter of undertaking and the vessel is consequently sold to satisfy the third party claim, the proceeds are distributed amongst the insured's creditors¹⁹⁸. Although the third party is a secured creditor in this scenario, he is still not guaranteed full satisfaction of his claim¹⁹⁹.

Nevertheless, taking into consideration how difficult it is for an injured third party to recover anything when the Club Member is insolvent, it would appear that arresting a Member's vessel may well be the most efficient method of circumventing the "pay to be paid" Rule.

In spite of this possible evasion of the "pay to be paid" Rule, it seems in general to be a strong and effective defence for the Club. Given the strength

¹⁹⁶ Wilson, J. F., *Carriage of Goods By Sea* (6th edition) 2008, Essex, U.K.: Longman/Pearson at p. 324

¹⁹⁷ Mance, *supra* note 187 at p. 47

¹⁹⁸ Baughen, S. *Shipping Law* (4th edition) 2009, London; New York: Routledge-Cavendish at p. 408

¹⁹⁹ The third party claim may be outranked by other claims. The priority of maritime claims depends on the jurisdiction, but see generally the International Convention on Maritime Liens and Mortgages 1993. For the U.K. position, see Tetley, W., *Arrest, Attachment, and Related Maritime Law Procedures* (1999) 73 Tul. L. Rev. 1895 at pp. 1909-1911

of the Rule therefore, is there a danger that liability insurers will “*drive a coach and horses through the Act*”²⁰⁰ by including “pay to be paid” Clauses into their policies? Lord Goff dismissed the concerns of Stuart-Smith in the Court of Appeal by saying that if liability insurers were to incorporate the “pay to be paid” provision to defeat third party claims, their policies would be less marketable, so it would be extremely doubtful that liability insurers would take such action²⁰¹.

Additionally, Hirst J. in *The Italia Express*²⁰² said the “pay to be paid” Rule would be “*entirely inappropriate*” outwith the P&I environment. This view however does not take into account a fundamental clause found in hull and machinery insurance policies – the 3/4ths Collision Liability Clause²⁰³. According to this Clause, the insurers will indemnify the assured for three-fourths of any sum paid by the assured to any person as a result of the assured being liable for damages resulting from a collision.

It was also revealed in the 2001 Report regarding the reform of the 1930 Act, that some consultees believed that “pay to be paid” Clauses are used more frequently by mutual insurance companies²⁰⁴. This is hardly surprising given that the defence has proven to be virtually indestructible where the insured is insolvent. It therefore appears to be the case that the concerns of Stuart-Smith J. have been realised somewhat and that third parties will continue to suffer if this practice continues.

The subsequent realisation of fears that liability insurers may insert “pay to be paid” clauses to defeat third party claims was one of the many issues addressed by the Commissions in the aforementioned Report on the reform of the 1930 Act. The reform of the 1930 Act had been on the legislative agenda for over a decade and with new legislation imminent, third parties were optimistic that the law would be modified to their advantage. The 2010 Act became law in March 2010.

The new legislation is more favourable towards third parties, as it simplifies the establishing of liability procedure, it provides a much clearer and broader right to information relating to the insurance policy under which the insured is liable, it applies irrespective of any foreign element to the claim and the insurer is deprived of certain defences which he would ordinarily be

²⁰⁰ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti) and Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island")* (No.2) [1989] 1 Lloyd's Rep. 239 at p.259 per Stuart-Smith J.

²⁰¹ *Firma C-Trade SA v. Newcastle Protection and Indemnity Association (The Fanti) and Socony Mobil Oil Co. Inc. and Others v. West of England Ship Owners Mutual Insurance Association Ltd (The "Padre Island")* (No.2) [1991] 2 A.C. 1 at p. 39 per Lord Goff

²⁰² *The Italia Express* [1992] 2 Lloyd's Rep. 281 at p. 298 per Hirst J.

²⁰³ See Clause 6.1 Institute Voyage Clauses Hulls 1995, Clause 8.1 Institute Time Clauses Hulls 1995 and Clause 6.1 International Hull Clauses 2003

²⁰⁴ Law Commission and Scottish Law Commission Report 2001 on Third Parties - Rights Against Insurers (Law Com. No. 272) (Scot Law Com, No. 184), July 2001, Cm 5217, SE/2001/134 at p. 69 fn. 44

allowed to rely upon if it was the insured that brought the action against him.

One of these defences that the insurer cannot rely on is the condition of prior payment²⁰⁵, although this condition precedent is still a valid defence in a contract of marine insurance, except in cases of personal injury and death²⁰⁶. Thus, the Act preserves the House of Lords decision in *The Fanti and The Padre Island*, whilst at the same time restricts the applicability of the defence to contracts of marine insurance, allaying the fears expressed in the Court of Appeal by Stuart-Smith J. in the abovementioned case.

Nevertheless, a third party still faces a grim outcome if an insolvent Club Member is liable to him, unless the claim involves death or personal injury. From a third party's viewpoint, this was one of the great injustices of the 1930 Act, so it is rather surprising that the U.K. Legislature failed to rectify this shortcoming. As mentioned above, the U.K. Legislature refrained from extending s.9(5) to all insurance policies as the Law Commissions were concerned that they would propose legislation which would be inconsistent with future international Conventions.

It is disappointing that the Commissions failed to extend what eventually became s.9(5) to all insurance contracts, especially as they explicitly stated their approval of the Court of Appeal's decision in *The Fanti and The Padre Island*. This case directly concerned third parties proceeding against P&I Clubs after being vested with the rights of the Member by virtue of the 1930 Act. Yet the only instances under the new statute where an insurer can still rely on the "pay to be paid" Rule are where the contracts are marine insurance policies.

The Commissions attempt to justify their decision by stating that they do not want to create a provision that will clash with a forthcoming international convention. This is somewhat strange, because by leaving the law relating to the "pay to be paid" Rule in marine insurance contracts in its current format, they are actually proposing a provision inconsistent with the present international liability regime. Examining the most recent liability conventions created under the auspices of the IMO prior to 2001, that is to say the CLC 1992 and the HNS 1996, it is observed that both contain Articles permitting the third party to pursue the insurer directly, without the need for the insured to be insolvent and without the need to establish or quantify liability. Thus, it is clear that the Commissions did precisely the opposite of what they intended to do. This type of Article is becoming increasingly popular in liability conventions, so this author finds it difficult to believe that the Committees and the U.K. Parliament did not recognise this trend.

It is also difficult to fathom that no U.K. representative at the IMO knew what might happen with the conventions being negotiated in the various

²⁰⁵ s.9(5), 2010 Act

²⁰⁶ s.9(6), 2010 Act

IMO Committees and Sub-Committees. If the subsequent liability conventions had not contained a direct action provision, then this author could see some credibility in the Commissions' argument. As it transpired though, the conventions did contain direct action articles, so a U.K. representative would have more than a mere inkling that this was on the agenda.

Furthermore, there is no guarantee that the U.K. will ratify these conventions, even though it is in the interests of the global community for the U.K. to do so. If the U.K. does not ratify and the courts choose not to apply the provisions of the conventions, they will have no effect there. On the other hand, if the U.K. was to ratify the conventions, this author proposes that the Legislature should simply amend the relevant implementing statute to rectify any provision inconsistent with the conventions.

When the U.K. implemented the CLC 1992 for example, a provision was inserted into the Merchant Shipping Act 1995 that stipulated that the 1930 Act would not apply to the provisions relating to direct action against insurers²⁰⁷. Moreover, when the U.K. implemented the Bunkers Convention 2001, s. 165 of the MSA 1995 concerning the non-applicability of the 1930 Act to liabilities within the scope of the CLC 1992 was expanded by Statutory Instrument to include liabilities covered by the 2001 Convention²⁰⁸. Although this was one of the Conventions being formulated at the time of the Commissions' Report, it illustrates that the U.K. Legislature can take appropriate action to modify the domestic law in order to comply with international regulations if the need arises.

It is still unclear therefore why the U.K. Legislature failed to extend s.9(5) of the 2010 Act to P&I insurances. Perhaps it was worried that more P&I Clubs would follow in the footsteps of the West of England P&I Club and the Shipowners' P&I Club by departing the jurisdiction and incorporating overseas²⁰⁹. Perhaps the Clubs themselves lobbied for the retention of the Rule. In any event, the Rule still exists in U.K. domestic law, much to the chagrin of third parties.

Nevertheless, maybe there is some hope for the third parties by virtue of the marine liability conventions being generated at international level. It has already been demonstrated that Article VII(8) of the CLC 1992 permits direct action against the insurer and that similar provisions are contained within four other IMO Conventions. The U.K. has ratified the CLC 1992 and the Bunkers Convention 2001, so they have force of law within the jurisdiction. The other three Conventions (the HNS Convention 1996, the

²⁰⁷ s. 165(5), Merchant Shipping Act 1995

²⁰⁸ Statutory Instrument SI1244 Regulation 19(8)

²⁰⁹ Both incorporated in Luxembourg: <http://www.westpandi.com/WestPandi/ClubProfile/> (retrieved 01/05/2010) and <http://www.shipownersclub.com/about-us/history-of-the-club> (retrieved 01/05/2010)

Athens Convention 2002 and the Nairobi Convention 2007) have neither been ratified by the U.K. nor are they in force globally.

If the U.K. ratifies the abovementioned Conventions, the substance of the Conventions will be incorporated into U.K. domestic law. Thus, it is conceivable that the U.K. will permit direct action in relation to liabilities arising from the spillage of hazardous and noxious substances, wreck removal and injury to passengers and damage to their luggage. Since these liabilities are generally covered by P&I Clubs²¹⁰, the Clubs would find themselves being subject to direct actions from third parties. As a result, they would not be able to rely on the “pay to be paid” Rule.

It is therefore apparent that the effect of the Rule is gradually being eroded by international liability regimes, even though the U.K. has yet to ratify three of the principal conventions²¹¹. Nevertheless, allowing third parties to pursue insurers in cases of crude and bunker oil pollution by implementing the CLC 1992 and the Bunkers Convention 2001 respectively is a significant setback for Clubs and the “pay to be paid” Rule. Unfortunately, for the Clubs, their discontent will be exacerbated should the U.K. opt to ratify additional liability conventions.

It is worth noting though that these IMO Conventions generally provide that the shipowner is strictly liable for the various offences covered, with the notable exceptions of loss or damage to luggage and injury or death to passengers not caused by a shipping incident under the Athens Convention 2002²¹². Fault-based liabilities are therefore not normally found in IMO Conventions. Thus, it is highly improbable that fault-based liabilities, such as collision liabilities, will be covered by future IMO Conventions. As a result, P&I Clubs will not be subject to international regulations permitting direct action against them in relation to fault-based liabilities.

Nonetheless, the relatively recent trend of incorporating direct action provisions into liability conventions indicates that any future liability conventions would include similar provisions. The international community now recognises that compulsory insurance provisions are extremely beneficial for the injured claimant as they ensure that compensation will be available should the insured incur a liability. Consequently, it has been observed that the social function of insurance has changed in the last twenty years; the predominant view now is that insurance proceeds are more for the benefit of injured parties rather than the insured²¹³.

²¹⁰ See for example Britannia P&I Club, Rules 19(2), 19(12) and 19(13)

²¹¹ The U.K. is a signatory though of the HNS Convention 1996 and the Athens Convention 2002: http://www.imo.org/includes/blastDataOnly.asp/data_id%3D28080/Status-2010.pdf (retrieved 01/05/2010)

²¹² Article 3, Athens Convention 2002

²¹³ Soyer, B., *Sundry Considerations On The Draft Protocol To The Athens Convention Relating To The Carriage Of Passengers And Their Luggage By Sea 1974* [2002] 33 JMARLC 519 at p. 528

This does not augur well for P&I Clubs, but in this author's opinion this change in outlook has the potential to remedy a great injustice being suffered by third parties in the U.K. when a liable insured becomes insolvent. The aforementioned Commissions refer to Viscount Goschen's view that direct action against insurers in the context of marine insurance should be achieved through international agreement²¹⁴. In spite of this, since it is abundantly clear that there is a desire both at international level and at domestic level for direct action against insurers, perhaps the U.K. government could take legislative action in the arena of marine insurance.

A number of the States in the U.S. have introduced legislation allowing injured third parties to pursue the insurer directly and the U.K. could look to the U.S. for inspiration in this area. In Louisiana for example, it was noticed as early as 1918 that liability insurers were inserting "no action" clauses into policies in order to make it virtually impossible for a third party to claim where the insured was insolvent. The Louisiana Legislature therefore enacted the Louisiana Direct Action Statute to combat this practice.

The Statute stipulates that a right of direct action will exist in insurance policies and that the insolvency of the insured will not release the insurer from liability²¹⁵. Consequently, the insurer cannot reject liability where the insured has been unable to pay out to the third party. It was held in the Fifth Circuit Court of Appeals that the underlying principle of direct action is the public policy of Louisiana; namely that insurance is issued for the protection of the public rather than the insured²¹⁶. Case law from the Louisiana courts has also revealed that the third party need not establish liability first before pursuing the insurer and that the insured need not be insolvent²¹⁷.

The Louisiana Direct Action Statute therefore has far-reaching third party rights, which has resulted from a firm belief in the principle of public policy. As admirable as that stance is, it does seem slightly harsh on the insurers, especially when the insurer's limited defences are taken into account. Fortunately for the insurers they can only be sued alone in limited circumstances, such as insolvency, so the majority of times they are joined with the insured in the proceedings. This prevents the insurers single-handedly facing innumerable claims from third parties, whose claims may have no basis and who could easily pursue the solvent insured instead.

Alternatively, the New York Direct Action Statute model adopts a more conservative approach. These Statutes generally require the third party to obtain a judgment against the insured and if it is unsatisfied, only then will the third party be able to proceed directly against the insurer²¹⁸. However, the Statutes still allow third parties to claim against the insurer, even if the

²¹⁴ 2001 Report, p. 62

²¹⁵ La. Rev. Stat. Ann. § 22:1269

²¹⁶ *Olympic Towing Corp. v. Nebel Towing Co.* 419 F.2d 230 (5th Cir. 1969)

²¹⁷ *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541 (5th Cir. 1983)

²¹⁸ N.Y. Ins. Law § 3420

insolvency of the insured has prevented him from discharging his liability to the third party²¹⁹. This means that the insurer cannot rely on the “pay to be paid” Rule.

Furthermore, by excluding P&I policies from the scope of the Direct Action Statute, the application of the Statute is narrower than that of Louisiana. Similar to their Louisiana counterparts however, New York courts do not allow the insurer to rely on defences personal to the insured, although they can rely on any of the defences, other than the “pay to be paid” Rule of course, that would have been available to them were the insured to bring an action against them.

The New York Direct Action Statute is thus more similar to the U.K. approach. The prior judgment requirement is identical to the U.K. position before the 2010 Act became law and New York’s stance in relation to P&I policies parallels the U.K. approach. On the other hand, the insurer can in general avail himself of more defences in the U.K. than in New York – the “pay to be paid” Rule being the most notable of these defences.

The abovementioned States and other States who have adopted Statutes similar to one of these models, with the notable exception of the State of New York, have relied very heavily on the public policy principle when shaping their legislation. It is abundantly clear that the protection of the injured party is paramount in importance and the States in question are well aware of the vulnerability of the third party, particularly when the tortfeasor becomes insolvent. The rights of the insurers are curtailed as a result, although the American P&I Club, which is based in New York, is able to rely on the “pay to be paid” Rule due to P&I insurance being excluded from the ambit of New York’s Direct Action Statute²²⁰.

Thus, the Legislatures of these States have gone to great lengths to protect the *bona fide* third party, with the effect in some States being the transformation of P&I policies into liability policies. This is by no means the end of the world for P&I Clubs; the legislation essentially deprives them of one safeguard against false claims. If the U.K. Legislature were to focus their concentration more on the parties injured by the actions of the insured, rather than the insurer, then it is possible that legislation will be enacted to protect the third party in cases of marine insurance.

²¹⁹ N.Y. Ins. Law § 3420(a)

²²⁰ See Rule 4.28 of the American P&I Club Rules: <http://www.american-club.com/index.cfm?objectId=38C2DD8B-1185-12E0-571977601905E0CF> (retrieved 14/05/2010)

9 Conclusion

Unfortunately, the new 2010 Act was an ideal opportunity to permit direct action against insurers in the realm of marine insurance and yet all other forms of insurance were covered. In the opinion of this author, the U.K. need not go as far as Louisiana and permit any third party with a claim to pursue the insurer, regardless of whether or not the insured is insolvent. The new system introduced by the 2010 Act simplifies the proceedings against the insurer and is thus preferable to the multiple proceedings approach favoured by the New York Direct Action Statute.

The U.K. Parliament cannot afford to wait for the newly formed Supreme Court to overrule the House of Lords decision in *The Fanti and The Padre Island*. The function of insurance is changing. This is abundantly clear from the enactment of protective Direct Action Statutes by a number of U.S. States and the international conventions being generated under the auspices of the IMO. The U.K. must accept this fact and adjust its legislation accordingly. If legislative action is not taken, third parties will continue to suffer.

As U.K. law currently stands, it is directly in conflict with three IMO liability Conventions. If the U.K. decides to ratify these Conventions, the law will need to be amended. Additionally, since future liability Conventions will contain a similar direct action provision, this author recommends that the U.K. Legislature should rectify a major inadequacy of the 1930 Act that was highlighted in *The Fanti and The Padre Island*.

The justification put forward by the Commissions for refusing to extend the prohibition on insurers relying on the “pay to be paid” Rule simply does not make any sense. Despite stating that they do not want to enact legislation that is contrary to international Conventions, by maintaining the *status quo* with regards to marine insurers and the “pay to be paid” Rule, U.K. domestic law is at a variance with international law.

It would be reasonable to assume that any legislative action by the U.K. Parliament would entail merely extending s.9(5) of the 2010 Act to marine insurance contracts and the total abolition of s.9(6). The defences available to the insurer under the Act would therefore be preserved. Consequently, P&I Clubs could still avail themselves of any defences available to the insured and any defences available to themselves if it were the insured that brought the action against them, unless the third party has satisfied a condition that the insured had failed to satisfy or the failure of the insured to provide information was a result of the death or dissolution of the insured.

The U.K. may not adopt this approach however. If this is the case, the number of defences at the disposal of the Clubs may vary considerably

depending on what approach the U.K. does actually take when prohibiting the use of the “pay to be paid” Rule in marine insurance policies. In the IMO Conventions the insurer is only allowed to rely on the defences of wilful misconduct in addition to the insured’s defences against the third party, although the insurer can limit his liability in accordance with the limits set forth in the Conventions. The U.S. Direct Action Statutes that have been examined also severely limit the insurer’s defences. The 2010 Act therefore, while limiting the insurer’s defences to an extent, is more insurer-friendly than these two examples.

If the U.K. Legislature is worried about having domestic legislation that may clash with Conventions though, then perhaps the defences will be limited to those enumerated in the Conventions; that is to say wilful misconduct, limitation of liability and defences of the insured. This author finds it difficult to see the U.K. restricting the insurer’s defences as much as the U.S. States of Louisiana and New York, so in reality it is a choice between the approaches of the Conventions or the 2010 Act.

As a result of any modification to the law, the P&I Clubs will lose their renowned “pay to be paid” Rule where a Club Member is insolvent. On the other hand, the Rule can still be utilised to protect the Club against financial impropriety by Members, albeit in relation to smaller claims, as the Club will in all likelihood waive the prior payment requirement with regard to large claims.

An additional consequence of losing the “pay to be paid” Rule would mean that P&I policies in essence become liability policies in relation to third party claims. This is a small sacrifice by the Clubs, but they are not entering unfamiliar territory. In the U.K., P&I policies are in reality liability policies if the third party claim concerns oil pollution, bunker pollution, personal injury or death. In the light of what has been said, the number of these categories will gradually increase as the U.K. implements further IMO Conventions. The future of the Rule is therefore in jeopardy and its decline in importance is inevitable.

From a third party’s point of view, this long-awaited change in the law would be warmly welcomed, as despite legislative intervention in the shape of the 1930 and 2010 Acts, third parties injured by a tortfeasor insured under a marine insurance policy are no better off than they were over 80 years ago. Moreover, other options open to the third party to obtain satisfaction of their claim are limited. Arrest is an appealing alternative given that a letter of undertaking may be issued by the Club; however the difficulty in actually arresting the ship and the possible non-fulfilment of the third party’s debt are significant shortcomings. Moreover, paying off the liability through borrowed money is no longer an option where the P&I Club Rules provide that the liability must be discharged purely out of the Member’s own funds.

Thus, forbidding the P&I Clubs to employ the “pay to be paid” Rule as a defence against a third party claim is the most effective method of ensuring that third parties are guaranteed a reliable source of compensation. Third parties suffering loss as a result of a tort committed by an insured under a marine insurance policy will finally be able to stand on an equal footing with third parties injured by insolvent tortfeasors insured under a non-marine insurance contract.

The “pay to be paid” Rule, despite achieving its objective of protecting Club Members from the financial impropriety of other Members in respect of smaller claims, precludes third parties from pursuing insurers upon the insolvency of a Member. This author suggests that the U.K. Legislature takes legislative action to put an end to this blatant injustice. It is quite simply a matter of public policy – insurance should protect injured parties rather than just the insured. If the U.K. Legislature acts accordingly, P&I Clubs will no longer be able to rely on the “pay to be paid” Rule in relation to third party claims, thus providing a long-awaited unobstructed road to compensation for the injured third party.

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