THE UNINTENDED CONSEQUENCE OF INSURANCE

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Legal Briefings

Last week, the UK's Supreme Court gave a decision by the closest of margins (3 to 2) which will have significant implications for Middle East projects where the parties have agreed a common approach to insurance. The Court held that even where one party is in breach of a clear warranty, if the parties have agreed to take out common or joint names insurance for the benefit of both, they cannot then claim against each other in respect of an insured loss. That was not surprising. But, the court went on to consider the position where the loss had been caused by a sub-contractor who was not a co-insured. It held that a negligent sub-contractor may escape liability for damage caused to the employer, as the main contractor has no claim to pass down the chain. While the case arose in the world of shipping, as the court pointed out "the business context in which this has most commonly arisen is the co-insurance of employer, contractor and subcontractors under standard forms of building contract."

(see Gard Marine and Energy Limited (Appellant) v China National Chartering Company Limited and another (Respondents), China National Chartering Company Limited (Appellant) v Gard Marine and Energy Limited Daiichi and Chu Kaisha (Appellant) v Gard Marine and Energy Limited and another (Respondents) [2017] UKSC 35 (Click Here))

1. BACKGROUND

The Ocean Victory ran aground on 24 October 2006 at the quay in Kashima, Japan.

The contractual relationship between the parties was as follows: **Ocean Victory Maritime Inc.("Ocean Victory")** *(as the vessels owners*) chartered the vessel to **Ocean Line Holdings Ltd. ("Ocean Line")** who time chartered the vessel to **China National Chartering Co. Ltd ("China National")** who then sub-chartered the vessel to **Daiichi Chu Kisen Kaisha ("Daiichi")**.

Importantly the charter agreement between Ocean Victory and Ocean Line provided that Ocean Line would purchase insurance for the vessel at their expense against various risks for the joint interest of Ocean Victory and Ocean Line. The key insurer was Gard Marine & Energy Ltd ("GME"). The charter agreement, time charter agreement and sub-charter agreement all contained undertakings that the vessel would only trade between safe ports.

In September 2006, Daiichi instructed the vessel to load at Saldanha Bay in South Africa and discharge at Kashima in Japan. Unfortunately, the quay at Kashima can be affected by long waves and the access route in and out of the quay is prone to gales. On 24 October 2006, due to long waves in the quay, the vessel attempted to leave Kashima port only to encounter gales. The vessel was grounded and as a result became a total loss.

GME, as insurer, took assignments of the rights of Ocean Victory and Ocean Line and brought a claim for damages against China National for breach of the undertaking to trade only between safe ports. Naturally, China National passed this claim down the contractual chain to Daiichi.

As the court pointed out, this set of circumstances is similar to the contractual structure adopted on construction projects via many standard form contracts, in that the Employer and Main Contractor may jointly benefit from insurance purchased by either one of them. A claim under this insurance may be triggered by the default of subcontractors engaged by the Main Contractor, as it was in this case.

2. THE QUESTION

The question in the case was complex, and was put a number of different ways. It is most succinctly summarised by Lord Sumption – although in the end, he was one of the judges in the minority. Lord Sumption noted that where it is agreed that insurance is to be bought for the benefit of both parties to a contract, they cannot claim against each other in respect of an insured loss. This means that insurers who pay the injured party cannot then bring a subrogated claim against the co-insured who caused the loss. As His Lordship said "It would be absurd for the insurer to bring a subrogated claim against a co-insured whom he would be liable to indemnify". But of course, the position is different if that co-insured could, in turn, sue someone else such as a sub-contractor who caused the problem in the first place. Should an insurer who has paid the employer's losses be allowed to sue that subcontractor? Again to quote Lord Sumption, this was a "question … which none of the existing English authorities purports to answer". If the co-insured (main contractor) had a liability in principle to the injured party (employer), then the insurers could pursue a subrogated claim on behalf of the main contractor against the guilty subcontractor. However, if the main contractor did not have a liability in principle, the main contractor had no loss, and so there was nothing the insurer could claim down the contract chain.

3. THE SUPREME COURT'S DECISION

Lord Toulson summarised the importance of the issue very neatly, saying "It has become a common practice in various industries for the parties to provide for specified loss or damage to be covered by insurance for their mutual benefit, whether caused by one party's fault or not, thus avoiding potential litigation between them. The question in each case is whether the parties are to be taken to have intended to create an insurance fund which would be the sole avenue for making good the relevant loss or damage, or whether the existence of the fund co-exists with an independent right of action for breach of a term of the contract which has caused that loss. Like all questions of construction, it depends on the provisions of the particular contract".

Ultimately, by that 3 to 2 majority, the Court held that by agreeing to a policy for the benefit of Ocean Victory and Ocean Line the parties were extinguishing claims between them. As Lord Mance said "the reason why owners have no claim against charterers for damages for loss of the hull is not that such a claim exists … but is at some point discharged. It is that, under a co-insurance scheme like the present, it is understood implicitly that there will be no such claim. This understanding applies, in my opinion, whether or not the insurance moneys have yet been paid."

4. APPLICATION TO CONSTRUCTION

This case goes much further than simply confirming that, under English law, in the absence of clear wording in the contract to the contrary, co-insureds cannot claim against each other for insured losses.

- It establishes a principle that if insurers have paid an Owner who would have held a claim against the Main Contractor who, in turn, could have sued a sub-contractor and so on, the insurers cannot advance a subrogated claim down the contractual chain;
- It emphasises that it is the contractual requirement to obtain insurance for the two parties which prevents claims between them, not the fact that the policy is actually paid, though their Lordships give different views of the possible impact of the insurers becoming insolvent;
- It clarifies that the rule that co-insureds cannot claim against each other applies where the policy is to be obtained for the benefit of both parties – they do not need to be jointly named.

This does not mean that a policy benefiting the employer and main contractor will give a sub-contractor complete protection from claims. If insurers have paid the main contractor's claims where, for example, the sub-contractor has caused damage which the main contractor was responsible to repair, the insurer can sue the sub-contractor in the normal way. The claims he is pursuing are the main contractor's claims. However, where the insurer has paid the employer for his losses, there is no claim down the chain to the sub-contractor as the flow of claims is interrupted by the common insurance of employer and main contractor.

As a final practical point, insurance rarely covers 100% of the losses it addresses. The parties should ensure that any joint insurance clause clearly says who is responsible for losses not covered by the insurance, for example, due to deductibles.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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