THE CHARTERED INSTITUTE OF LOSS ADJUSTERS

STUDY GUIDE

on

SUBJECT C1
THE PRINCIPLES OF INSURANCE

©CILA 4.2006

INDEX

		page
	Introduction	3
1.	Utmost Good faith, Physical Hazard, Moral Hazard	5
2.	Insurable Interest	7
3.	Proximate Cause	9
4.	Indemnity	12
5.	Contribution	15
6.	Subrogation	16
7.	Legal Principles relating to transfer of ownership of real property and goods	18
8.	Claims procedures	19
9.	Negligence etc	21
10.	Legislation	23

INTRODUCTION

This Study Guide will refer you to a limited number of books which cover the basic ground of the subject and consider some of the practical aspects.

These books are:

(SFP) Claims and Standard Fire Policies, Special Extensions and Special Perils
(R M Walmsley - CILA, London 1993)

(PL) Claims and Public Liability Policies
(J P P Shaw - CILA, London 1994)

(TAM) Claims and Theft, All Risks and Money Policies
(D Cutter - CILA, London 1994)

(FLC) Fire Insurance Law & Claims
(R M Walmsley – CILA,1997)

At the end of each section you will find a list of references which refer to the abbreviations (SFP etc) above. These books contain summaries of many essential legal cases but note the publication dates and use other resources to identify more recent cases.

General background reading is essential if you are to be able to present facts to illustrate your opinions and conclusions in your answers in the examination. Other books and material which may be of assistance are referred to in the Reading List published by the Institute.

In order to pass this subject it is necessary to thoroughly understand the basic principles of insurance. These are not abstract ideas. You will be required to demonstrate that you understand the practical implications of insurance law and if you are able to demonstrate by illustrations that you can apply these principles, you will be able to tackle the subject with confidence.

You must however be careful that you do not offer the examiner ‘solutions’ from cases you have handled where the insurers have made decisions about liability which have been influenced by ‘commercial’ considerations. Many day to day decisions are technically wrong! They may of course be valid for a particular purpose in a commercial context having regard to the relationship of all the parties involved.

For example insurers may pay, under storm cover, for internal damage arising from the ingress of rainwater through a defective felt roof, even though they have declined to pay for the repair to the roof. This is not correct. If the roof is not damaged by storm then the internal damage arises from the defect in the roof not the insured peril of ‘storm’. In this particular example it would also be necessary to consider in the light of decisions of the Court, if heavy rainfall is a storm.

It must be recognised that the Loss Adjusters’ professional opinion must be based on a correct interpretation of the law.

You are reminded that this text is a Study Guide to assist you in your study. It is not intended to be an exhaustive treatise on the syllabus. You should read each section of the Guide, and any associated reading in the recommended texts, making notes on cards etc; these will become convenient revision material.

After completing this procedure for each section, you should consider some of the wider reading. If you do not understand a section go over it again.

The topics interlock and overlap. For example, a full understanding of Indemnity will involve knowledge of Insurable Interest, Subrogation and Contribution; understanding Insurable Interest will involve knowledge of Sale of Goods legislation and Law of Property Act etc.

Your final revision should be to consider how you would explain a topic to a lay person. In order to avoid jargon you must know the subject properly.

Additional Resources which you should try to obtain

Sample policies [There are some in FLC]

Financial Ombudsman Service newsletter and annual report

Keep abreast of case law and legislation by reading an insurance trade magazine

Internet search engines are very useful in tracing material on insurance issues.

SECTION 1
UTMOST GOOD FAITH, PHYSICAL HAZARD, MORAL HAZARD

The first thing to recognise is that insurance policies are simply evidence of the contract which exists between the insured and the insurer.

The second thing to recognise is that the basic ‘rules’ of contract law apply to insurance contracts, subject only to one important additional feature, namely that of **Utmost Good Faith**.

Normal contract law requires the following features to be present in order to create a valid contract:

Offer and Acceptance
Intention to create a legal relationship
Consideration (unless a contract under seal)
Parties must have the legal capacity to enter into a contract
Parties must consent to the contract terms
The contract must be legal and capable of performance.

If any of these features are missing then there is no valid contract.

Underlying these rules is also the principle of good faith. That is, neither side to the negotiations should act fraudulently and mislead the other. Nevertheless the rule of ‘let the buyer beware’ also applies. The negotiator must ask the right questions - and must receive honest answers!

The insurance contract is however subject to a further much more onerous rule - **Utmost Good Faith**.

A definition of utmost good faith might be:

> The duty of **either** party to negotiations for a contract of insurance to voluntarily disclose to the other party any facts which are relevant to the risk involved.

The facts which must be disclosed are *material facts.* Such facts were defined in Carter v Boehm (SFP- p166) and you should note in the judgement the comment about what need not be disclosed.

There is also a definition of material fact in the Marine Insurance Act (1906) s18 (2)

> “ Every circumstance is material which would influence the judgement of a prudent underwriter in fixing the premium or whether he will take the risk”

You must understand the significance of material facts. Not least because the rule of utmost good faith creates a powerful weapon available to insurers in denying liability under the policy.

A Statement of General Insurance Practice issued by the Association of British Insurers stated that, in relation to ‘persons insuring in a personal capacity’, insurers would in certain circumstances not insist on their rights within the rule of utmost good faith. This statement should be considered in the light of the fact that it was an undertaking given by insurers as a ‘quid pro quo’ for being specifically excluded from the provisions of the Unfair Contract Terms Act 1977. It was updated several times during its lifetime. Regulation of general insurance by the Financial Services Authority (FSA) replaced the General Insurance Claims Code from 14 January 2005. [see www.abi.org.uk]

All this leads to serious consideration of the questions asked by a prospective insurer in the proposal form - see Roberts v Plaisted (FLC p.45). The Annual Report and monthly newsletters issued by the Financial Ombudsman Service often contains articles on the current approach to this issue. [see www.financial-ombudsman.org.uk]

It is not uncommon for a prospective insurer on commercial risks to arrange a survey of the risk address which will establish facts about such things as the trade process, fire hazards, security systems, etc. Once the survey is undertaken the insurer has accepted responsibility for establishing material facts. It is of course important that the proposer acts with good faith and does not seek to mislead the surveyor making the enquiries.

<u>Material facts</u> can be conveniently categorised as either *physical hazards* or *moral hazards*.

> **Physical hazard** is a characteristic of the proposed risk that introduces or increases the possibility of a loss arising from an insured peril or a characteristic of the risk which may affect the extent of the loss from the operation of an insured peril.
>
> **Moral hazard** is the possible effect on a risk because of the action of the proposer/insured or employees or other persons related to the proposer/insured which might increase the possible loss or increase the possibility of loss.

You should consider examples of each of these categories. For example a brick building might be considered desirable for the material damage fire insurers but the business interruption insurers might prefer to see a light weight building which could be replaced easily and quickly.

Similar considerations apply to such matters as the quality of a safe, security locks, and alarms.

There are of course often warranties which refer to such matters as occupation and construction and security. Similarly the nature of the business carried on is important, not only for material damage and business interruption insurance but also for liability cover.

Examples of moral hazards would be: lack of care; dishonesty; poor claims record; exaggerated claims.

There is some debate about when the duty of utmost good faith applies. That is, does it only apply during the negotiations leading to the contract or is it a continuing duty? This problem is generally dealt with by the policy having a condition which requires notification of any increase in risk during the term of the policy.

It should be recognised that there is legislation which is relevant to the question of what must be disclosed :

Rehabilitation of Offenders Act 1974

Sex Discrimination Act 1975

Race Relations Act.1976

References: *SFP* *1-6; 48-49; 166;184;188; 222; 223*

TAM *1-8; 47; 51; 111;142-143;146-147;162-163;164-165*

PL *10-13; 87-88; 89; 77*

FLC *27-31; 52-53; 326; 329*

SECTION 2
INSURABLE INTEREST

Insurable Interest is about the *financial relationship* of a person to the subject matter of the insurance, that is the property or liability referred to in the contract.

The subject matter of the contract is the insurable interest. The extent of the insurable interest is one of the limits to the liability accepted and covered by the policy. The other is the sum insured or a stated limit of liability.

The person named or identified in the policy may not have an insurable interest and, sometimes, insurable interests are not insured because they have not been correctly identified in the policy. This might arise because the person (corporate or individual) has not been correctly named or because 'The Business' has not been correctly described. These points are equally valid for material damage, business interruption and liability insurance.

Reference to the Marine Insurance Act (1906) is again useful. Insurable interest is defined at s.5 (2), (see p 12 of SFP).

It is also defined/explained in Lucena v Craufurd (1806) (see p 13 SFP et al)

Insurable interest can arise in a variety of ways but it is always related to the financial relationships involved. An owner of property has an insurable interest, as does a tenant of premises. Similarly a hirer/renter/leaser of goods or premises will have an insurable interest. The extent of that interest will probably be governed by the terms of the underlying commercial contract.

Similarly suppliers of goods and services will have an insurable interest in their possible legal liabilities arising from their business activities. Private individuals also have an insurable interest in possible legal liability arising from their negligence etc. hence the Third Party cover given by typical Domestic Building or Contents policies.

Bailors and bailees are good illustrations of the way in which insurable interest can arise. A bailor as owner of the goods subject to the bailment clearly has an insurable interest. Similarly the bailee has an insurable interest as he has a potential legal liability to pay for the goods if they are lost or damaged. Insurance can be arranged by either party in relation to their respective interests.

In addition however the bailee could arrange insurance to cover the interest of the bailor rather than simply insure his possible legal liability. Thus insurance is often arranged "On Goods in trust for which the Insured is responsible". This is legal liability cover even though it is given under a material damage policy. As an alternative cover may be arranged "On goods in trust". In this case the cover is **not** for legal liability but is arranged to cover the interest of the owner.

You should consider the Hotel Proprietors Act here. (see FLC p 105)

Also you should consider the King and Queen Granaries case (North British and Mercantile v London Liverpool and Globe (1876). This is usually quoted in relation to Contribution but it is essentially about insurable (and insured) interests. Indeed it was because the policies covered different interests that contribution did not arise in that case.

Goods passed to others for processing, including for example clothes sent to a Dry Cleaner, create financial relationships and insurable interests.

The nature of ownership or 'title' to goods is relevant to the debate about insurable interest.

You should consider the Sale of Goods Acts and other legislation.

Many contracts refer to responsibility for arranging insurance and create a legal relationship to property which establishes insurable interest: building contracts generally; contracts for Hire Purchase; Leases; Hire of TV sets etc; transit of goods (including household effects).

Clauses in contracts often say that the property (title) in goods delivered is retained by the seller until the buyer has actually paid for the goods. These clauses are sometimes referred to as 'Romalpa' clauses because of the leading case which tested their validity. As they are now commonplace they are more usually referred to as 'retention of title' clauses.

Building contracts in the JCT forms have references to who will arrange insurances and the responsibilities of the parties to the contract.

Where insurable interest is related to a contractual arrangement there may well be an effect on the rights of insurers in respect of Subrogation. This is considered in Section 6.

Consideration of the question of Contribution might also arise. See Section 5 of this Guide.

These references to other important insurance principles show how the various topics are linked.

References:

SFP	12-16; 144; 147; 168-169; 170-171; 190-191; 192-195; 203-204; 220-221; 223
PL	9; 53; 91; 92; 93; 156; 160; 193
TAM	14-17; 20; 51-52; 181-182
FLC	Ch.5 & 6

SECTION 3
PROXIMATE CAUSE

The principle of **proximate cause** is related to, and is indeed about, the perils which are stated to be covered and the exceptions and exclusions of the policy.

You should know the basic definition from Pawsey v Scottish Union and National. This classic definition of proximate cause was given in the Court of first instance in Jamaica. The case went to appeal to the Privy Council.

The matter of 'Onus of Proof' is related to the question of proximate cause. See Regina v Bossom.

In the context of the policy conditions and claims enquiries you should also know the other important case arising out of the Jamaica earthquake of 1907 (Tootal Broadhurst Lee v London and Lancashire) which makes reference to onus of proof.

In the context of perils and proximate cause you should consider the basic structure of the ABI Standard Fire Policies (see FLC p 349 ,- 355). Essentially they start out by stating that fire damage is covered. Then 'second thoughts' come in and the policy seeks to exclude certain types of hazard or 'fires' e.g. spontaneous combustion and heating processes. You should note the comments regarding 'processes involving the application of heat' and 'heating process'.

The 'process' exclusion of the ABI All Risks policy should be considered carefully. It is notionally very wide. It may actually eliminate much of the cover thought to be provided by the policy!

Other hazards are also considered too great for insurers and these also are excluded. e.g. 'War risks' ; 'nuclear risks'; and 'terrorism'.

Indeed you should make a point of understanding how 'terrorism' cover is now arranged or made available in the mainland UK following the withdrawal of cover by reinsurers. This led to the setting up of a mutual company involving insurers and the Government. There are various procedures to be followed in respect of 'terrorism' claims being made under this scheme. You should know them! They are referred to in CILA Technical Bulletins.

It is often said that the principle of proximate cause is 'modified' by the policy exceptions. That is not strictly true. The legal principle remains the same. What has happened is that for the contract entered into, the respective parties have agreed which perils are not insured. Indeed the fact is that many of the risks excluded can be insured by payment of an additional premium.

Agreement of special conditions for a contract is commonplace. For example the Sale of Goods Act when referring to the transfer of ownership refers directly to 'in the absence of any agreement in the contract ..[then] ....'

Consider the references to Explosion.

> ''1 FIRE but excluding loss destruction or damage caused by
> (a) explosion resulting from fire......
> 2..
>
> 3 EXPLOSION
> (a) of boilers
> (b) of gas
> ..
> used for ...."

Thus explosion is seen as a special case and has to be treated directly in the contract.

The wording of the All Risks policy should be considered carefully. There is a wide range of 'Exclusions'. You should work carefully through the words.

The sequence is for example:

Accidental loss and damage is covered.

Second thoughts ... no cover to be given for vermin damage or wear and tear etc

But if loss and damage arising from 'wear and tear' is excluded then a very large number of instances of damage will not be covered.

Consider for example:

A bearing overheats because it is worn

- ➢ the heat generated ignites a residue of oil and dust in the vicinity
  - ➢ the fire spreads to a timber partition
    - ➢ flames from this fire spread to the roof
      - ➢ the whole building and its contents are destroyed.

The proximate case of the fire is wear and tear (of the bearing); if the wear and tear exclusion is left at stage one, none of the loss and damage would be covered. What happens is that the policy includes further words to the effect that whilst losses arising from wear and tear are not covered this only means for the item that is 'worn and torn' and not the subsequent damage.

The exceptions and exclusions of the All Risks policy must be worked out carefully as the cover is almost certainly not as wide as some would wish to think.

The matter of onus of proof is relevant here. See Regina Fur Co v Bossom; Anderson v Norwich Union, and Young v Sun Alliance.

The latter two cases are related not only to Onus of Proof but they consider the definitions of perils. You should note the judge's comments about 'storm' in Anderson's case. It is not actually a definition of storm, the judge was speaking 'obiter' and the case was not decided on the basis that there was or was not a storm!

The insured is only required to provide prima facie evidence of the fact that the loss has arisen from the insured peril although the 'Anderson' and 'Young' cases appear to have required a substantial level of proof. Nevertheless as Tootal's case makes clear the insurer has to show if an exception applies. This is why the exclusions of the All Risks policy in particular require careful consideration.

Where there is a sequence of events, which involves excluded perils and hazards which are not in contemplation within the policy, the following is the way in which the combinations are considered in relation to operation of the Policy.

i An insured peril operates on its own - there is liability

ii An excepted peril or excluded peril operates on its own - there is no liability

iii If an insured peril operates and is followed by an excepted peril then the insured peril is considered as the proximate cause of the loss. (It may be necessary to consider the wording of the exclusion clause)

iv If an insured peril operates and is followed by a peril not mentioned then the

insured peril is the proximate cause of the loss

v if an excepted or excluded peril operates and leads to the operation of an insured peril, the excepted or excluded peril is the proximate cause of the loss and there is no liability. (Subject to the policy wording)

vi If an 'unnamed' peril is followed by the operation of an insured peril the insured peril is the proximate cause of the loss. Note that of course the damage by the unnamed peril is not covered.

vii If an insured peril and an excepted peril operate at the same time the loss is not covered as the excepted peril is considered to be dominant. If the loss attributable to each peril can be established the 'insured' loss would be covered in effect as in vi above.

You must understand what a 'fire' is within the meaning of the policy. What is considered fire damage for insurance purposes? You must understand the legal definitions of 'special perils' so far as these are defined; what is storm, spontaneous fermentation, or heating, riot, flood, etc.?

You must understand the nature of the debate about the definitions of perils and the practical issues that arise on a day to day basis. Consider for example the comment about storm and felt roofs in the Introduction to this Guide.

It is important to understand the way in which only some of the insured's legal liabilities are covered by Public and Product Liability policies. Professional Indemnity policies are special covers.

Consider also the way in which categories of goods are defined in Money, Theft etc policies. These definitions are related to the concept of proximate cause.

Note the relationship between the definition of theft in the Theft Acts and the way in which the Theft policy restricts the cover by requiring 'forcible and violent entry or exit'.

Relevant text references are:

SFP	29-42; 49-50; 84-86; 91-103; 161; 163; 173; 179; 183; 196; 198; 205; 212; 224.
PL	7; 43-67; 69-73; 118-119; 138; 140-141; 146-148; 150; 161-163.
TAM	26-33; 42-46; 75-77; 79-90;94;125-131;152-153;173-174
FLC	Ch. 8 & 9 and Appendix A

SECTION 4
INDEMNITY

The prime function of insurance is to provide an **indemnity** to the insured for a loss sustained by the operation of an insured peril or the occurrence of an insured event.

The principle of indemnity can be defined as the principle of placing the insured in the same financial position after the occurrence of an insured event as he enjoyed immediately before it.

The function of the material damage policy is to pay money. (see Castellain v Preston and Rayner v Preston.)

The legal liability policy in its various forms will, in effect, reimburse the insured for sums (of damages and costs) which he becomes legally liable to pay. This really means that the matter should be dealt with by the Court in order to establish 'legal liability'. However, the reality is that insurers, by virtue of policy conditions, take over the conduct of negotiations, discussions and enquiries of an incident once a possible claim is notified to them by their insured.

The indemnity is of course the 'net amount' of the loss, that is the real loss after taking into account other sources from which money can be recovered in diminution of the loss. That is usually a right under contract or arising from tort against third parties. However the insurer cannot insist on the legal rights being exercised by the insured before calculating the indemnity / loss under the policy.

In the event, of course, the insurer would normally deal with the loss under the policy and then pursue the rights against others. This is known as the principle of **Subrogation.** This is generally considered to be a principle of insurance. In fact the right of subrogation arises for anyone providing an indemnity to another. If this does arise the right only follows when the indemnity payment has been made. This diversion into comment about subrogation indicates how closely the various principles are entwined.

The real limit on the amount payable as indemnity is the extent of the insured's insurable interest. You will recall that this was related to the financial relationship of the insured to the subject matter of the insurance. This is one way of defining the amount payable as indemnity.

There is another constraint on the amount recoverable and that is related to the terms of the contract (policy). There may be limits of liability generally, or for particular events, or series of events, or for specific items. There may be an 'underinsurance' clause etc.

The first thing to do is to establish the overall indemnity and than consider the limits. Sometimes the policy will incorporate conditions which will define the basis upon which the indemnity shall be calculated; for example the amount of damages in a legal liability policy, or a formula in a Business Interruption policy, or an agreed amount in a valued policy. (See Elcock v Thomson.)

The ABI fire policy says the insurer will "...pay to the Insured the value...". The AR policy says ".. pay to the Insured the value ......". It is interesting to note that these policies do not use the specialist words 'indemnity' or 'indemnify'. Very often domestic policies do use these technical words but the policy usually incorporates some definition of indemnity.

Theft policies may say 'pay the value' or 'will indemnify' or some other form of words.

What is the value to be paid? The word "value" is not defined. To indemnify, is to place the insured in the same financial position, after the occurrence of damage following the operation of an insured peril, as was enjoyed before the occurrence.

The answer to the question 'What is the value to be paid?' is related to the question 'What is the insurable interest of the insured?'

Both questions are concerned with the financial relationship to the subject of the insurance and are indeed a measure of what the insured has lost in money terms. It should however be noted that the value here is the intrinsic value not a value which relates to such things as the potential profit arising from ownership. However it should be noted that it is quite possible that in some circumstances inclusion of the 'investment' or 'profit' element might in fact be the appropriate, or indeed the only, way to measure the indemnity.

None of the policies mentioned here have in their basic format any indication of the **amount** to be paid as the indemnity.

The principles of 'contribution' and 'subrogation' are related to indemnity. Subrogation in the context of alternative sources for an indemnity payment; 'contribution' in the context of other insurance contracts arranged for the benefit of the insured whereby an indemnity might be payable. Such contracts may have been arranged 'by the insured' or 'on behalf of the insured'.

You should note that it is usual for material damage policies of various types to incorporate a section whereby the insurers have the option to reinstate. This option is **not** the same as the reinstatement cover given by the Reinstatement Memorandum in fire insurance.

If insurers do exercise the option to reinstate, the policy ceases to be a policy 'to pay money' and becomes a policy to reinstate. This is very important. Once the option has been exercised the insurer is committed and must proceed. If reinstatement is not completed then compensation is payable by the insurer. Relevant cases are Brown v Royal (1859) and Anderson v Commercial Union (1885).

It would appear that these cases led to the ABI fire policy Claims Condition 3 whereby the insurer's liability is limited to the sum insured. There are no reported cases concerning a test of the conditions and it could be that if the insured has made decisions and commitments, in the light of insurers exercising their option, then insurers would be estopped from limiting their liability to providing say, half a building, because the sum insured had been exhausted.

The ABI All Risks policy has a similar provision at Claims Condition 3.

GENERAL PRINCIPLES OF VALUATION FOR INSURANCE INDEMNITY PURPOSE.

For building claims the normal basis for calculating the indemnity is to establish the cost of reinstatement of the structure as a base figure and then to make deductions for wear and tear. Improvement is a word sometimes used in this context but you should be careful how you use this word. It can mean something related to wear and tear or it can mean a specification for reinstatement which is better than existed.

Deductions for wear and tear would properly be related to component parts of the building. A general overall deduction is rarely, if ever, appropriate.

Consider the judgements in the cases of Reynolds and Anderson v Phoenix Assurance Co Ltd and Others (1978), Anderson v The Commercial Union Assurance Company (1885), and Pleasurama v Sun Alliance & London Insurance Ltd (1979).

The basic rule for all indemnity calculations is 'the value at the time and at the place of the damage'. Clearly brickwork on top of a remote mountain is going to be more expensive to replace than similar brickwork in a suburb of a large town. The reinstatement cost in this calculation would of course be

based on the general rule of reasonableness. Warehouse or mill construction in the 19th Century would involve very different methods and materials to the present day. This variation in possible methods of construction would probably have influenced the basis on which the sum insured was established.

The general rule is to establish the Value at Risk for purposes of average (see SFP p 61) on the same basis as the loss is calculated.

Market value is a possible basis for establishing the value to be paid cf Leppard's case. Note however that the decision to sell and for how much had been taken before the fire. Thus the rule about time and place applied. Recent cases all consider the 'Market Value' option. Generally it is not considered appropriate. This area of debate, ie method of calculating the loss, must be understood.

In domestic insurance there are often claims settlements where the lost item is not in fact replaced but the insured is told to go to a particular shop and select goods to a value equal to the value of the lost article. This is not strictly replacement within the terms of the policy.

You should be very careful about questions which relate to such points as 'How in practice would you..?' Similarly be careful about incorporating into your answer such phrases as "....of course in practice what would happen....". You are likely to offer day to day examples which may well be wrong technically.

Leases on buildings and other contractual arrangements might well include some reference to the basis upon which the tenant has to insure on behalf of himself, or the landlord, or both, or vice versa.

You should note the basis upon which damages/third party indemnity was calculated in Harbutts Plasticene and Bacon v Cooper.

References:

SFP	16-19; 168-169; 175-176; 186-187; 200-202; 203; 207-211; 216-217
PL	37-39; 146-149; 179-180; 183-184
TAM	13; 35-38; 89; 141
FLC	Ch.10 – 14.

SECTION 5
CONTRIBUTION

This is an important subject. You must understand that there is a significant difference between the way in which **contribution** arises in the normal course of commercial insurance activity, that is at common law, and the system or procedure developed by the Association of British Insurers (Property Committee).

Essentially there are two basic methods available for contribution calculations: **one related to the ratio of sums insured**, and **one related to the ratio of the liabilities of each policy involved** (known as the Independent Liability method).

It is because this second method is always to be utilised within the ABI Rules that many students become confused.

There are no hard and fast rules governing which method should be adopted. However the rule of contract construction known as *contra preferentum* should be borne in mind as a possible factor to influence a decision. Thus if the method of calculation in the policy penalises the insured, then a method which does not penalise him, or injures him least will be used.

It is normal to use the ratio of sums insured when none of the policies involved incorporates an average condition. Thus it is likely to be the preferred method in domestic insurance.

You should note here that in domestic policies the cover for alternative accommodation **does not have a sum insured.** The cover is for reasonable costs up to a limit of liability. Thus it is quite impossible to effect a calculation, as some still suggest, on the basis of sums insured. The method to utilise is that of independent liability.

Independent liability in the context of contribution calculations means the liability of a policy without regard to the existence of any other policy or policies. You should check the definition in the ABI rules.

There are worked examples in SFP and general discussion in the other texts.

The prime legal case which you must know is North British and Mercantile v London Liverpool and Globe more generally known as King and Queen Granaries.

You should note, from the full report, the Judge's comments about the meaning of the word 'property'

References:

SFP	59-74; 143; 149; 151-156; 177-178; 192-195
TAM	56-61; 67; 128; 156-158; 168-171
PL	81-84; 120; 136; 157; 166; 181-182
FLC	Ch.16

Additional reading **– Contribution by John Ball (a technical paper published by the CILA and downloadable from the CILA website – www.cila.co.uk)**

SECTION 6
SUBROGATION

The definition of **subrogation** is “the right of one person to stand in the place of another and avail himself of all the rights and remedies of that other whether already enforced or not’’.

This right ‘to stand in the shoes of another’ arises at common law. It is not a principle which is confined to insurance and it arises outside the insurance contract. The well known case of Castellain v Preston (from which the above definition is quoted) refers.

At Common Law the right only arises after the indemnity has been provided. This could lead to complications of delay in pursuing recovery and most insurance contracts have a condition which gives the insurer the right of subrogation before the actual act of indemnification.

This principle is of course important for loss adjusters as the possibility of ‘Recovery’ from a Third party must be recognised in the early stages of the enquiries. Its importance is recognised in the ABI Report format where specific comment is required at the section designated ‘Third Party Aspect’.

The right of recovery from a third party can arise in a variety of ways including Statute, ‘tort’, the rule in Rylands v Fletcher, and under ‘contract’. You will need to know how the liability can arise in these categories.

It is important is to realise that there is only one common law claim against a third party and all the costs to be claimed have to be included in the proceedings (see Lister v Commercial Union).

What must be appreciated is that there is a contract in force between the insured and the insurer. The conditions and obligations of the contract must be met as prime obligation. That is, the insurers must pay the claim without regard to the possibility of a recovery from someone. (see Collingridge v Royal Exchange)

This can often mean that the amount payable under the policy will be greater than the amount which might be recovered as damages from a third party. This could arise, indeed quite commonly does arise, because there is Reinstatement cover under the Material Damage Policy whereas the common law damages might require a substantial deduction for ‘wear and tear’. You should however consider the cases of Harbutts Plasticine and Bacon v Cooper. In these cases the Court decided that no deduction for wear and tear should be made. You must understand why the Court reached that decision in these cases.

Similarly the Business Interruption policy formula may well project an indemnity amount to be paid which would not be considered an appropriate method of calculation at common law. Conversely the amount payable under the policy may not actually indemnify the insured for the whole loss sustained because of an incident. This should be considered carefully.

This might arise because the sum insured was too low and cash simply ‘ran out’, or because average reduced the amount payable, or because of an excess or single article limits.

It might well be that there was no cover for some heads of loss such as Business Interruption and there would almost certainly be no cover for ‘consequential’ costs such as professional fees in obtaining legal advice or preparing the claim.

All in all the procedure for subrogation has to be considered carefully.

There have been cases arising from motor claims where there have been uninsured losses for car hire and the insurers case for recovery has not included this cost, conversely the insured has tried to pursue the uninsured loss only.

Refer again to Commercial Union v Lister where you will see that the insured was obliged to proceed to recover the whole loss sustained not just the uninsured loss. The reverse is also true i.e. the insurer must pursue the whole loss at common law which will include insured and uninsured losses.

Some argue that the insured should have first call on any money recovered in order that he should be fully indemnified. That is to recover the excess, and the insurer simply receives the balance of money in relation to the insured loss.

There is however a powerful and generally accepted argument that where the insured has accepted an excess he has in fact agreed to accept all losses up to the amount of the excess and insurer is entitled to recover before the insured. This is in essence the thrust of the Lloyd's Underwriters' case just mentioned.

It has been argued that there is a distinction between what is described as a 'voluntary excess' and an excess ' imposed ' by insurers. This is a false distinction. The function of the excess is in the context of the calculation of an appropriate premium for the risk being written. Thus the underwriter's risk is reduced by an excess whether this is suggested by the insured or the insurer. Indeed it would be normal negotiation to receive alternative quotations for a variety of options of premium calculation. Whilst the underwriter's risk is reduced the insured also has a benefit by way of a reduced premium.

Where the amount paid by the policy is reduced by the operation of average it would be necessary to consider carefully the words in the average clause. This might include the words '...his own insurer for the difference'. Does this place the insured in the same category as a coinsurer? Arguably it does and he is entitled to a pro rata share of the recovery.

Sometimes the insured will have included in the claim items which are not the subject of any insurance policy. In this event when a judgement is given there would be comment on the way in which the amount to be paid by a Third Party was calculated and thus to be allocated between the insured and uninsured losses. Apportionment of the recovered moneys would simply follow the judgement.

One way to approach this allocation problem is to consider that after the money is recovered the loss can be recalculated to a new 'net' sum. This sum can then be considered in the light of the policy cover.

This would also broadly be acceptable for goods recovered after a theft loss had been settled.

References:

SFP	74-76; 168-169; 170-171; 172
TAM	54-55; 104; 108; 148-149; 150
PL	78-80; 179-180; 187-188; 198; 204-205
FLC	Ch. 15

SECTION 7

LEGAL PRINCIPLES RELATING TO TRANSFER OF OWNERSHIP OF REAL PROPERTY AND GOODS.

Day to day examples of this topic are purchases of groceries, household goods such as furniture, and buying and selling a house.

You should appreciate that simply saying to a shopkeeper that you will buy 'one of that model or pattern' does not mean that you have, legally, purchased the item you saw in the shop. That is a sample. If you pay money over this becomes part of the funds of the business and if the business then goes 'bust' you are simply a creditor. You cannot successfully argue that you bought 'that item' ! The property in the goods has not passed; they have not been allocated to the contract; see Sale of Goods Act. In commerce, goods are regularly being bought and sold and the ownership passes at a time agreed. Reference was made earlier (see insurable interest) to 'Romalpa' or 'retention of title ' clauses in contracts. These are very important.

Each of these transactions arises out of, or forms, a contract. You have already considered the nature of contract in the context of Utmost Good Faith. In effect it is possible to enter into a contract for anything which is not illegal.

Provided that the parties to the contract have 'equal strength' the conditions can be freely negotiated. The Unfair Contract Terms Act 1977 is relevant here.

There is much consumer legislation which seeks to protect the private individual from exploitation by the imposition of unreasonable terms.

In the past the test has been that of 'reasonableness' but now that we have the Unfair Terms in Consumer Contracts Regulations 1994 (effective 1 July 1995) the test is one of 'fairness'. This is possibly much wider in scope and creates a problem for sellers of services and goods, including Insurers who are not excluded from this legislation as they were from the Unfair Contract Terms Act 1977.

The time at which the property in goods passes is important, as you will have considered in relation to your study of Insurable Interest.

The Sale of Goods Act 1979 refers to the time at which the property (ownership) in goods shall pass " in the absence of any condition in the contract ... [the property passes] .... when ...... "

You should note the terms of the Law of Property Act concerning the sale of real property.

Consider the Contract Price clause in fire insurance.

It would be appropriate to consider the transfer of title in salvage and the possible legal liabilities which would follow - see policy conditions.

References:

PL 64-67; 152; 183-189;

SFP 12-16; 80-81; 115-116; 144; 147; 168-169; 170-171; 203-204;

SECTION 8
CLAIMS PROCEDURES

Insurance Policies usually have some condition which requires the insured to notify the insurer about damage to the property which is the subject of the insurance. In relation to Business Interruption insurance and Legal Liability insurance the insured must notify insurers of any incident which may give rise to a claim.

This latter point is very important. It means that insurers can decide what action to take in anticipation of proceedings etc from a Third Party. Many legal liability insurers simply note the report of an incident and await further developments on the grounds that the Third Party must prove their claim.

You should check specimen policies of all covers to see what is required.

It is arguable that even if the policy did not contain such a condition it would be necessary for the insured to notify a possible claim within a reasonable time. Nevertheless the situation is that the onus of proof both as to loss and peril remains with the insured.

Policies often say that the notification should be in writing. This is not often done. Usually a phone call is made to the agent or broker or to the insurer direct.The insurer will then initiate the procedures which are laid down within that company.

It may be that details of the claim are taken down over the telephone and the claim settled without any further contact. Alternatively papers may be passed to one of the insurer's own staff; they may simply send a claim form for completion; they may instruct a loss adjuster; they may instruct a consulting engineer; or they may instruct an accountant.

Traditionally the Loss Adjuster has been a professional adviser to his/her instructing principal but from time to time there has been debate over the years as to whether adjusters were really agents of insurers. It was of course commonplace to find that adjusters wrote to an insured with words like "We act on behalf of XY insurers Ltd..........". It is difficult to see how this could not be taken as the adjuster acting as an agent, even if that is not what was intended.

In many cases adjusters are now agents of insurers. This has interesting implications.

The adjuster should be aware of the possible hazards of the Hedley Byrne case in the dealings with the insured.

Consider the question of value at risk

i The value at risk is agreed at £x

ii Average is applied accordingly

iii The insured increases the sum insured to £x

iv The day after the agreement on value and the increase in sum insured the property is destroyed

v The actual value is now 150% of £x

You should appreciate that adjusters' reports are not privileged except in special circumstance.

It must always be recognised that the onus of proof lies with the insured.

It has traditionally been the case that adjusters obtained the signature of the insured on an ***Acceptance Form.*** This was generally in the form of a letter to the insurer confirming that the insured would accept £x in settlement of the claim. From time to time there is debate about whether the document is binding. It is argued that as the document says that the insured will accept £x 'subject to the approval' of the insurer it is not binding on the insurer. For the form to make the insurer bound by the Form it would be necessary to show that there was an unqualified offer on the part of the insurer. This may well now arise as adjusters are increasingly dealing with claims for insurers under delegated authority / agency agreements of one form or another. There is a reported case (Chandle v Poland (1933) 44 Ll L Rep 349) where assessors (who would be known as adjusters nowadays) acting on behalf of the insurers agreed the sum payable and it was held that there was a binding agreement i.e. one not subject to underwriters approval. This case does not however cover the question as to whether the insured is committed irrevocably by the form.

Forms of Discharge are documents in frequent use. Such a form acknowledges that a claim has been met or at least a sum of money or other form of restitution has been made in discharge of a liability. In adjusting practice it would be used in Third Party Claims. A form of discharge is not the same as a form signed by a Third Party agreeing to accept a sum of money etc. in discharge of a claim. It is often the case that a form of discharge will be obtained when settlement of the insured's claim under his own policy has been made by replacement or repair.

Assignment is an important legal procedure. It is the transfer of a legal right to another. The word is also used to describe the document actually making the transfer. Policies of insurance are personal contracts and therefore cannot be assigned (except for Marine Insurance, see Marine Insurance Act 1906). It is however possible to assign the *proceeds* or benefit of a policy. This is often done when an insured wishes the insurer to pay a builder direct for work done in repairing damage which has been the subject of a claim.

What you must realise is that in the absence of such a document as an assignment (and possible a Mandate - see below) the settlement cheque or form of discharge must be in the names of **all** the parties identified/named in the policy. If this is not done further payments may have to be made if someone can properly claim that they have not been indemnified by the payment made.

Once insurers have received a notice of assignment they must proceed as instructed. They have no option.

You should understand the case of Smith v Mainwairing where insurers failed in a subrogation action because their insured's company had ceased to exist by the time the action came on. Assignment of the insured's rights would have enabled insurers to proceed.

The Concise Oxford Dictionary defines a ***mandate*** as 'Judicial or legal command from superior; commission to act for another..'. The word 'mandate' is often used in insurance claims practice particularly in the context of the insured wishing payment to be made to a builder as mentioned above. Thus the word is not apparently being used correctly as what is apparently intended is something akin to a combined form of discharge and an assignment.

SECTION 9
NEGLIGENCE, NUISANCE, STRICT LIABILITY, THE RULE IN RYLANDS v FLETCHER, STAUTORY DUTY.

The legal relationships between individuals and/or corporate bodies arise from duties at common law or by legislation.

The syllabus refers to Negligence, Nuisance and the Rule in Rylands v Fletcher. These form part of the law of tort.

Relationships also arise because of contracts.

In recent years there has been much legislation concerned with consumer protection. In fact some of this legislation is referred to specifically in the Syllabus

Negligence was defined in Blyth v Birmingham Waterworks (1856) as

> ''The omission to do something which a reasonable person guided by those considerations which ordinarily regulate the conduct of human affairs would do or doing something which a prudent and reasonable person would not do.''

You should also consider the way in which this subject was considered in the famous case of Donoghue v Stevenson

An action for negligence can only succeed if the plaintiff can show:

- i That the defendant owed him or her a duty of care
- ii That there was a breach of that duty
- iii That he or she has sustained injury or damage as a result of that breach

Nuisance has been defined (Law of Tort, Winfield - Third Edition) as:

> "The wrong done to a person by unlawfully disturbing him or her in the enjoyment of his or her property or, in some cases, the exercise of a common law right.''

This is complex area of law.

It is often considered in relation to 'Tree Root' claims following subsidence.

Strict Liability is a liability which the law imposes even though the defendant has taken reasonable care. An example is Rylands v Fletcher (1868). The idea of strict liability should be distinguished from that of absolute liability***.*** There are defences available to a case based on strict liability but not to a case based on absolute liability. The law rarely imposes an absolute liability and the distinction is largely academic.

<u>The rule in Rylands v Fletcher</u>

This case establishes that a liability arises where dangerous things are brought onto land and they escape causing damage to a third party's property. What is often overlooked is that the case also hinges on the idea of the 'non natural user' of land. Consider the case of Cambridge Water v Eastern Counties Leather (1993).

Statutory Duty is related to legislation requirements. The most common day to day instance would be that of Motor insurance where Third Party personal injury and damage cover has to be arranged.

Another commonplace instance is that of Employers Liability insurance. The Occupiers Liability Acts (1957 and 1984) and the Defective Premises Act (1972) are other examples.

References:

PL 1-5; 27; 47; 56-57; 99; 106; 112-115; 124-139; 148-149; 151-152; 173; 202; 203

SECTION 10
LEGISLATION

The various items of legislation referred to in the syllabus are some of the basic matters which must be understood. Not only for the legal responsibilities which they establish for normal commercial affairs, but also because they link with the various insurance principles and other matters which have to be considered in claims enquiries.

For example, the Fires Prevention (Metropolis) Act is relevant to the question of subrogation. Indeed many of the items are related to legal responsibilities relevant to subrogation.

Insurable interest is relevant to the Law of Property Act and sections of the Sale of Goods Act.

Utmost Good Faith is the principle relevant to Unfair Contract Terms in Consumer Contracts Regulations and the Unfair Contract Terms Act. It is also very relevant to the Rehabilitation of Offenders Act.

Whilst the specific references to legislation in the Syllabus are limited, comment has already been made that the Race Relations and Sex Discrimination legislation is relevant to Utmost Good Faith and that you would find value in considering various sections of the Marine Insurance Act 1906.

Brief comments on the sections of the Acts are set out below.

Fires Prevention (Metropolis) Act 1774

There are only two sections of this Act now in force. They cover

i responsibility for spreading fires and
ii rights to insist that insurance companies (NB not Lloyd's Underwriters) ensure that insurance money is expended in reinstatement.

SFP 26;54-55
TAM 14;161
FLC 103; 182-3; 253-4; 317

Hotel Proprietors Act 1956

Defines an hotel and sets out the responsibilities of an hotel proprietor.

FLC 105-106

Law of Property Act 1925

Part I ss 34,35,36,37,38
Part II ss 40,41,47,61,62,63

This is important legislation related to item 1 ii of the Syllabus. You should note how section 47 relates to the 'Purchasers Memorandum' of the Standard Fire Policy. Note also Sect 62 regarding Fixtures and Fittings.

SFP 80-81
FLC 22; 99-100; 104; 184

Rehabilitation of Offenders Act 1974

Ss 1,2,4,5,9

This is extremely important in the context of the duty of disclosure. Note that given certain conditions, the legislation 'wipes out' (as though they had never been) certain convictions.

SFP 5
FLC 32-3; 58

Sale and Supply of Goods Act 1994

Ss 1,2,3; Sch 2 Ss 5,6; Sch 3

This should be considered in the context of Sale of Goods Act 1979, Supply of Goods and Services Act 1982 and The Unfair Terms in Consumer Contracts Regulations 1994.

FLC 2; 22; 252

Sale of Goods Act 1979

Part I s 1
Part II ss 2,3,4,5,6,7,11,13,14,15
Part III ss 16,17,18,19,20

This is related to a wide range of matters which arise in relation to claims enquiries.

You should consider this Act in relation to Sale and Supply of Goods Act 1994 and Supply of Goods and Services Acts 1982. (see below)

SFP 1;116
TAM 1
FLC various

Supply of Goods and Services Act 1982

Part I ss 1,2,3,4,5
Part II ss 12,13,14,15,16

Note the relationship to item 1 ii of the Syllabus.

Various sections are relevant to legal liability both in relation to legal liability policies and to subrogation.

You should note this Act in relation to Sale and Supply of Goods Act 1994 and the Unfair Terms in Consumer Contracts Regulations 1994 (see below).

FLC 22; 252; 337

Third Parties (Rights against Insurers) Act 1930

Note that whilst the Third Party may proceed directly against the Insurer, the Third Party has no more rights than the Insured would have had.

FLC 264-6

Unfair Contract Terms Act 1977

Ss 1,2,3,4,5,11,12,13,14

You should note that insurance was excluded from the provisions of this Act, because the insurance industry agreed to self regulation in this regard so far as ‘personal’ insurance was concerned.

Note the reference in Part I Sec 11 to ‘reasonableness’ and consider this with the new test of ‘fairness’ in the Unfair Terms in Consumer Contracts Regulations 1994.

PL 103
TAM 1
FLC various

The Unfair Terms in Consumer Contracts Regulations (1994)

The text is not reproduced here. You should purchase a copy of these Regulations which arise out of European Union legislation.

This set of regulations is very important. Note the test of ‘fairness’.

You should note particularly that insurance contracts are subject to these Regulations.

Water Industry Act 1991

Section 209 is a significant statement about the liability of Water Authorities. It replaces s 6 of the 1981 Water Act because Water Authorities are no longer Statutory undertakings.

FLC 251