Judicial boldness and the unauthorised insurer

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Int. I.L.R. 94 The enforceability of contracts made with unauthorised insurers or reinsurers has been a vexed issue in insurance law for the last ten years. The recent decision of Gatehouse J in *Bates v Barrow* [1] has heralded a welcome new approach to this question.

Since as long ago as 1870 it has been considered necessary for insurance companies to be subject to additional regulation over and above that of ordinary companies. Insureds are thought to deserve special safeguards against the failure of their cover, on the basis that obtaining protection against a risk should not itself be a risky business. The pattern has generally been that of history repeating itself, inasmuch as new legislation providing for further control has generally been introduced in the immediate aftermath of the collapse of an insurance company, highlighting the defects of the existing regulatory regime. Two notable examples are the demise of the Fire, Auto and Marine Insurance Company, which led to the introduction of Part 2 of the Companies Act 1967, and the disastrous collapse of Vehicle and General in 1971, which left a million motorists without insurance, and led to the Insurance Companies Amendment Act 1973, and subsequently the Policyholders Protection Act 1975. The current requirements for authorisation were first enacted in the Insurance Companies Act 1974, and were substantially repeated in the Insurance Companies Acts 1981 and 1982.

Whatever the shortcomings of the various regulatory regimes may have been, however, there had always been prior to 1984 a clear distinction between the role of the Department of Trade and Industry (DTI) in authorising companies to carry out business, and the business itself. Authorisation did not directly affect the way that business was carried on, nor did it directly affect any policies that had been agreed.

This changed in 1984, with the decision of Parker J in *Bedford Insurance Co. Ltd v IRB*. [2]

BEDFORD INSURANCE

In this case, the insurers had provided insurance cover for which they were not authorised and had subsequently obtained reinsurance protection for these risks. The reinsurers refused to pay, and the insurers had sued. The reinsurers contended that they were not liable to pay as the reinsurance contracts were illegal, because of the lack of authorisation.

The essential problem for the judge was the interpretation of the 1974 Act. Section 2(1) provided that: “no person shall carry on in Great Britain insurance business’ of certain listed classes without the appropriate DTI authorisation. Under section 11(1) it was a criminal offence to carry on business in contravention of the 1974 Act. The 1974 Act did not precisely define what is meant by “carry on insurance business’; however section 83 defined the classes referred to in section 2(1) and the definition for each class of business referred to as: “the business of effecting and carrying out contracts of insurance’.

The question for the court was deciding what precisely the Act made illegal, and what effect this had on the enforceability of the contracts. There were essentially two approaches that the court could take. First, it could take the view that the insured is asking the court to order the payment of claims, that is, to carry out the insurance contract, which is precisely what is forbidden under the Act. The alternative would be to find that the illegality is in some way “collateral’ to the contract, and the contract itself is therefore still legal.[3]

The first approach follows the wording of the statute precisely but fails to meet what common sense clearly indicates is the purpose of the process of authorisation, namely, to protect the insurer, who would now be worse off under a system of regulation that he would be without it. The second approach makes better overall sense of the regulatory regime but requires a distortion of the apparently unambiguous wording of the statute.

JUDICIAL DISCRETION

One of the practical difficulties in litigation is that, however good the legal arguments are, there is often a degree of uncertainty within which there is room for judicial discretion. One of the most important factors influencing the outcome of difficult cases is the judge’s approach to the interrelationship between formal law and a more common sense concept of fairness and justice. Judges can be divided into two broad types in this respect: those who are more concerned to uphold the requirements of a formal, internally coherent, system of law, and those who are more concerned to see that a more intuitive sense of fairness is achieved, and are prepared ***Int. I.L.R. 95** to “develop’ formal doctrine in order to achieve this. These two tendencies have been categorised by Pollock[4] as “judicial caution’ and “judicial valour’. More polemically, Lord Denning made a similar categorisation, into “timorous souls’ and “bold spirits’,[5] and it is not hard to guess in which he placed himself. These are of course abstract types, and inevitably most judges display elements of both traits. The question of the illegality of insurance contracts as a result of a lack of authorisation is a good example of the sort of issue that will cause difficulties for judges in this respect.

”A MOST UNFORTUNATE STATE OF AFFAIRS’

Parker J, in *Bedford,* concluded that the basic insurance contracts were illegal and void, and therefore the reinsurance contracts were unenforceable as there was no risk for the insurer to reinsure. He further held that even if the original contracts were enforceable by the insured, the insurer would have to rely on his own illegal act in order to claim under the reinsurance contracts. On the facts, little injustice was done in this case, because it was the unauthorised insurer himself who was trying to claim under reinsurance contracts from an authorised reinsurer.

Stewart v Oriental Fire & Marine Insurance Company Ltd, [6] however, concerned an authorised insurer who had entered into a valid insurance contract, but had reinsured itself with an unauthorised reinsurer who subsequently refused to pay claims. Leggatt J decided that the insurance contracts were enforceable, because there was no reference in the 1974 Act to “contracts of insurance’ and thus it was “insurance business’ that was prohibited.

There were therefore two conflicting first instance decisions; one could be described as cautious, the other bold. The question first came before the Court of Appeal in *Phoenix General Insurance Co. of Greece SA v Halvanon Insurance Co. Ltd,* in October 1986.[7] On the facts, the Court of Appeal held that the insurer was properly authorised on the basis of its interpretation of EC law. However, given the importance of the matter, they went on to consider what the position would have been if the insurer had not been authorised. Would the Court of Appeal exercise judicial caution or valour?

Kerr LJ, who gave the leading judgment, held as follows:

The [1974 Act] imposes a unilateral prohibition on unauthorised insurers. If this were merely to prohibit them from carrying on “the business of effecting contracts of insurance’ of a class for which they have no authority, then it would clearly be open to the Court to hold that considerations of public policy precluded the implication that such contracts are prohibited and void. But unfortunately the unilateral prohibition is not limited to the business of “effecting contracts of insurance’ but extends to the business of “carrying out contracts of insurance’ In the same way as Parker J in the *Bedford* case, I can see no convincing escape from the conclusion that this extension of the prohibition has the unfortunate effect that contracts made without authorisation are prohibited by necessary implication and therefore void. Since the statute prohibits the insurer from carrying out contracts - of which the most obvious example is paying claims - how can the insured require the insurer to do an act which is expressly forbidden by statute? And how can a Court enforce a contract against an authorised insurer when Parliament has expressly prohibited him from carrying it out?[8]

He therefore felt obliged to uphold the coherence of formal law, against the requirements of fairness. He recognised however that this was a problem:

If this conclusion is correct and applied to all cases of unauthorised insurance business, it is of course a most unfortunate state of affairs for the insurance market, as all judges who have had to grapple with this problem have recognised. In the *Stewart* case Leggatt J referred to "widespread consternation' in the market as the result of the decision in the *Bedford* case. Nevertheless, for the reasons already stated, I feel bound to uphold the *Bedford* case and to say that the *Stewart* case should be overruled. But will this really cause consternation? The illegality in question is not a patent one which the court is bound to take into account of its own volition. None of the Counsel before us, all experienced in the Commercial Court, had heard of any case where an insurer had taken the point, by relying on his own illegality as a defence, in order to avoid payment to an insured. Undoubtedly it may have serious repercussions on contracts of reinsurance, and we were told that a number of other reinsurance cases were awaiting the outcome of this appeal. All that one can say in that regard is that any reputable reinsurers, solicitous of their good name and reputation will do doubt hesitate long before relying on this defence.[9]

This is in many ways an odd remark, because Kerr LJ is essentially saying that the honourable thing for an unauthorised insurer to do is to commit an illegal act. He effectively recognised that there was a disparity between formal law and what the market would regard as just and fair, but goes on to suggest that the internal demands of the market will override any possible advantages to be had from strict adherence to the precise legal effects.[10]

SECTION 132

There were two ways around the problem: either the House of Lords could overrule the Court of Appeal case, or the law could be changed by statute. *Phoenix* was not appealed, no doubt principally because it had been decided on other grounds, but the Financial Services Bill was at that time being debated in Parliament and swift lobbying led to the inclusion of a clause dealing with the problem. This was enacted as section 132 of the Financial Services Act 1986 ("section 132') and it provides that an insurance contract entered into by "a person in the course of carrying on ***Int. I.L.R. 96** insurance business in contravention of section 2 of the Insurance Companies Act 1982 shall be unenforceable against the other party', but that the insured will be entitled to be repaid any premiums and, subject to certain conditions, to enforce the contract for, essentially, the payment of claims. This appeared to solve the problem rather neatly, with the new statutory regime effectively replacing the 1982 Act.

The precise effect of section 132 was one of the issues in *DR Insurance Co. v Seguros America Panamex.* [11] The case concerned contracts placed through the Stetzel Thomson pool, which had a complicated arrangement of agents in London and America, to by-pass the need for authorisation. There were two legal questions: (1) whether the contracts made by the pool via its agents were illegal under the 1982 Act, including whether the decision in *Phoenix* could be distinguished; and (2) whether section 132 could retrospectively apply to contracts entered into before it came into effect in 1987.

The matter came before Adrian Hamilton QC, sitting as a deputy high court judge. He held that section 132 did not have a retrospective effect for two reasons; first, he pointed to the general presumption against given retrospective effect to statutes that altered the substantive rights of parties without express wording: he referred to a passage in *Craies on Statute Law* [12] and in *Re Athlumney,* [13] as follows,

Perhaps no rule of construction is more firmly established than this - that a retrospective operation is not to be given to a statute so as to impair an existing right or obligation, otherwise than as regards matters of procedure unless that effect cannot be avoided without doing violence to the language of the enactment.

Secondly, he pointed to the wording of the statute itself, especially subsection (6) which states that,

A contravention *shall not* make a contract of insurance illegal and a contravention *shall not* affect the validity of any reinsurance contract

He thought that "shall' was being used to conjugate in the future tense and thus only applied to contracts entered into after it had come into force.

It appeared therefore that legislation which should have plugged a hole had merely prevented it from spreading and there were still a considerable number of illegal contracts that did not fall within the scope of the amendment.

BATES V BARROW

To the relief of many, however, the question of the retrospectivity of section 132 has now been reconsidered by Gatehouse J in *Bates v Barrow.*

The facts of the case are set out in the judgment as follows:

The Plaintiffs are Lloyd's names who on various dates between 1981 and 1983, took out stop loss cover in respect of their 1982, 1983 and 1984 years of account. The Placing Broker was Robert Barrow Limited the cover was placed with Kansa General International Insurance Company Limited.

The Second [to Fifth] Defendants were members' agents who, on behalf of their respective names, instructed Barrow to obtain a cover and act as intermediaries between Barrow and the Names.

Kansa are a Finnish Reinsurance Company based in Helsinki who, at least in the years in question, were regarded in the London market as a substantial and reputable company. They met the demanding solvency requirements of the Finnish insurance authorities. But they were not authorised under the Insurance Companies Act to carry on insurance business in the UK.[14]

Gatehouse J had to decide two preliminary points: first, whether section 132 is retrospective, and, if it is, how far back it extends; second, if the section is not retrospective, whether the underwriters are liable in negligence for failure to effect valid stop loss policies.

RETROSPECTIVITY

On the first issue, Gatehouse J construed the wording of section 132 differently from Adrian Hamilton QC:

The use of the word "shall' is simply stating what the various effects of contravention are to be as from the date when the section comes into force. It is not stating by implication - and of course nowhere does the section expressly state - that these effects are to apply only to contravening contracts entered into after that date. The matter can be tested in this way; even if the legislature had made it clear that retrospectivity was intended, e.g. by providing in sub-section (1):

"subject to sub-section (3) below, a contract of insurance *whether entered into before or after this section comes into force* by a person in the course of etc.'

<DPAC2>the word "shall' would still have been necessary in exactly the same places as it now features. In my view, the word "shall' is directed at, and is a necessary introduction to the description of, the legal consequences which are henceforth to follow: it gives no indication as to which contracts, whether entered into before or after the Act, it applies to.[15] </DPAC2>
Thus he interpreted the word as being a statutory imperative, rather than being the future tense.

Having taken this view he considered whether the general presumption against retrospectivity precluded his construction. The presumption has been recently reconsidered in *The Boucraa,* [16] in which the House of Lords had started from the basic premise that statutory interpretation must be approached from the perspective that a statute is not intended to have retrospective effect, but found that "the basis of the rule is no more than simple fairness' and therefore could operate to provide retrospectivity in certain circumstances. Lord Mustill, who delivered the leading speech, explained that fairness is determined by the interaction of two main factors: first, it is necessary to look at "the value of the rights which the statute effects or the extent to which that value is diminished' and second, "the clarity of the language used by Parliament and the light shed on it by consideration of the circumstances in which the legislation was enacted'.[17]

Int. I.L.R. 97 Lord Mustill's decision is an interesting one because it allows the process of statutory interpretation to bridge the gap between the requirements of formal law based on a close reading of the text, and the common sense notions of fairness and justice. His judgment allows for a more purposive approach to statutory interpretation and thus allows judges to consider the spirit as well as the letter of the law.

Gatehouse J therefore embarked on a review of the case law from *Bedford* onwards to consider what mischief section 132 was trying to overcome, and what the effect would be on the parties of allowing the rights to be asserted retrospectively. He held that:

Prior to the *Bedford* decision, the evidence is clear that no one in the insurance market thought that a contract would be unenforceable merely because the insurer was not authorised under the 1982 Act or the 1981 Act, or the 1974 Act.

It can be inferred with certainty that at the time of contracting, every insurer as well as every assured intended to fulfil its obligations (and enjoy its rights) under the contract. Even by the time of the hearing of the *Phoenix* appeals in July 1986, no insurer had apparently taken the point, relying on his own illegality, although some reinsurance cases were then said to be awaiting the outcome to argue that Section 132 created a new obligation is, in my view, not supported by the rationale of the decided cases which, as the House of Lords' decision in *The Boucraa* makes clear, is founded on the concept of fairness. I see nothing unfair in restoring the parties in 1987 to the contractual position that they both assumed and long acted upon. No authority was cited which prohibited retrospectivity because of an "obligation' of this kind.[18]

On the question of the mischief that section 132 was trying to counter, he held as follows:

If Parliament was intending to reverse the *Bedford/Phoenix* decision which is clear, and intending to remedy the mischief which followed, it seems to be remarkable if Section 132 was nevertheless intended to have effect only upon contracts entered into after January 12th 1987. This would leave wholly unaffected the vast number of earlier contracts which were in jeopardy, while only "biting' on what by comparison must be a very small number of post-January 1987 infringing contracts.[19]

RETROSPECTIVITY: HOW FAR BACK?

There remained, however, one problem. The wording of section 132 refers to "a contravention of Section 2 of the [1982 Act]'; it does not refer to a contravention of either the 1981 Act or the 1974 Act. It was therefore arguable that even if the 1986 Act was retrospective, it was only retrospective to 1982, and no further. Given that Gatehouse J was bold enough to hold that the 1986 Act was retrospective, it is hardly surprising that he did not accept this limitation, although he acknowledged that it created a problem of construction. He thought it was not possible to argue that illegal contracts under the 1974 and 1981 Acts were translated into illegal contracts under the 1982 Act merely because of the repeal and re-enactment of these sections in the 1982 Act. However, he held that, although the contracts may have been entered into illegally under the 1974 and 1981 Acts, nevertheless any claim by the insurers now would be carried out under the 1982 Act. Thus he concluded:

When the Name then makes a claim he is seeking illegal performance of the contract and is doing so at a time when the 1982 Act regime is in force.[20]

BROKER'S DUTIES

Finally, Gatehouse J dealt with the (now otiose) question of whether the placing brokers were negligent by placing the business with an unauthorised insurer. He held that there had been a breach of the duty of care, because the brokers should have realised that Kansa were unauthorised, and that they were therefore effecting an illegal contract. Thus he said,

Barrow, as brokers, were under a duty to each Name to use reasonable care to ensure that his stop-loss policy did not infringe the Insurance Companies Acts. Barrow themselves either knew or ought to have known, because they themselves were operating the scheme, that there was infringement at least in the way the contracts were effected.[21]

However he held that the damage was too remote, because the broker could not have contemplated the loss that would have been caused by his breach and it was therefore too remote, under the principles set out in *Parsons (Livestock) Ltd v Uttley Ingham & Co. Ltd.* [22]

There was some evidence to suggest that, if the legal consequences had been thought through, then the brokers would have realised that the contracts were illegal, but Gatehouse J also considered whether it was reasonable to foresee that the unauthorised insurer would refuse to pay; he considered that "Kansa were regarded in the London market as entirely reputable and solid security'.[23] This is again an interesting conclusion since it revolves around what "the market' would consider sensible, in terms of the actual reinsurer, rather than holding that consideration of the legal consequences was the only criterion. In this way it suggests that an awareness of the consequences of formal law is not enough, and that common sense notions of reasonableness on a case-by-case basis must be considered too.

CONCLUSION

The next question is what the appeal courts will make of his judgment: will the Court of Appeal and the House of Lords accept Gatehouse J's interpretation, or will they consider that he has overstepped the mark? Commercially, it is to be hoped that they will see this as a sensible way of resolving what has been regarded for the last decade as an absurd side-effect of British insurance regulation.

Footnotes	
1	*Sir Jeffrey Bates and Others v (1) Sir Robert Barrow Limited, (2) RF Kershaw Limited, (3) DM Green & Co. (Underwriting) Limited, (4) Gooda & Partners Limited, (5) David Evers Limited Underwriting Agents Limited, (6) Kansa General Insurance Company Limited, (1981 Folio 2276) and Mrs Elizabeth Ansell and Others v (1) Robert Barrow Limited, (2) RF Kershaw Limited, (3) BPC Members Agency Limited, (4) JH Miner Agencies Limited, (5) Postgate & Denby (Agencies) Limited, (6) Kansa General Insurance Company Limited* (1992 Folio 2209); 8 December 1994, unreported; all references are to the transcript.
2	[1984] 1 Lloyd's Rep. 210.
3	For example, *Archbold's Freightage Ltd v S. Spanglett Ltd* [1961] 1 QB 374.
4	"Judicial Caution and Valour', 45 LQR 293 to 306.
5	*Candler v Crane, Christmas & Company* [1951] 2 KB 164, at 178.
6	[1984] 2 Lloyd's Rep. 109.
7	[1988] 1 QB 216.
8	*Ibid.,* at 274.
9	*Ibid.,* at 276.
10	His response highlights the way that many regulatory offences are regarded, inasmuch as they are not treated as "real crime'. This is most clearly spelt out by Wright J in *Sherras v DeRutzen,* who held that they were "not criminal in any real sense but which in the public interest are prohibited under a penalty', [1895] LOB 918 at 922.
11	[1993] 1 Lloyd's Rep. 120.
12	London, (7th edn), at 387.
13	[1898] 2 QB 547 at 551 to 552.
14	Note 1 above, at 1.
15	*Ibid.,* at 10.
16	*Yamashita-Shinnihon Steamship Co. Ltd v L'Office Cherifien Phosphates and Unitramp SA* [1994] 1 Lloyd's Rep. 251.
17	See *ibid.,* Footnote 6, at 258.
18	Note 1 above, at 13 to 14.
19	*Ibid.,* at 15.
20	*Ibid.,* at 22.
21	*Ibid.,* at 24.

22	[1978] 1 QB 791.
23	Note 1 above, at 29.