

“Pay to be Paid” Wording in Marine Insurance Policies

By Thomas S. Hawkins
A Vancouver Lawyer
With Bernard & Partners

It is common knowledge that most fleet protection and indemnity policies of insurance contain a form of collision clause which provides that if the insured is involved in a collision and as a consequence the insured “*shall be liable to pay and shall pay by way of damages*”, to the Third Party, then the Underwriters will pay such sum to the insured. It is understood that such requirement means that an insured who has had a claim brought successfully against him must first pay before he could claim indemnification from his underwriters in respect of his liability. Disputes involving this issue often find their way to the courts when the insured for financial reasons is no longer in a position to make the payment.

A recent decision of the Federal Court of Appeal in *Conohan v. The Co-Operators, 2002 F.C.A. 60* provides an excellent analysis and overview on just such a problem. The case involved a collision of the “Lady Brittany” with the “Cape Light II”, in the off-shore waters of Eastern Prince Edward Island on September 21, 1996. In April 1997 the owner of the “Cape Light II”, Conohan, commenced an action *in rem* and *in personam* in the Federal Court against the “Lady Brittany” and its owner, Gaudet, for the loss of his vessel and for loss of revenue. Several months later Gaudet signed an “Admission of Liability, Confession to Judgment and Assignment of Rights” in favour of Conohan and his underwriters. Gaudet admitted that he had no defence to the action and that the collision resulted from his errors of navigation and improper look out. The insurers of Gaudet’s vessel “Lady Brittany” refused to provide any indemnification to Gaudet and refused to defend or even participate in the proceedings on the basis that Gaudet had made no payment in respect of any liability. Gaudet also agreed to assign to Conohan and his underwriters all of Gaudet’s rights of claim against his own underwriters The Co-Operators in respect of his policy of insurance.

As a result, the action in the Federal Court was commenced by Conohan and his underwriters against Gaudet’s underwriters seeking damages for the total loss of the “Cape Light II”.

Conohan and his underwriters alleged in the Statement of Claim that Clause 16 of the Policy of Insurance for the “Lady Brittany” obligated Gaudet’s underwriters to indemnify him for all sums he would need to pay as a result of his liability resulting from the collision. In the Statement of Defence, Gaudet’s underwriters raised a number of defences including alleged alcoholic impairment of Gaudet and breach by Gaudet of warranties contained in the *Marine Insurance Act*. These defences failed at trial and were not relevant to the Appeal. The trial judge considered Clause 16 of the policy and The Co-Operators argument that it was not obliged to indemnify Gaudet under the policy for liability arising from the collision because Gaudet had failed to comply with the so called “pay to be paid” requirement in Clause 16. The operative wording in Clause 16 is as follows:

“It is further agreed that if the vessel hereby insured shall come into collision with any other vessel and the insured shall in consequences thereof become liable to pay and shall pay by way of damages to any other person or persons any sum or sums in respect of such collision for:

...

The insurer will pay the insured such sums so paid provided always that their liability in respect of any one such collision shall not exceed the value of the vessel hereby insured...”

The trial judge concluded that Clause 16 required Gaudet to first pay before he could claim indemnification from his underwriter in respect of his liability to the Appellant Conohan. He rested his conclusion on the 1991 decision of *The House of Lords in Firma C – Trade S.A. v. Newcastle Protection and Indemnity Association*. Conohan and its underwriter appealed the decision to the Federal Court of Appeal.

Mr. Justice Stone writing for the Court of Appeal began his discussion on the substantive issue by recalling, as Subsection 6(1) of the *Marine Insurance Act* emphasizes, that a contract of marine insurance “is a contract whereby the insurer undertakes *to indemnify the insured, in the manner and to the extent agreed* in the contract...”. In other words it is not a contract of indemnity ideally, but of an indemnity *according to the conventional terms of the bargain*. The

question for the court then is rarely – how much is the assured out of pocket? It is more properly what is the measure of indemnity that *by the convention of the bargain has been promised to the assured?*

Mr. Justice Stone then embarked on a very informative review of the evolution of the collision clause in England during the 19th Century. The learned judge pointed out that at common law, no action could be maintained on a contract of indemnity until actual loss had been incurred. Subsequently, equity found a way of relieving against this harshness by requiring the indemnifier to pay the creditor direct or to pay the indemnified person before he had paid the creditor. However the insurance contract did not contain an express “pay to be paid” clause.

Nevertheless Conohan and its underwriter argued on appeal that the trial judge had erred by relying on the decision of the House of Lords in *Firma*. The main issue in *Firma* turned on the construction of two rules of the P & I Clubs, which constituted a policy of insurance. By those rules the Clubs undertook to protect and indemnify their members in respect of losses or claims for which the member “shall become liable to pay and shall have in fact paid...”. It was argued in the *Firma* case that the requirement of prior payment to the Third Party loss did not amount to a condition precedent to recovery under the P & I Club contracts of insurance. The House of Lords disagreed.

The House of Lords held that the rules of the Clubs which contained the “pay to be paid” provisions, meant that the ship owner members were not entitled to be indemnified by the Clubs in respect of third party liabilities which they had incurred, unless and until the members had first discharged and paid those liabilities themselves. To say it another way, the payment by the members to the third parties was a condition precedent to payment by the Clubs to the members. The House of Lords in *Firma* confirmed that where the ship owner member was ordered to be wound up and therefore unable to pay the relevant claim, then the condition precedent is not fulfilled and the member has no right to be indemnified by the Club. Further the transfer of his right to another party can not put that party in any better position than the member.

Conohan and its underwriter also contended that the House of Lords decision in *Firma* does not contain a principle of broad application that would govern non-mutual marine insurance policy collision clauses. They pointed out that *Firma* was concerned with determining the meaning of a

P & I Club rule, part of a mutual insurance contract, rather than a clause in an ordinary marine policy available in the open market. Mr. Justice Stone was not persuaded. He observed that the language of Clause 16 covering collision liability where the insured “becomes liable to pay and shall pay by way of damages” was strikingly similar to those considered in the *Firma* decision. Mr. Justice Stone considered that whether Clause 16 set up a condition precedent to indemnification, ie: a “pay to be paid” clause, was essentially a question of construction of the language in the clause. He proceeded to review a number of English authorities and their applicability in determining whether compliance with the “pay to be paid” requirement in Clause 16 of this ordinary marine insurance policy should be viewed as a condition precedent to recovery there under. Stone J.A. observed that some authorities in England are to the effect that the “pay to be paid” requirement of a collision clause means what it says, namely, that the liability must be discharged by the insured before the insurer becomes liable to indemnify the insured.

Ultimately Mr. Justice Stone for the Federal Court of Appeal held that the ordinary meaning of the words employed in Clause 16 of the policy plainly required that Gaudet pay the damages incurred to the Appellant Conohan by reason of the collision before he could collect under the policy issued by his underwriter. Accordingly the trial judge was correct in his conclusion that Gaudet’s non-compliance with the requirement to pay under Clause 16 released his underwriter from all liability under the policy. Therefore the claim by Conohan and his underwriters against Gaudet’s underwriter under the policy failed.

Conclusion

The importance of this decision for marine underwriters is two fold. Firstly, the “pay to be paid” requirement more closely associated with P & I Clubs and their mutual insurance contracts, should receive the same interpretation when it is present in a non-mutual insurance policy as when it appears in a mutual insurance policy.

Secondly, if an assured does not or can not pay the third party liability claim where there is a “pay to be paid” requirement of a collision clause, the assured’s underwriter will be able to successfully defend an action brought against it by the other vessel owner and its underwriter even where the assured has assigned all his rights to those parties.

Tom Hawkins is a partner and maritime lawyer with Bernard & Partners and can be reached at hawkins@bernardpartners.com