RIDING ON THE WINDS OF CHANGE: TRANSFORMING WARRANTIES INTO LESSER CONTRACTUAL TERMS

1.0 Introduction

A breach of warranty has drastic consequences. When a breach of warranty occurs, the insurer is automatically discharged from liability.

In many countries the war against this draconian remedy has begun. In Australia, the Australian Law Reform Commission in its Report No. 91 on *The Review of the Marine Insurance Act 1909*, recommended reforms in many areas of marine insurance and warranties were on top of the reform list, where the Commission recommended the abolition of this concept. A similar trend is also seen in Canada.

In the United Kingdom statistics show that the marine insurance market in London has been under significant threat for some time. The London market has lost its market share of the world marine insurance business due to the intense competition from France, Germany, Switzerland, Italy, Scandinavia, the USA and especially Norway.

Many of these alternative markets were able to offer marine insurance cover on the lowest available market rate and on the best possible terms. Norwegian law does not have the concept of warranties.

To remain competitive and to regain lost market share the IHC 2002 was introduced in the UK. These clauses have been viewed as more consumer-friendly; as there appears to be a drift away from the use of insurance warranties in these clauses.

2.0 The Principle of Automatic Discharge From Liability

In *Bank of Nova Scotia* v. *Hellenic Mutual War Risks Association (Bermuda) Ltd. (The Good Luck)*[1], the House of Lords held that

[1] [1991] 2 Lloyd's Rep. 191.

where a breach of warranty occurs, the insurer is automatically discharged from liability from the date of the breach of the warranty.[2] The breach of warranty also leads to the automatic termination of the risk.

The above principle applies *ipso facto* in all classes of insurance (marine/non-marine insurance).

2.1 The Facts of *'The Good Luck'*

The warranty that was breached in *'The Good Luck'* was a navigation and locality warranty. The 'Good Luck' (a ship was owned by the Good Faith Group) was insured with the defendant club (P&I Club) and mortgaged to the plaintiff bank. By the requirements of the mortgage the benefit of the insurance was assigned to the bank and the club gave a letter of undertaking to the bank, whereby the club promised to advice the bank promptly if the club should 'cease to insure' the ship (parag. 3 of the letter of undertaking).

The insurance provided was defined in and governed by the rules of the club which provided *inter alia* by Rule 20:

> A. The Directors have power under Rule 26 to specify any ports, places, countries, zones or areas (whether on land or sea) as Additional Premium Areas (AP) and to specify any special terms, conditions, exceptions, or limitations of or to the Association's cover which shall apply while an entered ship shall be or remain in any such area.
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> B. If an entered ship shall proceed to or be or remain in any Additional Premium Area (AP), then: (i) the owner shall continue to be insured while the ship proceeds to or is or remains within such area. PROVIDED ALWAYS that:-

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[2] In *Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd (The Good Luck)* [1991] 2 Lloyd's Rep. 191, Lord Goff stated at page 202:

> So it is laid down in s.33(3) [Marine Insurance Act 1906] that, subject to any express provision in the policy, the insurer is discharged from liability as from the date of breach of warranty. ...They show that discharge of the insurer from liability is automatic and is not dependent on any decision by the insurer to treat the contract of insurance as at an end ...

> It is a condition of the insurance given by the Association that the owner shall give prompt notice to the Association of the fact that the entered ship will enter, has entered or is in the Additional Premium Area as soon as the owner knows of such fact.

Rule 25 provided as follows:

> A. The Directors shall at all times have power to give any member or members such orders, prohibitions, ...as the directors in their absolute discretion may see fit as regards routes, ports, ...including orders to go or depart from or remaining at (or prohibitions from going to, departing from or remaining at) any port, place, country, zone or area.
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> C. Every insurance given by the association shall be deemed to contain and shall contain a warranty by the owner that all such orders, prohibitions, directions or recommendations as are referred to in paragraphs A of this rule shall be acted upon and complied with by the insured ship...

During the relevant period, the most important additional premium area was the Arabian Gulf. Prohibited zones [areas], the subject of r. 25, were zones of such extreme danger that it was not considered acceptable that the vessels should be covered at all by the club while in such an area. The club declared as a prohibited zone the Shatt Al Arab and Khor Musa and the approaches to those places at the northern end of the Gulf, which were areas directly affected by the hostilities between Iran and Iraq.

The Good Faith were in the practice of chartering vessels to Iranian charterers and, under those charters, sending the vessels into the Gulf and to various Iranian ports including Bandar Abbas, Bushire and Bandar Khomeini. These voyages took the vessels into additional premium area and when they went to Bandar Khomeini, into the prohibited area.

On April 7, 1982 Good Faith chartered *The Good Luck* to Iranian charterers: the charterers had the right to order the vessel to Iranian ports including Bandar Khomeini. *The Good Luck* arrived at Bandar Abbas on May 30. The next day she proceeded northwards bound for

Bandar Khomeini and on Sunday, June 6 at 11:15 local time, she was hit by one or more Iraqi missiles while proceeding up the Khor Musa channel to Bandar Khomeini. She was badly damaged and ultimately declared a constructive total loss.

The ship was sent to the Arabian Gulf in breach of the warranty under the contract of insurance as certain restrictions were placed in the form of a warranty in the policy on the movement and operation of the insured vessel. Such warranties are called navigation (locality) warranties where the assured will undertake that the insured vessel will not navigate in specific waters.

2.2 The Decision

Lord Goff stated:

> Rule 20 conferred on the directors of the club power to specify certain areas or places as additional premium areas, the broad effect of which was that, if an entered ship proceeded to or remained in such an area, the owner continued to be insured but was bound to pay to the club an additional premium (that is to be arranged between the parties). As the Judge held, r. 20 is essentially a "held covered" provision.
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> The scheme of r. 25 is also clear. It lays down an express warranty in the marine insurance sense.
> During the relevant period, the most important additional premium area was the Arabian Gulf. Prohibited zones [areas], the subject of r. 25, were zones of such extreme danger that it was not considered acceptable that the vessels should be covered at all by the club while in such an area."

3.0 The Locality Warranties - The Institute Warranties (1/7/1976) & The Significant Changes made by The International Hull Clauses (1/11/2003)

It is a general rule in marine insurance that the assured ship will navigate in any navigable waters – see Cl. 10.2 IHC 2003 (1/11/2003), unless there are restrictions expressed in the policy to the contrary.

In the field of marine insurance law in the past, clauses which restricted the navigation and locality limits of an insured vessel usually took the form of a warranty. There were 5 sets of locality warranties that were drafted by the London Market Joint Committee and were published by the Institute of London Underwriters as the Institute Warranties 1976 (1/7/1976).

However, there were significant changes made by the Institute Hull Clauses 2003 (1/11/2003), where the locality warranties mentioned in the Institute Warranties (1/7/1976) were no longer to take effect as warranties. If the geographic policy limits are breached there is no cover for loss during the period of the breach, unless the Assured immediately advises the Underwriter of details of the breach and terms are agreed – See Clauses 10, 11, 32 & 33 IHC 2003. A critical discussion of the IHC 2003 is beyond the scope of this article.

Today, the insurer can still insert an express provision with regards geographical limits (i.e. restricting the assured vessel to proceed to areas for e.g. where there is war) and expressly state that such provision is to take effect as a warranty and perhaps stipulate expressly the consequences of breach as was done in the *'The Good Luck'* – Rule 25.

4.0 The Draconian Nature of a Breach of Warranty & The Winds of Change: Transforming Warranties into Lesser Contractual Terms

The principle that a breach of warranty automatically discharges the insurer from liability without the need for a causal link between the loss and the breach has been the subject of severe criticism. The International Hull Clauses 2003 has altered the legal character of some obligations that have traditionally been regulated by the warranty regime.

Firstly, the locality warranties mentioned in the Institute Warranties (1/7/1976) will no longer take effect as warranties under the Institute Hull Clauses (IHC) 2003. If the geographic policy limits are breached there is no cover for loss during the period of the breach, unless the Assured immediately advises the Underwriter of the details of the breach and terms are agreed. The locality warranty under the Institute

Warranties (1/7/1976) has in essence been transformed into a suspensory provision by the IHC 2003.

Secondly, Clause 14.4 of the IHC 2003 states the failure by the assured, owners and managers to comply with the requirements of the vessel's flag or classification society relating to the general seaworthiness of the vessel renders the underwriter not liable for any loss attributable to the breach.

Dr. Baris Soyer argues that there seems to be an overlap between section 39(5) of the Marine Insurance Act 1906 and clause 14.4 of the IHC 2003. Clause 14.4 of the IHC 2003 gives the underwriter a contractual defense in addition to the statutory defense provided for under section 39(5) of the Marine Insurance Act 1906. However, there can also be a situation where section 39(5) of the Marine Insurance Act 1906 might not be applicable but where clause 14.4 of the IHC 2003 could come to the rescue of the underwriter. One such instance is *The Star Sea* where the assured was not privy to the unseaworthiness and as a result section 39(5) of the Marine Insurance Act 1906 was not applicable. However, had *The Star Sea* been insured under the IHC 2003, the underwriters would have succeeded as 'privity of the assured' was not a requirement under clause 14.4.[3]

Thus as Professor Rhidian Thomas has argued in such an instance there appears to be a drift away from the use of the marine insurance warranties, as under IHC 2003 breach of clause 14.4 will exclude the liability on the part of the underwriters to compensate for any loss attributable to the breach. The position is now treated as an exclusion from liability and the underwriters will have a contractual defence. However, the association from warranty has not been completely severed as the underwriter still has to comply with the ISM Code, and the obligations relating to Class under clause 13 IHC 2003 is still a warranty.[4]

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[3] B Soyer, 'A Survey of the New International Hull Clauses 2002' [2003] 3 JIML 277-278.

[4] R Thomas, 'International Hull Clauses 2002' [2003] 3 JIML 202.

5.0 Breach of Warranty & The Waiver / Estoppel Dichotomy

In insurance cases, the distinction between "waiver" and "estoppel" is not often drawn.[5] Waiver in the present context means either an abandonment of a right or a defence that may occur as a result of an election by the insurer or of the creation of an estoppel that precludes the insurer from relying upon his contractual rights against the assured.[6]

Thus, a waiver by election arises in circumstances where the insurer when faced with the repudiation of the contract, has two choices, either to affirm the breach or to accept the repudiation and treat the contract as terminated.

Waiver by estoppel, on the other hand, arises in circumstances where the insurer makes it clear to the assured that he does not intend to rely upon the breach of warranty.

In marine insurance law, where a breach of warranty occurs, the insurer may waive the breach of warranty [7] due to the commercial realities of the day.[8]

6.0 Doctrine of Waiver by Election Incompatible with the Principle of Automatic Discharge from Liability

Where an assured has breached a warranty, the insurer is automatically discharged from liability as from the date of the breach of warranty. Secondly, cover dies. Thirdly, risk terminates.

As a natural consequence, the insurer acquires an immediate defence to a claim by the assured. Thus, the insurer is not required to elect to exercise a remedy such as rescission of the contract, in order to acquire a defence.

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[5] M Clarke, 'Breach of Warranty in the Law of Insurance', [1991] LMCLQ 437,439.

[6] In *Commonwealth v. Verwayen* (1990) 95 ALR 321, 328 Mason C.J. said, "... waiver is an imprecise term capable of describing different legal concepts, notably election and estoppel."

[7] Section 34(3) of the Marine Insurance Act 1906 (UK) states, "a breach of warranty may be waived by the insurer."

[8] Among the factors for waiving the breach of warranty include the commercial importance to the insurer of retaining the particular assured as a client or the climate in the market, might require the insurer to take such a step.

The present editors of MacGillivray submit that "waiver by election is therefore inapplicable to breach of warranty ... because the insurer is not put to any election by the occurrence of the breach ...." [9]

In *Kirkaldy & Sons Ltd.* v. *Walker*,[10] Longmore J. held that the principle of "waiver by election"[11] has no part to play in the law of warranties. Longmore J. said:

> Section 33 of the Marine Insurance Act 1906 provides for the insurer to be discharged from liability as from the date of the breach of warranty. It is therefore apparent that no question of election arises although, by s 34(3), the insurers may waive the breach. Since the breach of warranty does not give rise to any election by the insurer e.g. to choose to keep the contract on foot, the doctrine of waiver by election has no application. The owners must rely on the doctrine of waiver by estoppel (see Clarke The Law of Insurance Contracts (2nd edn, 1994) pp 515-516, para 20-7A and MacGillivray on Insurance Law (9th edn, 1997) pp 253-254, paras 10-96 to 10-98). The owners must, therefore, show a representation by words or conduct that the insurers would not rely on the [breach of the warranty].

Similar views have been expressed in *Brownsville Holdings Limited and Another* v. *Adamjee Insurance Company Limited, (The Milasan)*[12] where Aikens J. stated that "waiver by election" did not survive the judgment of the House of Lords in *The Good Luck*.

In *HIH Casualty and General Insurance Ltd.* v. *Axa Corporate Solutions*[13] Deputy Judge Sher Q.C. echoed a similar view when he stated that waiver by affirmation (election) is inapplicable to a case of breach of warranty. This decision was upheld on appeal to the Court of Appeal.[14]

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[9] MacGillivray, *Insurance Law*, 10th ed., (London, Sweet and Maxwell, 2003) 266.

[10] [1999] Lloyd's Rep. IR 410.

[11] It is respectfully submitted, that cases that have been decided on grounds of "waiver by election" should be held to have wrongly applied the law.

[12] [2000] 2 Lloyd's Rep. 458, 467.

[13] [2002] Lloyd's Rep. I.R. 325.

[14] [2003] Lloyd's Rep. I.R. 1.

A case which seems to depart from the established authorities is *Bhopal* v. *Sphere Drake Insurance Plc,*[15] where the courts treated the matter as one of election. Both the first instance judge and the Court of Appeal did not decide whether the doctrine of waiver by election was the appropriate doctrine in the context of a breach of warranty. However the present editors of MacGillivray argue that the above case should not be treated as authority that runs counter to the proposition that waiver by election is inapplicable to a case of breach of warranty.[16]

The assured who wishes to argue that an insurer has waived a breach of warranty must therefore plead waiver by estoppel (equitable estoppel).

7.0 Waiver by Estoppel[17] – Insurer Estopped from pleading Discharge from Liability

What was once known as "waiver of a breach of warranty" must now be regarded as a case of "waiver by estoppel" whereby the insurer is estopped from pleading that he has been discharged from liability.[18]

7.1 Elements of Waiver by Estoppel

In *Motor Oil Hellas (Corinth) Refineries S.A.* v. *Shipping Corporation of India (The "Kanchenjunga")*[19] Lord Goff stated:

> Equitable estoppel occurs where a person, having legal rights against another, unequivocally represents (by words or conduct) that he does

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[15] [2002] Lloyd's Rep. I.R. 413.

[16] MacGillivray, *Insurance Law*, 10th ed., (London, Sweet and Maxwell, 2003) 267.

[17] The doctrine of estoppel has been characterised as a principle of honesty, common sense and common fairness.

[18] In *Bank of Nova Scotia v. Hellenic Mutual War Risks Association (Bermuda) Ltd (The Good Luck)* [1991] 2 Lloyd's Rep. 191, Lord Goff stated at page 202, "When, as s.34(3) contemplates, the insurer waives a breach of a promissory warranty, the effect is that, to the extent of the waiver, the insurer cannot rely upon the breach as having discharged him from liability."

[19] [1990] 1 Lloyd's Rep. 391, 399.

> not intend to enforce those legal rights; if in such circumstances the other party acts, or desists from acting, in reliance upon that representation, with the effect that it would be inequitable for the representor thereafter to enforce his legal rights inconsistently with his representation, he will to that extent be precluded from doing so.

In *Brownsville Holdings Limited and Another* v. *Adamjee Insurance Company Limited, (The Milasan)*[20] Aikens J. stated:

> Waiver by estoppel requires proof of a clear and unequivocal representation by the representor and reliance by the person to whom the representation was made.

In *HIH Casualty and General Insurance Ltd.* v. *Axa Corporate Solutions*,[21] Deputy Judge Sher Q.C. stated:

> Waiver by estoppel or promissory estoppel, as it is more commonly described, involves a clear and unequivocal representation that the insurer will not stand on its right to treat the cover as having been discharged on which the insured has relied in circumstances in which it would be inequitable to allow the insurer to resile from its representation. In my judgment it is of the essence of this plea that the representation must go to the willingness of the representor to forgo its rights. If all that appears to the representee is that the representor believes that the cover continues in place, without the slightest indication that the representor is aware that it could take the point that cover had been discharged (but was not going to take the point) there would be no inequity in permitting the representor to stand on its rights. Otherwise rights will be lost in total ignorance that they ever existed and, more to the point, the representee will be in a position to deny the representor those rights in circumstances in which it never had any inkling that the representor was prepared to waive those rights. It is of the essence of the doctrine of promissory estoppel that one side is reasonably seen by the other to be forgoing its rights. There is nothing improbable in such a forgoing of rights. It

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[20] [2000] 2 Lloyd's Rep. 458, 467.

[21] [2002] Lloyd's Rep. I.R.325, para 24.

might, for example, be prompted by considerations as to the preservation of future goodwill.

7.1.1 Unequivocal and Positive Conduct

Unequivocal means precise and unambiguous (without doubt).

Positive conduct: Although mere inactivity on the part of the insurer could not constitute waiver, a delay if it prejudices the insured would amount to waiver. However, after *The Good Luck*, the position is that the insurer's liability under the contract of insurance is automatically discharged from the time of the breach. Thus, how can it be inferred from silence on the part of the insurer that liability survives? Cases that have allowed for "waiver by silence" must be reconsidered. In the final analysis, to find an estoppel in respect of breach of warranty, it can only be by conduct that is unequivocal and positive.

To find an estoppel against an insurer, the representation by the insurer that he will not rely on a breach of warranty must be clear, and unequivocal.[22]

Among the examples include:-

(a) The insurer's actions in issuing or renewing the policy.
(b) The insurer has accepted further premiums under the contract of insurance.

7.1.2 Reliance

Some degree of reliance on the part of the insured is essential. Reliance means some action or inaction by the insured to his disadvantage.

Examples include:

(a) Payment of further premiums by the insured.
(b) Not seeking alternative cover.

7.2 Estoppel – Burden of Proof

A breach of warranty must be proved by the insurer. Estoppel on the other hand, must be pleaded and proved by the insured.

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[22] MA Clarke, *The Law of Insurance Contracts*, 3rd ed., (London, LLP, 1997) 552.

Where an insured seeks to raise an estoppel in order to prevent an insurer from being discharged from liability on the basis of breach of warranty, the burden of proof will be on the insured.

8.0 Breach of Warranty : Contract of Insurance is Not Terminated

Clarke argues that after *The Good Luck* a "breach of warranty by the insured automatically terminates the contract of insurance... Waiver concerns an election but if the contract has been terminated automatically, the insurer has no election to make. ...(what was once) waiver of breach of warranty, should now be regarded as a case of estoppel ..."[23]

It is respectfully submitted that the above argument cannot be supported at all, as a breach of warranty does not automatically terminate the contract of insurance. Lord Goff has clearly emphasised in his judgment in *The Good Luck*[24] that:

> [a breach of warranty] does not have the effect of avoiding the contract *ab initio*. Nor strictly speaking does it have the effect of bringing the contract to an end.

9.0 Conclusion

The principles of automatic termination of risk and liability are unique to the law of warranties. Once a breach of warranty occurs, the risk and liability of the insurer automatically terminates. A breach of warranty results in harsh consequences for the assured. It is now settled that waiver by election (affirmation) has no application in breach of warranty cases. What was once known as waiver by election (affirmation) must now be regarded as a case of "waiver by estoppel" whereby the insurer is estopped from pleading that he has been discharged from liability.

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[23] MA Clarke, *The Law of Insurance Contracts*, 3rd ed., (London, LLP, 1997) 548, 549.

[24] [1991] 2 Lloyd's Rep. 191, 202.

In recent years a number of first instance judges and the Court of Appeal have endorsed the view that the doctrine of waiver by election is inapplicable to a case of breach of warranty.

The judicial pronouncements in *Kirkaldy,*[25] *The Milasan,*[26] *HIH v. Axa*[27] are certainly welcomed, as they seek to clarify very complex and technical aspects of the law. It is strongly speculated, that the House of Lords will endorse the views expressed by these lower courts on this issue in the near future.

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[25] A first instance decision.

[26] A first instance decision.

[27] A Court of Appeal decision.

TREATY-MAKING POWER IN FEDERAL STATES WITH SPECIAL REFERENCE TO THE MALAYSIAN POSITION

Since States possess international personality, they undoubtedly have the power to conclude international treaties, agreements or conventions. Nevertheless, in the context of the federal States, the issue of which organ has the capacity to make treaties or whether the component units of the federation can enter into treaties with other countries still remains a hotly debated and controversial question. The present article attempts to answer the question on the basis of international law rules and constitutional law principles. Special reference is made to the treaty-making capacity of Malaysia, which is also a federal State, in the light of the Federal Constitution, case law and the treaty-making practice. This article is written on the proposition that in Malaysia, treaty-making power is vested in the Federal Government (i.e. Yang di-Pertuan Agong, and in effect the Cabinet headed by the Prime Minister) and that the executive authorities of the component States have no power whatsoever to conclude treaties with foreign countries.

1. Introduction

A treaty may be defined as a consensual engagement which subjects of international law have undertaken towards one another, with the intent to create legal obligations under international law.[1] States may

[1] G Schwarzenberger, *International Law as Applied by International Courts and Tribunals*, vol. 1, Stevens & Sons, London, 1968, 438. See also L Oppenheim, *International Law: A Treatise*, vol. 1, Peace, 8th. ed., Longman, London, 1966, 877. This is the traditional definition of 'treaty' which is established under customary international law. However, according to Article 2(1) of the Vienna Convention on the Law of Treaties, 1969, 'treaty' means an international agreement concluded between States in written form and governed by international law.... This is not a comprehensive definition of 'treaty' because it is only meant for the purposes of the Vienna Convention and it does not reflect definition of treaty under general international law. It is only limited to a treaty between States and in written form.