Under-insurance and the effect of the average clause on insurance contracts

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ABSTRACT

Keywords: Average clause, insurance contract, insured, under-insured, financial advisor.

Under-insurance can have dire consequinces for insurers if they are held liable for the full value of the damage that occurred while an insured only paid small premiums in relation thereto. It has become common practice under insurers to insert an average clause into insurance contracts to protect themselves in instances of under-insurance. The average clause today is a standard term that forms part of insurance contracts that can have a negative effect on an insured if they are not aware of the clause and its consequences.

An average clause entails that an insurer is able to evade full liablity for damages that occurred to an object of risk, where the insured was under-insured. The insurer will be held liable for only a proportion of the loss in relation to the proportion by which the insured was under-insured. The insured will be deemed his/her own insurer for the proportion by which it was under-insured.

This dissertation evaluates the consequences that the average clause can have for an insured as well as the financial advisor of an insured in instances where an insured is not made aware that his/her insurance policy contains an averace clause. The research is conducted through the means of a literature study of the origin of the average clasue and what it entails as a standard form term for the insured and the finacial advisor. Various avarage clauses from different insurance policies are evaluated in this regard, and various items of legislation and case law are evaluated in order to determine the validity and consequences of the application of an average clause.

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LIST OF ABBREVIATIONS (TOC_HEADING)

ASSAL	Annual Survey of South African Law
BN	Board Notice
JBL	Juta's Business Law
PELJ	Potchefstroom Electronic Law Journal
SA Merc LJ	South African Mercantile Law Journal
Stell LR	Stellenbosch Law Review
THRHR	Tydskrif van die Hedendaagse Romeins-Hollandse Reg

Chapter 1

1 Introduction

1.1 Problem statement

An insurance contract can be defined as a contract whereby an insured will be compensated by the insurer for the approximate patrimonial loss (or non-patrimonial loss, depending on the type of contract) caused by an uncertain future event insured against.[1] The insured pays a premium in exchange for the reassignment of the risk to the insurer.[2] Over time two distinct types of insurance contracts have evolved, namely indemnity insurance and non-indemnity insurance.[3] The difference between the two forms of insurance contracts lies therein that in the case of indemnity insurance the insurer undertakes to compensate the insured for patrimonial loss,[4] whereas in non-indemnity insurance contracts the insurer undertakes to reimburse the insured for non-patrimonial loss or grief.[5]

This research, however, will only focus on indemnity insurance due to the fact that under-insurance occurs only in indemnity insurance.[6] When the amount which the insured is insured for is less than the value of the insured's interest in the object of risk at the time of the loss or damage, under-insurance will occur.[7] A practical example of under-insurance would be where a house has a value of R1 million but

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1 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 76 and Botha *et al The South African Financial Planning Handbook* 151, 152 and Sweet and *Maxwell Encyclopedia of Insurance Law* 1004.

2 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 77.

3 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 57; Nagel *et al Kommersiële Reg* 342 and Botha *et al The South African Financial Planning Handbook* 153. Non-indemnity insurance can also be referred to as capital insurance.

4 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 82; Nagel *et al Kommersiële Reg* 342 and *Botha et al The South African Financial Planning Handbook* 153.

5 Reinecke, van Niekerk and Nienaber South African Insurance Law 84 and Botha *et al The South African Financial Planning Handbook* 153.

6 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501 and Reinecke and Van der Merwe *General Principles of Insurance* 235 and Reinecke *et al General Principles of Insurance Law* 371 and Botha *et al The South African Financial Planning Handbook* 154.

7 Millard *Modern Insurance Law in South Africa* 119 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501; Nagel *et al Kommersiële Reg* 372 and Botha *et al The South African Financial Planning Handbook* 154 and Reinecke and Van der Merwe *General Principles of Insurance* 235 and Reinecke *et al General Principles of Insurance Law* 371.

is insured for only R500 000. As a result, the house is under-insured by R500 000 or by 50 percent. This gives rise to practical problems when the event insured against occurs and the insured risk materialises. In this case, a distinction has to be made between a full or partial loss. Would the insured be compensated for the full value of the loss? Common sense should dictate that should the insured suffer a loss of R500 000, the insured should be able to claim the full insured amount of R500 000, but what if the average clause is applicable?

The average clause originated from marine insurance, where the principle of average is automatically applied to all marine insurance contracts.[8] This clause entails that the insured is responsible for the amount by which the object of risk is under-insured and that the insurer will be liable for only a proportion[9] of the total amount of damage.[10] By way of example, assume the insured has a house to the value of R1 million, but at the time of the damage the house is insured for R500 000 and a total loss or partial loss of R200 000 occurs, the insured will be able to claim only the R500 000 in the case of total loss; or R100 000 in the case of partial loss.[11] As can be seen from this example, the insured was able to recover only 50 percent of the amount of the partial loss from the insurer, because the house was insured for only 50 percent of its true total value. Although Reinecke[12] states that the total loss will be recoverable in cases of total loss when the average clause is applied, this is not always the case.[13] Sometimes when the average clause is applied and total loss occurs, the insured may be able to recover only 50 percent, which will be R250 000 of the total loss in the case of the example above.

The principle of average is not limited to marine insurance and also finds application in non-marine insurance by inserting a detailed average clause[14] or by stating that

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8 Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279 and Millard *Modern Insurance Law in South Africa* 119.

9 Van Niekerk 2006 JBL 92 and Botha *et al The South African Financial Planning Handbook* 154.

10 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501 and Van Niekerk 2006 *JBL* 91 and Millard *Modern Insurance Law in South Africa* 119.

11 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501.

12 Van Niekerk and Nienaber *South African Insurance Law* 501.

13 Nagel *et al Kommersiële Reg* 373.

14 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502.

the insurance is "subject to average".[15] A further challenge with under-insurance, and more specifically the average clause, arises in cases where a financial advisor has to convey the material information[16] in an insurance contract to the insured. This includes information about special terms in the policy,[17] but the insured is not made aware of this type of clause in the insurance contract. The relationship between a financial advisor and his client is a contract of mandate[18] and the financial advisor has the obligation to act with reasonable skill, care and diligence.[19] Unfortunately, they often do not.[20] All the terms of a contract must be explained to a client to enable them to make an informed decision as to whether they accept the terms of the contract or not.

Contractual freedom entails that one has the right to decide whether, with whom and on what terms to contract.[21] In practice the insured normally fills out a standard application form from an insurer when an application for insurance is made, which will be[22] incorporated in the insurance contract; upon which the insurer will then offer a contract to the applicant. The question arises as to how much say the insured truly has in the terms contained in the contract and the exclusion of the average clause from the insurance contract.

This research will focus on the origin of the average clause as well as the role of this clause in insurance contracts. The research will also focus on the influence of contractual freedom on the average clause and lastly the influence of the *FAIS*-framework[23] together with the *Treating Consumers Fairly* principles (the *TCF*-

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15 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502. In the case of commercial insurance and Reinecke *et al General Principls of Insurance* 219.

16 Information which is seen as "material information" is listed in s 7 and 8 of the *General Code of Conduct.*

17 *PFC Foods CC v Tree Peaks Management (Pty) Ltd* 2012 JOL 29486 (KZD) para 85 and Nagel *et al Kommersiële Reg* 366.

18 Van Niekerk 2013 *SA Merc LJ* 79 and Botha *et al The South African Financial Planning Handbook* 68, 109-110.

19 Botha *et al The South African Financial Planning Handbook* 110.

20 Van Niekerk 2013 *SA Merc LJ* 80, 82.

21 Lane 2015 *Without Prejudice* 52.

22 Nagel *et al Kommersiële Reg* 346.

23 This includes the *Financial Advisory and Intermediary Services Act* 37 of 2008 (the *FAIS*-act) together with the *General Code of Conduct for Authorized Financial Services Providers* (the *General Code of Conduct*) from GN 80a of GG 25299 of 3 August 2003 and the new *Policyholder Protection Rules* (the *PPR's*) from GN 1433 in GG 1433 van 15 December 2017.

principles) and the *Conduct of Financial Institutions Bill* (the *COFI*-bill) on the principle of average will be discussed.

1.2 Research question and aims

The general research question asked in this project is:

What is the effect of the average clause on insurance contracts where the insured is under-insured?

In order to answer this question the following specific research questions have been formulated:

- Where did the average clause originate from?
- What is the role of the average clause in insurance contracts?
- What is the impact of contractual freedom on the average clause?
- What is the influence of the *FAIS*-framework and the *TCF*-principles on financial advisors?

The aims of this research are thus:

- to establish where the average clause originated from and to elaborate on the development the clause has undergone to find application in insurance contracts;
- to discuss what the average clause entails and the implications thereof on the insured, should it be applied;
- to investigate the impact of contractual freedom on the application of the average clause and to establish whether an insured truly has the option to exclude the average clause from an insurance contract; and
- to critically discuss the effect of the *FAIS*-act, the *General Code of Conduct*, the *PPR's* and the *TCF*-principles on the conduct of the financial advisor.

1.3 Case study

Mr. X concluded an insurance contract with ABC Insurers for his home and the contents thereof. He insured his home and its contents for R1 million. A fire occurred which caused damage to the house and its content to the value of R500 000. At the time of the damage, his house and its contents had a value of R2 million. When claiming from ABC Insurers for the full amount of the damage, he was informed that his insurance contract contained an average clause, which exonerates ABC Insurers from full liability in instances where an insured object is under-insured at the time at which the damage occurred. He would be compensated only proportionately. In this case he would receive only 50 percent of his claim, which is R250 000, because his home and its contents were under-insured by 50 percent at the time of the damage. Mr. X was not aware that his insurance contract contained this contractual term. He wants to know more about this term and what exactly it entails for him. He also wants to know whether he would have been able to exclude this term from the contract and whether it would be applicable in his situation. He also wants to know whether he would be able to institute action against his financial advisor for not properly informing him when he concluded his insurance contract.

1.4 Research outline

Chapter 2 of this research serves as the background for this study. In it the history of how the average clause developed and how the clause found its way into being applied in contracts of insurance is discussed. In Chapter 3 a discussion follows of what the average clause entails, as well as the application of the average clause in insurance contracts. In this Chapter, the consequences of non-compliance with the average clause are discussed and a comparison between various different average clauses from different insurance policies is also drawn.

In Chapter 4 the application of the law of contracts in insurance contracts is discussed, as well as whether contractual freedom has an influence on the average clause. A critical evaluation of the ruling of the Constitutional Court in the case of *Barkhuizen v Napier* is made. The role of standard form contracts and their consequences is also discussed with special reference to the minority ruling of Sachs J in *Barkhuizen v Napier*.

Chapter 5 first evaluates what a "financial service" entails and secondly the obligations of a financial advisor, as set out in the *FAIS*-act. The *General Code of Conduct* and the new *PPR's* are discussed, as are the *TCF*-principles. The new *COFI*-bill, which has not yet been promulgated, is also discussed briefly. Although the *COFI* bill has not yet been promulgated, the importance of it lies in its aim to incorporate the *TCF*-principles further into legislation. Lastly, the consequences of non-compliance with the obligations set out in the above-mentioned legislation when rendering a financial service are also investigated.

The findings of this research are summarised in the sixth and final chapter. The summary answers the general research question, what is the effect of the average clause on insurance contracts where the insured is under-insured.

Chapter 2

2 The origin of the average clause

2.1 Introduction

In order to discuss the origin of the average clause, it is important first to provide an overview of how the insurance contract originated and which authorities regulate the South African law of insurance.[24] It is common knowledge that the common law of South Africa is the Roman-Dutch law, so one would expect to find the South African law of insurance in modern legislation and the writings of the Roman-Dutch authorities, but this is not necessarily the case.[25]

2.2 Origin of the insurance contract

The modern contract of insurance developed from two different forms of insurance, namely mutual or not-for-profit[26] insurance, and insurance for profit or premium insurance.[27] These two forms of insurance contract contain the same basic terms, which enables them to be governed by the same rules of insurance.[28]

2.2.1 Mutual insurance

The earliest idea of mutual insurance can be seen amongst the Romans,[29] where societies existed that afforded benefits to members, such as burial rites or a financial contribution towards burial costs or travelling expenses to members of the army, in exchange for a contribution to the society. [30] During the Middle Ages in England and

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24 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 14, 15 and Reinecke and Van der Merwe *General Principles of Insurance* 6 and *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 329.

25 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 15 and Reinecke and Van der Merwe *General Principles of Insurance* 6.

26 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 7 and Joubert and Faris *Lawsa* Vol 12 Part 1 p 11.

27 Reinecke *et al General Principles of Insurance* 3 and Reinecke and Van der Merwe *General Principles of Insurance Law* 7.

28 Reinecke *et al Genereal Principles of Insurance Law* 7 and Reinecke and Van der Merwe *General Principles of Insurance* 3.

29 And perhaps even the ancient Greeks and Egyptians.

30 Reinecke *et al General Principles of Insurance Law* 7 and Reinecke and Van der Merwe *General Principles of Insurance* 3.

Europe mutual assistance was afforded by guilds and societies to their members for losses caused by dangers such as fire, shipwreck, theft, etc.[31] Members were originally assisted to the extent of the actual need of the member, but eventually, they were compensated to the extent of their loss.[32] Members paid a contribution to the guild or society in exchange for a right to assistance, and in most cases individual members and not the guild itself had the obligation to assist members who suffered a loss.[33] In modern-day mutual insurance premiums are fixed to make sure that all claims and expenses are paid. If there is a shortage of premiums to pay all the claims, the insured policyholders may be called upon to pay for the shortfall, but if more premiums are accumulated than needed to pay claims, the surplus is either returned to the policyholders or preserved to their credit.[34]

2.2.2 Profit insurance

Modern profit insurance seems to have originated in about 2000 years BC in Babylon, in contracts pertaining to the loan of trading capital to travelling merchants.[35] These contracts contained a clause that stated that the party facilitating the loan bore the risk of loss due to robbery, and in exchange, therefore, the lender calculated interest at a very high rate.[36] During the fourth century BC, in Greece, a form of maritime loan existed where the lender afforded the ship-owner or merchant capital that could be employed for overseas trade, but due to the fact that the capital was exposed to maritime risk, the loan was repayable only upon the safe arrival of the ship or capital.[37] In this case rates of interest were also very high,[38] as in the case of loans afforded to merchants in Babylon. Roman traders made use

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31 Reinecke and Van der Merwe *General Principles of Insurance* 3 and Reinecke *et al General Principles of Insurance Law* 8.

32 Reinecke *et al General Principles of Insurance Law* 8 and Reinecke and Van der Merwe *General Principles of Insurance* 3.

33 Reinecke *et al General Principles of Insurance* 3 and Reinecke and Van der Merwe *General Principles of Insurance Law* 8.

34 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 8.

35 Reinecke and Van der Merwe *General Principles of Insurance* 4 and Reinecke *et al General Principles of Insurance Law* 8 and Sweet and Maxwell *Encyclopedia of Insurance Law* 1003 and Botha *et al The South African Financial Planning Handbook* 151.

36 Reinecke *et al General Principles of Insurance Law* 8 and Reinecke and Van der Merwe *General Principles of Insurance* 4.

37 Reinecke *et al General Principles of Insurance Law* 8 and Reinecke and Van der Merwe *General Principles of Insurance* 4.

38 Reinecke *et al General Principles of Insurance Law* 8.

of the *foenus nauticum* or *pecunia traiectica,* which were contracts of trade of which maritime loans[39] formed the basis.[40]

The idea of transferring risk to the creditor can clearly be discerned in these early contracts used by traveling merchants.[41] The contracts of maritime loan differed from ordinary contracts of loan in that the creditor would also bore the risk of damage to the goods for the duration of the journey.[42] These contracts could hardly be seen as contracts of insurance because the shifting of risk forms the basis of an insurance contract whilst these early contracts mainly formed debtor-creditor relationships.[43]

During the Middle Ages the development of insurance contracts was greatly influenced by the merchants of this time.[44] The merchants made use of contracts named the *commenda,*[45] where the *commendator*, the creditor, provided the *commendatarius*, the debtor, with capital for overseas trade, whilst the *commendator* bore the maritime risk and the *commendatarius* shared in the profit of the undertaking.[46] Another form of a contract of sale used by the merchants was one where the delivery of the goods or payment of the purchase price would take place at a place different from where the contract was concluded.[47] If payment or delivery would take place at a different venue, the goods bore the risk of damage

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39 More specifically, the Grecian maritime loan.

40 Reinecke *et al General Principles of Insurance Law* 8 and Reinecke and Van der Merwe *General Principles of Insurance* 4. A clause of risk relating to the safe arrival of a ship or goods could be found in the *foenus nauticum*.

41 Reinecke *et al General Principles of Insurance Law* 8 and Reinecke and Van der Merwe *General Principles of Insurance* 4.

42 Reinecke *et al General Principles of Insurance Law* 8 and Reinecke and Van der Merwe *General Principles of Insurance* 4.

43 Reinecke *et al General Principles of Insurance Law* 8 and Reinecke and Van der Merwe *General Principles of Insurance* 4. These contracts focussed on the granting of credit. The risk clause was only supplementary.

44 Reinecke *et al General Principles of Insurance Law* 9 and Reinecke and Van der Merwe *General Principles of Insurance* 5.

45 Contracts of sale.

46 Reinecke *et al General Principles of Insurance Law* 9 and Reinecke and Van der Merwe *General Principles of Insurance* 5.

47 Reinecke *et al General Principles of Insurance Law* 9 and Reinecke and Van der Merwe *General Principles of Insurance* 5.

whilst being transferred, so risk clauses were included in regard to the safe arrival of the goods.

Profit insurance originated from risk clauses contained in maritime loans, *commendae* and some contracts of purchase and sale.[48] The modern-day profit insurers, however, are insurance companies with a share capital, where the insurer carries on an insurance business to generate profit.[49] Set premiums are paid to ensure that the remaining profit, after the claims and expenses incurred have been paid, can be distributed amongst shareholders.[50]

Firstly, it is clear that both mutual insurance and profit insurance contracts are methods of spreading risk amongst a society of exposed persons.[51] Secondly, the modern insurance contract clearly originated from the law of early trade merchants.[52] The South African law of insurance, however, has undergone further development.

2.3 The South African law of insurance

As previously mentioned, it is common knowledge that Roman-Dutch law is the common law of South Africa.[53] It is not necessarily the case that the South African insurance law can be found in the writings of Roman-Dutch law authorities and modern legislation.[54] In 1977 the *Pre-Union State Law Revision Act* 43 of 1977 (the *Pre-Union Statute Law Revision Act*) was passed, which in principle had the effect that Roman-Dutch law could be applied in matters relating to insurance.[55] This research will discuss the position prior to the passing of this Act in 1977 and the position after the passing of this Act in order to form a clear timeline of the progression of South African insurance law.

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48 Reinecke *et al General Principles of Insurance Law* 9 and Reinecke and Van der Merwe *General Principles of Insurance* 5.
49 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 7.
50 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 7.
51 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 7.
52 Reinecke and Van der Merwe *Genereal Principles of Insurance* 7. The *lex mercatoria*.
53 Under par 2 above.
54 Reinecke and Van der Merwe *Genereal Principles of Insurance* 6.
55 Reinecke and Van der Merwe *Genereal Principles of Insurance* 6.

2.3.1 The position prior to 1977

In 1652 the Roman-Dutch law of insurance was introduced in South Africa when the Dutch settled at the Cape of Good Hope.[56] The Roman-Dutch law of insurance has its origins in the *lex mercatoria* of the middle ages.[57] The writers of Roman-Dutch law mostly expressed themselves on marine insurance, because it corresponded with the needs of their time.[58] These writings of the Roman-Dutch writers never fully developed the fundamental principles of the *lex mercatoria,* because these writers wrote before all the various forms of insurance existed.[59] The writers of Roman-Dutch law are not the only authority on insurance law in South Africa. Traces of the Italian mercantile law as well as the European *ius commune* can be found in South African insurance law.[60] Roman-Dutch law is capable of being adapted to conform to the needs of our modern-day society,[61] this is why it is acceptable to look at the law of insurance of other jurisdictions when Roman-Dutch law does not make provision for a certain instance or if it is in conflict with the general principles of our law.[62] These authorities stem from the same original sources, mercantile law.[63]

During the early nineteenth century courts considered English law, and to a lesser extent the law of America, to extend Roman-Dutch law.[64] The English law of

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56 Reinecke *et al General Principles of Insurance Law* 10.

57 *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 325-327.

58 *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 327.

59 Reinecke *et al General Principles of Insurance Law* 11 and Reinecke and Van der Merwe *General Principles of Insurance* 7.

60 *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 327 and *Trust Bank Bpk v President Versekeringsmaatskappy Bpk* 1988 1 SA 546 (W) p 552. The court held that the *ius commune* was the source of our insurance law. Reinecke *et al General Principles of Insurance Law* 11 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 15.

61 *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 328. Roman-Dutch law is "a virile living system of law, ever seeking, as every such system must, to adapt itself consistently with its inherent basic principles to deal effectively with the complexities of modern organized society".

62 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 15.

63 *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 327.

64 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 16 and Reinecke *et al General Principles of Insurance Law* 11 and Reinecke and Van der Merwe *General Principles*

insurance also stems from mercantile law.[65] It was only after the passing of the *General Law Amendment Act* in 1879 that the English law of insurance was formally introduced into the Cape Colony.[66] This had the effect that English law became binding in the Cape Colony.[67] In 1902 English law was also introduced into the Orange Free State with the publication of the *General Law Amendment Ordinance* 5 of 1902.[68]

English law would be applicable only to matters peculiar to insurance and not to every aspect of insurance.[69] This formulation seemed simple enough but often caused confusion, so the applicability of English law was often up for debate.[70] Mention was made of the English law relating to fire, life and marine insurance in

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of Insurance 7 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 2.

65 *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 329 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 15.

66 *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 328 Reinecke and Van der Merwe *General Principles of Insurance* 7 and Reinecke *et al General Principles of Insurance Law* 11-12 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 2. The act read that "in every suit, action and cause having reference to fire, life and marine insurance, stoppage in transit and bills of lading , which shall henceforth be brought in the Supreme Court, or in any other competent Court in this Colony, the law administered by the High Court of Justice in England, for the time being, so far as the same shall not be repugnant to, or in conflict with, any Ordinance, Act of Parliament or other statute having force of law in this Colony, shall be the law to be administered by the said Supreme Court or other competent Court."

67 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 16 and Reinecke and Van der Merwe *General Principles of Insurance* 7 and Reinecke *et al General Principles of Insurance Law* 12.

68 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 16 and Reinecke and Van der Merwe *General Principles of Insurance* 7 and Reinecke *et al General Principles of Insurance Law* 12 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 2. The ordinace stated "the law administered by the Supreme Court of the Cape of Good Hope".

69 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 16 and Reinecke and Van der Merwe *General Principles of Insurance* 7 and Reinecke *et al General Principles of Insurance Law* 12 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 3. Examples of matters peculiar to insurance are insurable interest, good faith, over-insurance, under-insurance etc. Examples of matters not peculiar to insurance contracts are contracts in favour of third parties, trusts, the interpretation of insurance contracts etc.

70 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 16-17 and Reinecke and Van der Merwe *General Principles of Insurance* 7 and *Reinecke et al General Principles of Insurance Law* 12.

the Act of 1879 as well as in the ordinance of 1902, so it was also not clear whether other forms of insurance were included.[71]

In the Transvaal and Natal, English law was not applicable, due to its not being incorporated into legislation, so Roman-Dutch law remained the common law relating to insurance matters for these provinces.[72] The courts regarded English law as persuasive, however, whenever Roman-Dutch law was unsatisfactory relating to certain matters.[73]

The reign of the English law in parts of South Africa was brought to an end when the *Pre-Union Statute Law Revision Act* was promulgated, which repealed the Colonial Acts that introduced English law.[74] A short discussion of the position after 1977 will now follow.

2.3.2 The position after 1977

The promulgation of the *Pre-Union Statute Law Revision Act* effectively reinstated Roman-Dutch law as the common law in South Africa.[75] When the *Pre-Union Statute Law Revision Act* came into operation in 1977 no retroactive provision was made. The effect of this was that contracts concluded before the commencement of the Act would still be regulated by English law.[76] Only if English law principles have been

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71 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 18 and Reinecke and Van der Merwe *General Principles of Insurance* 7 and Reinecke *et al General Principles of Insurance Law* 13 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 3.

72 Reinecke and Van der Merwe *General Principles of Insurance* 8 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 4.

73 Reinecke and Van der Merwe *General Principles of Insurance* 8 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 4-5.

74 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 18 and Reinecke and Van der Merwe *General Principles of Insurance* 10 and Reinecke *et al General Principles of Insurance Law* 13 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 5 and *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 328.

75 Reinecke and Van der Merwe *General Principles of Insurance* 10 and *Mutual and Federal Insurance CO LTD v Oudtshoorn Municipality* 1985 1 All SA 324 (A) p 329 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 19.

76 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 18 and Reinecke and Van der Merwe *General Principles of Insurance* 10 and Reinecke *et al General Principles of Insurance Law* 13.

taken over into our law and operate satisfactorily, not in conflict with the general principles of our law, will these principles still retain persuasive force in our law.[77]

Because of the fact that both Roman-Dutch law and English law originated from the *lex mercatoria* it will always be acceptable to consider English law when our common law does not make provision or makes little provision for certain instances.[78] If English principles which were applied satisfactorily in the past were evacuated simply for the sake of change, this would be a retrograde step.[79]

2.4 The origin of the average clause

As previously mentioned,[80] the insurance contract developed from the *lex mercatoria.* The Roman-Dutch authorities wrote mainly about marine insurance and not all the various other forms of insurance. For this reason the *lex mercatoria* was never fully developed in their writings.[81]

According to Reinecke and other authors,[82] marine insurance is the oldest form of insurance, from which all the other forms of insurance stemmed. A marine insurance contract is an agreement where one party (the insurer) indemnifies another party (the insured) against loss or damage resulting from an uncertain event during a sea voyage in exchange for payment of a premium by the insured.[83] The average clause is automatically applicable to contracts of marine insurance,[84] in two different forms, namely general average and particular average. General average occurs when some portion of a ship or cargo is sacrificed voluntarily for the common safety of the adventure, which sacrifice should be borne proportionately by all the interests

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77 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 18 and Reinecke and Van der Merwe *General Principles of Insurance* 10.

78 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 18-19 and Reinecke and Van der Merwe *General Principles of Insurance* 10.

79 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 19.

80 Under *2.1.2.*

81 See *2.2.1* above for more information.

82 Reinecke *et al General Principles of Insurance Law* 378 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 366 and Botha *et al The South African Financial Planning Handbook* 151.

83 Reinecke *et al General Principles of Insurance Law* 379 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 367.

84 Merkin *Colinvaux's Law of Insurance* 381 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501 and Van Niekerk 2006 *JBL* 92.

involved.[85] Particular average loss occurs incidentally to a maritime threat and has to be borne by a specific party to the adventure, upon whom it falls.[86] The average clause in the sense that it is referred to in this research should not be confused with the general and particular average clause as used in marine insurance.[87]

The difference between the average clause in marine insurance contracts and non-marine insurance contracts lies therein that in marine insurance the insurer is liable for a proportion of the insured's loss which the sum insured bears to the value of the subject-matter insured.[88] The insured will be seen as his own insurer for the balance of the uninsured proportion.[89] In the latter case, the insurer is liable for the amount of loss subject to the sum insured.[90] The average clause in non-marine insurance contracts is inserted to incorporate the marine insurance rule of average[91] by enabling insurers to be held liable for the full amount of the partial loss only in instances where the insured was not under-insured. If the insured was under-insured, he will be seen as his own insurer for the proportionate part of the partial loss by which he was under-insured.

2.5 Conclusion

The origin of the insurance contract dates as far back as the ancient Romans and Greeks. The assistance that was afforded to members of society in regard to contracts relating to burial rites, financial assistance with travel and the loan of trading capital contained traces of the modern insurance contract.[92] Such contracts are found mostly in mercantile law. The two forms from which the insurance contract originated are mutual insurance and profit insurance. Both forms still exist

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85 Reinecke *et al General Principles of Insurance Law* 416 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 386.

86 Reinecke *et al General Principles of Insurance Law* 416.

87 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501 and Merkin *Colinvaux's Law of Insurance* 393.

88 Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279.

89 Reinecke *et al General Principles of Insurance Law* 371 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 278 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501 and Reinecke and Van der Merwe *General Principles of Insurance* 235 and Merkin *Colinvaux's Law of Insurance* 514.

90 Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279.

91 Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279.

92 See par 2.2.1 and 2.2.2.

today, but the most commonly found form is profit insurance. In the case of mutual insurance, the insured is entitled to receive a proportion of his/her premiums back if there are excess funds left after all claims were paid. However, if there was a shortage of funds to pay all claims, the members are obliged to compensate the insurer proportionately for the shortage in funds. On the other hand, profit insurance aims to ensure a profit for the insurer. The insured is not entitled to receive a proportion of his/her premiums back if there is an excess of funds left after all claims were paid. The insured pays his/her premiums and is entitled to receive cover only in the event that damage occurs. This form of insurance is thus a business venture in the case of the insurer.

In South Africa Roman-Dutch law is the common law of our country. Most of the principles relating to insurance can be found in the writings of the Roman-Dutch authors and legislation. Before 1879 Roman-Dutch law was applied in South African courts, but with the passing of the *General Law Amendment Act* in 1879, English law was declared the law of application in the Cape Colony. In 1902 the *General Law Amendment Ordinance* also introduced English law in to the courts in Natal. Roman-Dutch law, however, remained the authoritative law in the rest of the country. In 1977 Roman-Dutch law was once again reinstated as the common law of the whole country with the promulgation of the *Pre-Union State Law Revision Act.*

As marine insurance is said to be the oldest form of insurance,[93] one can conclude that the average clause originated from marine insurance. Average is automatically applicable in marine insurance contracts, but not in other forms of insurance contracts. By inserting an average clause in indemnity insurance contracts, insurers incorporate the concept of average found in marine insurance contracts into other forms of insurance contracts as well.[94]

The term average is not one that is commonly known to persons who are not skilled in the field of insurance or law. For this reason, a more detailed inquiry into the meaning of the term average will be made. A discussion of the consequences of

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93 See par 2.4.
94 See par 2.4.

non-compliance with an average clause in an insurance clause will also be led. A comparison between different average clauses from two different insurance policies will also be made.

Chapter 3

3 Under-insurance and the average clause

3.1 Introduction

In general terms, risk is the probability that harm may occur.[95] The value of the property to be insured is important when calculating the premium to be paid because the value has an influence on the risk.[96] When concluding the insurance contract the parties to the contract must reach an agreement regarding the full extent of the risk and the possibility of the risk occurring.[97] It is important for the insured to obtain clarity on this issue in order to prevent him/her from obtaining insurance cover that is uneconomical in the sense that it constitutes over-insurance or under-insurance.[98] For this research, however, the instance of under-insurance is of more importance, as the average clause is a mechanism incorporated into insurance contracts in order to discourage under-insurance.[99]

This Chapter aims to provide insight into what the average clause is and what the clause entails for an insured party, should the situation arise where it finds application. In order to achieve this, the following topics are discussed: under-insurance and the average clause, as very few people actually know about the

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95 Reinecke *et al General Principles of Insurance Law* 191 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 238 and Reinecke and Van der Merwe *General Principles of Insurance* 169.

96 Leigh-Jonesb Birds and Owen *MacGillvray on Insurance Law* 439.

97 Reinecke *et al General Principles of Insurance Law* 191-192 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 238 and Reinecke and Van der Merwe *General Principles of Insurance* 169 and Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 439.

98 Merkin *Colinvaux's Law of Insurance* 89 and Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 439 and Reinecke *et al General Principles of Insurance Law* 192 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 238 and Reinecke and Van der Merwe *General Principles of Insurance* 169. This conclusion influences the insured's decision on whether to obtain insurance as well as the insurer's decision as to whether the premiums in relation to the risk he or she takes upon themselves should be adjusted.

99 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279 and Reinecke and Van der Merwe *General Principles of Insurance* 203 and Reinecke *et al General Principles of Insurance Law* 371.

average clause. The average clauses from various insurance policies, from different insurers, are then compared with one another in order to create a clearer understanding of the practical application of an average clause to insured objects.

3.2 Under-insurance

As mentioned above,[100] when the amount for which the insured object is insured[101] is less than the value of the insured's interest in the object of risk at the time of loss or damage, under-insurance will occur. In the case of under-insurance, a person whose interest is, or becomes, under-insured will be able to recover the insured amount or the amount of the loss when damage or loss occurs, whichever amount is the lesser of the two.[102] This entails that if an insured suffers loss or damage, they will be able to recover the full amount of the loss unless the amount insured for is less than the amount of loss or damage.[103]

An insured might be tempted to under-insure when they realise that the chances of a full loss are very slim and that most of their losses will be partial losses.[104] The person who under-insures an asset will pay a smaller premium, because of the fact that the amount insured for is smaller than the true value of their interest.[105] From this, it is clear that being under-insured works to the disadvantage of insurers.[106]

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100 Under par 1.1.

101 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501. This amount forms the maximum limit of the insurer's liability.

102 Millard *Modern Insurance Law in South Africa* 119 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501 and Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 629 and Reinecke and Van der Merwe *General Principles of Insurance* 235 and Reinecke *et al General Principles of Insurance Law* 371 and Botha *et al The South African Financial Planning Handbook* 154.

103 Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 278 and Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 629. In the latter case the insurer will have to pay only the amount insured for and not the full amount of the loss or damage.

104 Millard *Modern Insurance Law in South Africa* 119 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279. In the case of a partial loss, they will still be able to recover the full amount of their loss.

105 Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 179 and Millard *Modern Insurance Law in South Africa* 119.

106 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502 and Reinecke and Van der Merwe *General Principles of Insurance* 202.

Insurers are likely to object to under-insurance on the basis that in the event of a partial loss occurring, they may be liable for the full amount of the loss[107] even though the premium paid is very low in relation to the value of the thing insured.[108] Insurers argue that if the insured is entitled to pay premiums on a sum insured which was smaller than the value at risk, they should be entitled to insure for only a corresponding proportion of the risk.[109] For this reason, it has become common practice for insurers to declare a policy subject to average.[110] This research will now discuss the average clause in more detail.

3.3 The average clause

The average clause discourages under-insurance,[111] encourages the insured to be and remain fully insured, and also enables an insurer to earn a higher premium.[112] By inserting an average clause into indemnity insurance policies, insurers incorporate the marine insurance principle of average into non-marine insurance contracts.[113]

As previously mentioned[114] the average clause entails that the insured is responsible for the amount by which the object of risk is under-insured and that the insurer will be liable for only a proportion[115] of the total amount of damage.[116] The difference between under-insurance and average can best be described by way of an example. Assume a house has a value of R2 million but is insured for R1 million and that the

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107 If the policy is not subject to average.

108 Merkin *Colinvaux's Law of Insurance* 8.

109 Van Niekerk 2006 *JBL* 91.

110 Millard *Modern Insurance Law in South Africa* 119 and Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 629 and Reinecke and Van der Merwe *General Principles of Insurance* 235 and Reinecke *et al General Principles of Insurance Law* 218 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279 and Merkin *Colinvaux's Law of Insurance* 392-393.

111 Millard *Modern Insurance Law in South Africa* 119.

112 Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279 Reinecke *et al General Principles of Insurance Law* 219 and Reinecke and Van der Merwe *General Principles of Insurance* 202.

113 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279.

114 Under par 1.1.

115 Van Niekerk 2006 *JBL* 92 and Botha *et al The South African Financial Planning Handbook* 154.

116 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501 and Van Niekerk 2006 *JBL* 91 and Reinecke and Van der Merwe *General Principles of Insurance* 202.

building is damaged in a fire which causes damage to the value of R1 million. In the case of under-insurance, where a policy does not contain an average clause the insured will be able to recover the full amount of the damage or the sum insured, whichever is the lesser amount. In this case the insured will be able to recover the full amount of R1 million of the damage. If the insurance policy contained an average clause the insured would be able to recover only 50 percent of the amount of damage that occurred, because the house was under-insured by 50 percent. In this case, the insured will be able to recover only R500 000 of the R1 million damage that occurred. The insured is deemed to be his own insurer for the balance for which he was not indemnified, in this instance the outstanding R500 000.[117] This will be the case where a partial loss occurs.[118]

According to Reinecke, it may be thought that average applies in the case of total loss, but it does not.[119] The insured pays premiums based on the sum insured and the sum insured is in all instances the limit on the amount of indemnification recoverable; thus average is irrelevant in the case of a total loss.[120] In the case of a total loss, an insured will be entitled to claim the total sum insured for, regardless of the fact that the insured is under-insured.[121]

An example of an average clause can be the following:

> Where immediately prior to its loss or damage the market value of property separately insured hereunder is greater than the sum for which such property is insured, the insured shall be deemed to be his own insurer for the difference and the company's liability shall be limited to the sum which bears the same proportion to the amount of loss or damage as the sum insured bears to the aforesaid value.[122]

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117 Reinecke *et al General Principles of Insurance Law* 219-220 and Leigh-Jonesb Birds and Owen *MacGillvray on Insurance Law* 629 and Merkin *Colinvaux's Law of Insurance* 392.

118 Reinecke and Van der Merwe *General Principles of Insurance* 202 and Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501 and Reinecke *et al General Principles of Insurance Law* 219. An average clause applies only where an insured is under-insured and they suffer a partial loss.

119 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 501. See also Millard *Modern Insurance Law in South Africa* 120

120 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502.

121 Reinecke *et al General Principles of Insurance Law* 220 and Reinecke and Van der Merwe *General Principles of Insurance* 202.

122 Reinecke and Van der Merwe *General Principles of Insurance* 202 and Reinecke *et al General Principles of Insurance Law* 219 and Reinecke, van Niekerk and Nienaber *South African*

In an insurance contract, this average clause can be referred to as the "first" or "pro rata" condition of average.[123] A second average condition can also be added to a policy where there is more than one insurance policy[124] covering the same property, which regulates the contribution amongst insurers.[125] An example of a second condition of average can be the following:

> But if any of the property included in such average shall at the breaking out of any fire, or at any commencement of any destruction of or damage to such property by any other peril hereby insured against, be also covered by any other more specific insurance i.e. by and insurance which at the time of such fire or at the commencement of such destruction or damage applies to part only of the property actually at risk and protected by this insurance and to no other property whatsoever, then this Policy shall not insure the same except only as regards any excess of value beyond the amount of such more specific insurance or insurances, which said excess is declared to be under protection of this Policy, and subject to average as aforesaid.[126]

This will ensure that where a property, or part thereof, is insured by a policy of a wide range as well as a policy of a lesser range, which covers only that same property, or some part thereof, the policy of wider range shall insure that property, or part thereof, in respect of only the excess value that the policy of lesser range does not cover.[127]

It is also possible for an average clause to be restricted to certain instances, as for example if the sum insured is less than 80 percent of the value of the property; only then will the average clause apply.[128] By restricting the average clause in this

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Insurance Law 502. This wording does not read easily for an unexperienced insured, making it hard to understand.

123 Reinecke *et al General Principles of Insurance Law* 219 and Reinecke and Van der Merwe *General Principles of Insurance* 202 and Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 630.

124 When all the policies are subject to average.

125 Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 632.

126 Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 632-633.

127 Leigh-Jones Birds and *Owen MacGillvray on Insurance Law* 632 and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 280.

128 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502 and Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 632 and Reinecke *et al General Principles of Insurance Law* 220 and Reinecke and Van der Merwe *General Principles of Insurance* 203 and Van Niekerk 2006 *JBL* 93.

manner, the application of average in cases of slight under-insurance can be avoided.[129]

Once an insurer elects to reinstate the object of risk, the average clause cannot be invoked to require the insured to pay for a proportion of the costs regarding the reinstatement of the object of risk.[130] For example, if the house from the example above burns down and the insurer decides to rebuild the house rather than to pay out the amount of damage, the insured cannot be held liable for the proportion of the damage for which he was not insured. In this case, the insurer will be liable for the full amount of R1 million in damages and the insured cannot be held liable for the R500 000 by which he/she was underinsured even though the contract contained an average clause. Average clauses have been subject to criticism, such as that no more value should be awarded to them than is absolutely necessary.[131] The Court stated in *Kaffrarian Colonial Bank v Grahamstown Fire Insurance Co*[132] that:

> Especially this should be so when it is sought to put an interpretation on the clause in question which I doubt whether it can be made to bear[,] I mean when it is maintained that the Insurance Company can not only claim its right to re-instate instead of paying, but can also compel the insurer to contribute his share to the cost of re-instatement.

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129 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502 and Leigh-Jones Birds and Owen *MacGillvray on Insurance Law* 632. Slight under-insurance will typically occur in cases where the insured did not realise that the value of the insured object increased and the insured value of the object did not increase in accordance with the replacement value of the insured object.

130 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 502 and Reinecke *et al General Principles of Insurance Law* 220 and Reinecke and Van der Merwe *General Principles of Insurance* 202 and and Getz, Davis and Gordon *Gordon and Getz on The South African Law of Insurance* 279 and *Kaffrarian Colonial Bank v Grahamstown Fire Insurance Co* 1885 5 EDC 61 and Millard *Modern Insurance Law in South Africa* 120.

131 *Kaffrarian Colonial Bank v Grahamstown Fire Insurance Co* 1885 5 EDC 70.

132 1885 5 EDC.

This research will continue by briefly comparing different average clauses from different insurance policies. A comparison will be made between an insurance policy from King Price Insurance,[133] OUTsurance,[134] Youi,[135] and Discovery.[136]

3.4 A comparison between insurance policies

The four insurance policies that will be used all relate to business cover of some sort. Only the introductions and the average clauses of these policies will be discussed. The introductions will be discussed in order to place the policies in context, and the average clauses will be discussed, because of their relevance to this research.

3.4.1 Introductory clauses

The King Price insurance policy makes it clear from the beginning that the policy is long and that it might contain complicated wording, by pointing out that the policy consists of "nearly 200 pages" and quoting some difficult words[137] that the average person might not know the meaning of.[138] The text of the policy sympathises with the insured regarding this. The policy urges the insured to read through the whole document by way of a subtle warning that the insured will probably not want to read this "long and probably boring" document in order to understand what the

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133 Downloadable from https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=11&cad=rja&uact=8&ved=2ahUKEwisgIjHsIrlAhWVShUIHYkDByoQFjAKegQICBAC&url=https%3A%2F%2Fwww.kingprice.co.za%2FContent%2Fdocuments%2FKing-price-insurance-policy.pdf&usg=AOvVaw01emGlvgHk5aaXw309VjJU.

134 Downloadable from https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=2ahUKEwj0zpil5qflAhWkVRUIHUDKBnsQFjABegQIAxAC&url=https%3A%2F%2Fwww.outsurance.co.za%2Fglobalassets%2Fpdfs%2Fpersonal%2Fessential_eng_a5_may18_web.pdf&usg=AOvVaw1YDr3TG_I5vznY9Cx391j1.

135 Downloadable from https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=2ahUKEwiclrbu-aflAhUZShUIHVB6AhoQFjAAegQIABAC&url=http%3A%2F%2Fwww.youi.co.za%2Fdocuments%2Fpolicy-booklet%2F&usg=AOvVaw1RcKGGCcdXSeYC9PEXH6Ud.

136 Downloadable from https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&ved=2ahUKEwj-z_nU56flAhXKWRUIHfobDCUQFjABegQIAxAC&url=https%3A%2F%2Fwww.discovery.co.za%2Fassets%2Ftemplate-resources%2Fcar-home-insurance%2Finsure-plan-guide.pdf&usg=AOvVaw2EYjmuqz_VCgxgXQACFONR.

137 Like infectious epidemics, capital additions and mortgagee.

138 On p 4 of the policy document.

insured's responsibilities are as well as the cover that the insured's business will enjoy, and goes on to say "Remember, incorrect details = incorrect cover for your business."[139] The policy also asks that the insured make sure that s/he understands the policy clearly and contacts the insurer regarding anything in the policy that is unclear:

> So, even though we hate to nag, please go read this, check all the details on your schedule and make sure that you fully understand the policy wording. If anything is unclear at all, or should you need to update your information, don't hesitate to give us a call on 0860 21 00 00. It's in your own best interest to do so.

This creates a negative view in the mind of the reader. The wording used in the introduction of the King Price insurance policy is more to the advantage of the insurer than the insured, in that it "warns" the insured that the policy is long and complicated. King Price thus guards itself against a claim that the policy is hard to understand and very long. The policy makes no attempt to simplify the complicated wording or lighten the load on the insured when s/he has to read through the "long and probably boring" policy document. Long and complicated policy wording is to the advantage of the insurer as the insured might not understand what s/he is reading or may lose concentration while reading through the long policy. It creates a feeling of "too bad, so sad" for the insured, who may think that s/he just has to deal with this fact. The policy also makes no reference to the obligations of the insurer if the insured complies with all his/her responsibilities. Further, stating that the insured must read through the document and contact the insurer with any queries infringes on the insured's contractual freedom. It leaves no room for negotiation on the policy terms. It says only that the terms will be explained if they are unclear.

The introduction to the OUTsurance insurance policy welcomes the insured to OUTsurance, "where you always get something out".[140] The policy declares OUTsurance to be a leader in the field of insurance and immediately directs the insured's attention to the unique reward known as the OUTbonus.[141] If an insured

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139 On p 4 of the policy document.
140 On p 1 of the policy document.
141 On p 1 of the policy document.

remains claim free for a certain cycle,[142] s/he is entitled to receive a percentage of his/her premiums back.[143] This specific product, the Essential OUTsurance product, provides cover for vehicles, the contents of homes and buildings, and it also provides out-and-about cover. The policy states that plain language is used, which makes it easy for the insured to understand and read the policy.[144] The policy further encourages the insured to read through the policy to make sure that s/he understands the policy, and to contact the insurer if there are any questions or to update his/her information.[145]

Directing the insured's attention to the possibility of an OUTbonus so early on in the policy could have a positive or a negative influence. It might encourage the insured to be extra cautious in order to ensure that s/he receives the OUTbonus or it may cause an insured to refrain from reporting an incident to the insurer out of fear of losing the OUTbonus. The latter was the case in *Jerrier v Outsurance Insurance Company Limited*[146] (the *Jerrier*-case). The Court held that the allure of the OUTbonus should not be underestimated and that was not surprising for an insured to opt to absorb the damage personally in order to "get something out".[147] The Court also cautioned against stating that a policy uses plain language, because that places a responsibility on the insurer to ensure that the insured understands exactly what a certain term means in every situation.[148] As in the case of the King Price insurance policy, the policy also does not afford the insured the option to negotiate on the terms contained in the policy. The insured must only read the policy and contact the insurer with any inquiries or if s/he needs to update his/her information.

The Youi insurance policy makes it clear that Youi (Pty) Limited is a financial service provider that is underwritten by OUTsurance, which is also a financial service provider. Youi does not believe in "one-size-fits-all" insurance and this is the reason

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142 No OUTbonus cycle is indicated in the policy. It only states that it is indicated in "your schedule".

143 On page 4 of the policy document.

144 On p 1 of the policy document.

145 On page 1 of the policy document.

146 2015 JOL 33474 (KZP) par 21-23.

147 *Jerrier v Outsurance Insurance Company Limited* 2015 JOL 33474 (KZP) par 36.

148 *Jerrier v Outsurance Insurance Company Limited* 2015 JOL 33474 (KZP) par 23.

that the policy contains so many options.[149] The policy is written in plain language, according to them, ensuring that the policy reads easily and is understandable.[150] The policy itself is not that long and is written in a big font, making it easier to read all of it, as they urge the insured to do.

The Youi insurance policy creates a more positive atmosphere when reading the introduction than the King Price insurance policy. Youi has regard for the needs of the insured, by making it possible for him/her to choose the insurance options that suits him/her the best. Youi also wants to make it as easy as possible for the insured to understand the policy, by using plain wording and ensuring that the policy is in plain words, as in the case of the OUTsurance policy. The introductory clause of the Youi insurance policy contains almost exactly the same information as the OUTsurance policy does. This could be because OUTsurance is an underwriter of Youi and requires them to have certain information in their insurance policies.

The Discovery insurance policy welcomes and thanks the insured for choosing Discovery as his/her insurer.[151] The policy provides cover for a range of car and household assets and options will be provided to tailor the policy for the needs of the insured. It makes reference to the obligation of the insurer to pay out claims when stating:

> We use the money you pay as premiums to pay for the benefits described in your Plan Guide and Plan Schedule if you suffer a financial loss arising from an insured event.[152]

The policy also encourages the insured to read through the policy document to ensure that s/he understands the contents thereof and stays up to date with changes that they might make to the policy contents.[153] Right after this the policy ensures the insured that s/he will be informed of any changes made to the policy document. Under the heading of "Terms and conditions of your Plan"[154] the policy

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149 On p 2 of the pdf-document.
150 On p 2 of the pdf-document.
151 On p 2 of the policy document, under the heading of "Your Discovery Insure Plan".
152 On p 2 of the policy document, under the heading of "Your Discovery Insure Plan".
153 On p.1 of the policy document, under the heading of "This document will help you understand the finer details of your Discovery Insure Plan".
154 On p.2 of the policy document.

informs the insured of what forms part of the Plan and how it must be read as follows:

> All the information you need on the benefits Discovery Insure offers is in this Discovery Insure Plan Guide. Details of your chosen Discovery Insure benefits are in your Plan Schedule. More details on these benefits are in the annexures to your Plan Schedule. This Plan Guide refers to the terms and conditions of the Vitality Drive benefit. An overview of the Vitality Drive terms and conditions is on www.discovery.co.za (from here on referred to as the website). You need to read the Plan Guide and Plan Schedule together, including the annexures and website terms and conditions, as they make up your whole Discovery Insure Plan. If the terms and conditions in the Plan Guide, Plan Schedule and on the website conflict, what the Plan Guide states will apply. You must always follow the terms and conditions of your Plan. You may lose your benefits if you do not.

Lastly, the policy urges the insured to make sure that the objects insured by him/her are correct and to notify them if they are not.

The introductory clause of the Discovery insurance policy is well structured. It provides more information than any of the other three policies that were discussed. The policy also makes reference to the obligations of the insurer, when stating that the insurer uses the premiums to pay for claims and that the insurer will notify the insured of any changes to the policy document. The insured is informed of which documents to read together with the policy to ensure that the insured understands the policy and what it entails as well as where an overview of certain parts of the policy can be viewed. Although this introductory clause does not make reference to a contact number if the insured object is incorrect, the contact details are provided in the very next clause under "Contact Details".[155] Overall this introductory clause has regard for the mutual interests of both parties. It does not favour one over the other as much as the previous three introductory clauses that were discussed.

3.4.2 Average clauses

The average clause contained in the King Price insurance policy reads as follows:[156]

> The insured value noted on your policy schedule is the maximum amount that we'll pay for any of your property-related claims, less the excess amount payable by you, and less any dual and under-insurance, if applicable.

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155 On p.3 of the policy document.

156 On page 11 of the policy document.

> You need to insure your property for its replacement value. This means the amount that it will cost you at the time of the claim to repair, replace or rebuild your property.
> The replacement value of a building, for example, must also provide sufficiently for all the outbuildings, walls, fixtures and fittings, and the following possible additional costs:
> • Professional and municipal fees.
> • Demolition charges.
> • Waste removal.
> • Making the site safe.
> Should you insure your property for an amount less than its replacement value, then we'll pay out your claim proportionately. So, for example, if the value of your building is R400,000 and you only insure it for R200,000 (50% of the replacement cost), then you'll only be compensated for 50% of your loss.[157]

The policy places the onus on the insured to ensure that the replacement value is realistic, in order to ensure that the insured has enough cover in the event that it may be needed. The policy urges the insured to be over-insured rather than under-insured.

The first part of this clause relates to the value of the property and the calculation thereof. The emphasised part of the clause forms the average clause and explains the application thereof by way of an example.

No explicit mention is made to an average in the OUTsurance or Youi insurance policies, but when you read the wording under "What does BUILDINGS refer to?"[158] the average clause is contained therein. The average clauses in both of these policies read as follows:

> The insured value noted on your schedule is the maximum amount we will pay for any claim, less the excess and any dual insurance and under insurance.
> You need to insure your building for its replacement value. This is the cost of rebuilding or repairing the building with new materials.
> The replacement value must include the following additional costs:
> • Professional and municipal fees
> • Demolition charges
> • Debris removal
> • Making the site safe against further incidents
> Should you insure the building for an amount less than its replacement value, we will pay you proportionately.
> · E.g. If the correct insured value of the building is R400 000 and you insure it for R200 000 you will be compensated for 50% of your loss.

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157 Own emphasis in order to indicate the average clause.
158 On page 31 of the policy.

> Water heating systems will be covered up to the maximum amount noted on your schedule.
> It is your responsibility to update your insured value. [159]

The average clauses in both of these policies are exactly the same. This can be because OUTsurance is an underwriter of Youi, as mentioned earlier.[160] The plain language used in these two policies has the effect that the average clauses do not catch the eye of the insured. The insured might gloss over the clause due to the plain language used. The word "average" is not well-known and due to its uncommonness, it would catch the eye of a potential insured and ensure that s/he reads the clause with more attentiveness. The insured has the obligation to ensure that the insured value of the insured object is up to date, but many people are unaware of the tempo at which an insured object's value might increase, making it hard to stay up to date with the value of an object. There are also costs associated with the valuation of a property that might be very high if a property needs to be valuated often. In this instance, it would be advisable to insert a secondary average clause that provides leeway on the under-value of a property. For example, if the property is insured for less than 80% of its market value, the average clause will apply.

The average clauses of the King Price insurance policy and the OUTsurance and Youi insurance policies are almost exactly the same. The only difference is that the King Price insurance policy gives examples of what the replacement of a building must provide for, where the OUTsurance and Youi insurance policies do not. The example used to explain the average clause is also exactly the same. In the *Jerrier*-case the Court also cautioned against the use of examples in insurance policies. The Court held that the problem with supplying examples is that:

> examples of all conceivable applications can never be provided, and if the very situation which arises is not covered by one of a myriad of examples to be given, the same complaint will remain.[161]

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159 Own emphasis in order to indicate the average clause.
160 Under par *3.4.1*.
161 *Jerrier v Outsurance Insurance Company Limited* 2015 JOL 33474 (KZP) par 33.

It would be impossible to supply an example of each and every situation that may occur where an average clause will find application.

The average clause contained in the Discovery insurance policy reads as follows:

> 5.4 | Average / under-insurance
> You must insure your household contents and building for the correct value. The correct value is the total, current replacement cost of your insured property. This is listed as the sum insured on your Plan Schedule. *If at the time of any loss or damage, the amount which is needed to replace all your insured property with similar and/or new property is more than the amount it is insured for, you will be expected to bear your share of the loss or damage for the difference. For example: If the correct replacement value of your household contents is R600 000 and you have insured it for R300 000 and you have a loss of R100 000, you will only be compensated for 50% of your loss (or R50 000).*[162]

This average clause can be found under the heading "Important Conditions".[163] This already alerts the insured's attention to the importance of the clause. As in the case of the OUTsurance and Youi insurance policies, there is an obligation on the insured to ensure that the household contents and building are insured for their correct value, which is the replacement value. If the insured is uncertain of what is meant by the replacement value, s/he can read the Plan Schedule for clarity. The average clause is very simple and easy to understand.

All four of these average clauses contain the same basic information and consequences. In none of the policies can a secondary average clause can be, which would be to the detriment of the insured. It would be advisable to include a secondary average clause in an insurance contract in order to make provision for the mutual interests of both parties to an insurance contract.

3.5 Conclusion

In a case where under-insurance occurs, that would be to the disadvantage of the insurers unless the insurance policy contained an average clause. This is because the insured would be able to recover the full amount for which the object of risk was insured or the full amount of the loss, whichever was the smaller of the two

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162 Own emphasis to indicate the average clause.
163 On p 8 of the insurance policy.

amounts. The amount that the insurer is required to pay out might be very large in relation to the premiums paid in order to receive insurance coverage.

An average clause is a method of discouraging under-insurance that is incorporated into insurance contracts by insurers. An average clause will enable an insurer to be held liable for only a proportion of the damage that occurred, while the insured is held liable as his own insurer for the proportion of the damage to the object of risk that was under-insured. This would be the primary average clause, while a secondary average clause might be incorporated into a policy in order to reduce the consequences to the insured of an average clause. The secondary average clause would typically state that the average clause will find application only in certain instances, such as if the insured is under-insured by more than 20% of the market value of the object at risk. It would be advisable to include a secondary average clause in an insurance policy to ensure fairness for both parties.

For Mr. X[164] the average clause would result in him being able to recover only a proportion of his damages from the insurer, as the insurer held in the case study. Mr. X will be able to recover only R250 000 from ABC Insurers and he would be seen as his own insurer for the other R250 000 of his damages because he was underinsured by 50 percent.

This research continues by enquiring into the interpretation of insurance policies and the constitutional validity of contractual terms, as well as whether an insured has the option to negotiate the terms of an insurance contract, as it is a standard form contract.

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164 See par 3.1.

Chapter 4

4 Interpretation of contracts

4.1 Introduction

A contract is an agreement concluded between two or more parties with the serious intention of creating a legal obligation between them.[165] When concluding a contract, a person has the freedom to choose with whom and on which terms s/he want to contract. This is known as contractual freedom.[166] The principle of *pacta sunt servanda* means that contracts which were freely concluded between parties must be honoured and, when necessary, enforced by courts.[167] The parties should be honest and reasonable[168] when contracting, in order to conclude a contract that has mutual regard for the interests of both the involved parties.[169] The primary goal of a contract is to give effect to the intentions of the contracting parties,[170] and insurance contracts are no different.

Disputes concerning the interpretation of contractual clauses are among the most common forms of contractual disputes that occur, so the layout of a contract and the wording used therein must be considered very carefully.[171] Interpretation is the process by which the common intention of contracting parties expressed by their words or conduct is determined, by ascertaining the meaning of the language used.[172] Various rules of interpretation are used by the courts to ascertain the meaning of contractual terms. These rules of interpretation are applicable not only

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165 Hutcheson *et al Kontraktereg in Suid-Afrika* 41 and Nagel *et al Kommersiële Reg* 23 and Cornelius *Principles of the Interpretation of Contracts in South Africa* 3-4.

166 Hutcheson *et al Kontraktereg in Suid-Afrika* 22 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 10 and *Natal Joint Municipal Pension Fund v Edumeni Municipality* 2012 ZASCA 13 (SCA) par 18.

167 Hutcheson *et al Kontraktereg in Suid-Afrika* 12; 13; 22; 24; 42 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 11 and Millard 2014 *THRHR* 584 and *Barkhuizen v Napier* 2008 JOL 19614 (CC) para 10 (*Barkhuizen v Napier)*.

168 Hutcheson *et al Kontraktereg in Suid-Afrika* 22.

169 Bhana and Meerkotter 2015 *SALJ* 504 and *Botha v Rich NO* 2014 4 SA 124 (CC) 46.

170 Hutcheson *et al Kontraktereg in Suid-Afrika* 268 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 240; 271.

171 Hutcheson *et al Kontraktereg in Suid-Afrika* 268.

172 Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 296, 297.

to written contracts but also to oral agreements,[173] even though it might sometimes be hard to prove the exact content of an oral agreement.[174] The primary, secondary and tertiary rules of interpretation will be discussed in the next paragraph.[175] These rules of interpretation are of relevance for this research, because ignorance of the average clause and the consequences thereof may lead to disputes which need to be heard by courts.

When contractual clauses are interpreted, this must be done in accordance with the *Constitution of the Republic of South Africa,* 1996 (the *Constitution*).[176] The application of constitutional values to contracts can take place directly or indirectly.[177] The interpretation of contracts in the light of the *Constitution*, and more specifically of the *Bill of Rights*, was discussed in *Barkhuizen v Napier*. In this case the Court had to decide on the constitutionality of time limitation clauses in insurance contracts.[178] The majority ruling of Ngcobo J[179] laid down a double-barrelled test for assessing the fairness of a contractual provision.[180] The first objective of this test is to determine whether a contractual term in itself is obviously unfair and the second objective is to determine whether a contractual term that is objectively reasonable should be enforced in the light of the surrounding circumstances.[181] In the minority ruling of Sachs J, he identified insurance contracts as often being standard form contracts.[182]

The objective of this Chapter is to present a brief survey of the interpretation of contracts and the test to determine the constitutional validity of a contractual term. Further, this Chapter aims to create awareness of standard form contracts and their challenges. In order to reach this goal, this research now turns to a discussion of

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173 Hutcheson *et al Kontraktereg in Suid-Afrika* 268-269 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 293.

174 Hutcheson *et al Kontraktereg in Suid-Afrika* 268.

175 Hutcheson *et al Kontraktereg in Suid-Afrika* 280, 281, 282.

176 *First National Bank of SA v Rosenblum* 2001 4 SA 189 (SCA) para 196B and Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

177 *Barkhuizen v Napier* 2008 JOL 19614 (CC) paras 35, 178 and 186. In terms of s 39(2) of the *Constitution.*

178 Van Niekerk 2007 *ASSAL* 564.

179 In *Barkhuizen v Napier* 2008 JOL 19614 (CC).

180 Lane 2015 *Without Prejudice* 54.

181 Lane 2015 *Without Prejudice* 54.

182 *Barkhuizen v Napier* 2008 JOL 19614 (CC) paras 136-137.

the various rules of interpretation of contracts. A summary of the majority ruling, as well as the reasons therefore, in *Barkuizen v Napier* is given, after which standard form contracts and its challenges are discussed with special reference to the minority judgment of Sachs J, as insurance contracts often take the form of standard form contracts and the average clause forms a standard form term in an insurance contract.

4.2 The rules of interpretation

The three most common primary rules of interpretation are: the general intention of the contracting parties must be ascertained – this means, the true intention of both parties when concluding the contract, not the idea that one of the parties may have had in the back of his/her mind.[183] Secondly, the normal, grammatical meaning of words must be attributed to words used in a contract.[184] Thirdly, what was intended by words in a clause must be interpreted in the contextual milieu they were used.[185]

In cases where the meaning of a clause is still uncertain, the broader context of the contract may be taken into account.[186] Evidence from outside the contract that can help to shed light on the contract must be considered.[187] In order to determine the broader context to a contract, the "parol evidence"-rule is applied.[188] This rule implies that in the event that parties intended for the agreement to be completely in writing, any evidence that contradicts, changes, adds to or subtracts from the content of the written agreement is inadmissible.[189] The principle of admissibility is

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183 Hutcheson *et al Kontraktereg in Suid-Afrika* 269 and Iyer 2016 *Without Prejudice* 17.

184 Hutcheson *et al Kontraktereg in Suid-Afrika* 269 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 298 and *Natal Joint Municipal Pension Fund v Edumeni Municipality* 2012 ZASCA 13 (SCA) par 11, 18 and Iyer 2016 *Without Prejudice* 17.

185 Hutcheson *et al Kontraktereg in Suid-Afrika* 270 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 299 and *Natal Joint Municipal Pension Fund v Edumeni Municipality* 2012 ZASCA 13 (SCA) par 18 and Iyer 2016 *Without Prejudice* 17.

186 Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 300 and Hutcheson *et al Kontraktereg in Suid-Afrika* 270 and Iyer 2016 *Without Prejudice* 17.

187 Hutcheson *et al Kontraktereg in Suid-Afrika* 271 and and Reinecke *Contract General Principles* 167 and *Natal Joint Municipal Pension Fund v Edumeni Municipality* 2012 ZASCA 13 (SCA) par 15.

188 Hutcheson *et al Kontraktereg in Suid-Afrika* 271 and Iyer 2016 *Without Prejudice* 17.

189 Hutcheson *et al Kontraktereg in Suid-Afrika* 271 and Reinecke *Contract General Principles* 167 and Iyer 2016 *Without Prejudice* 17.

applicable to the "parol evidence"-rule, namely that irrelevant evidence is inadmissible.[190] In the first instance, the rule determines which evidence is admissible to determine the contents of the contract and in the second instance, the rule determines which evidence is admissible in order to determine what was intended with the wording used by the parties in the contract.[191]

The secondary rules of interpretation are applied only after the primary rules of interpretation have been applied, and if there is still confusion regarding a contractual clause.[192] Only a few secondary rules of interpretation will be examined. Some of the secondary rules of interpretation overlap with the primary rules of interpretation; for instance, the *eiusdem generis*-rule.[193] This rule entails that when words are used in the same context as words of a certain *species*, the meaning attributed to these words may be limited,[194] which could be seen as a narrower expression of the rule that words must be interpreted in the context of the contract as a whole.[195] The *noscitur a sociis*-rule implies almost the same, in that it states that words must be interpreted within the "conversation" in which they appear. [196] An example would be in the case of *Foster v Diphws Casson*[197] where the law required that explosives be kept in a "case or canister". In this case, the defendant used a bag made of cloth. On closer inspection it was found that the legislature intended for the case or canister to be of the same strength as a container.[198]

In instances where a contract contains a typed or written insertion, a further secondary rule states that the insertions must be implemented due to the fact that words chosen by parties, rather than the standard text, are to be seen as a precise reflection of their intentions.[199] In the event that there is no evidence to the contrary,

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190 Hutcheson *et al Kontraktereg in Suid-Afrika* 271.

191 Reinecke *Contract General Principles* 168 and Hutcheson *et al Kontraktereg in Suid-Afrika* 271.

192 Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

193 Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

194 *St Paul Insurance Co SA Ltd v Eagle Ink System (Cape) (pty) Ltd* 2010 3 SA 647 (SCA) 651 and Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

195 *First National Bank of SA v Rosenblum* 2001 4 SA 189 (SCA) 196B and Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

196 Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

197 1887 18 OBD 428.

198 This example was found on https://www.yourdictionary.com/noscitur-a-sociis.

199 Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

a court may also accept that the parties intended for the contract to be legally binding, rather than illegal.[200] Further, courts should also:

> be slow to conclude that words in a single document are tautologous and superfluous.[201]

Thus, when a court is interpreting a contract, it is not applying a rule of law, but merely being guided by its principles.[202] A court must be slow to cast aside written insertions in contracts and be slow to deviate from the original written agreement.[203]

The tertiary rules of interpretation will be implemented as a last resort.[204] They aim to achieve a fair outcome,[205] as do both the primary and secondary rules of interpretation. This is in line with our Constitutional values. The *quid minimum*-rule is a tertiary rule of interpretation that requires words to be interpreted strictly in order to cause the least amount of disadvantage to the disadvantaged party.[206] Another example of a tertiary rule of interpretation would be the *contra preferentum*-rule. This rule states that when more than one meaning can be attributed to contractual clauses, the clauses must be interpreted against the party that suggested the clause.[207] From this it can be concluded that in the event that there is no logical conclusion to be reached as to the intentions of the parties in regard to a specific term when concluding the contract, and the application of none of the primary- secondary or tertiary rules of interpretation has brought any relief, a court must rule in favour of the party to whose detriment the application of the contractual term would be.

When a dispute arises about the wording of an average clause, all the rules of interpretation must be applied by courts in order to determine the intention of the parties. Only if the wording of the term is so vague that no logical conclusion can

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200 Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

201 *Wellworths Bazaars Ltd v Chandler's Ltd* 1947 2 SA 37 (A) p 43 and Hutcheson *et al Kontraktereg in Suid-Afrika* 281.

202 Cornelius *Principles of the interpretation of Contracts in South Africa* 64.

203 *Natal Joint Municipal Pension Fund v Edumeni Municipality* 2012 ZASCA 13 (SCA) par 12.

204 Hutcheson *et al Kontraktereg in Suid-Afrika* 282.

205 *South African Forestry Co LTD v York Timbers Ltd* 2005 3 SA 323 (SCA) p 340I and Hutcheson *et al Kontraktereg in Suid-Afrika* 282.

206 Hutcheson *et al Kontraktereg in Suid-Afrika* 282.

207 *Fedgen Insurance Ltd v Leyds* 1995 3 SA 33 (AD) 38E and Hutcheson *et al Kontraktereg in Suid-Afrika* 282.

be reached in this regard may a court "cast the term aside" and rule in favour of the insured. In this instance the average clause would be to the detriment of the insured and the policy would be interpreted as if it never contained an average clause.

Contractual disputes do not always relate to the wording and application of a specific contractual term, especially not in the instance of an average clause. One of these instances occurred in the case of *Barkhuizen v Napier*.[208]

4.3 The proper approach to the question of the constitutionality of contractual terms

In the *Barkhuizen*-case the applicant entered into a short-term insurance contract with a representative of Lloyd's Underwriters of London, the respondent in this case. The applicant had a motor vehicle accident and lodged a claim with the respondent, but the claim was repudiated on the basis that the vehicle was being used for business purposes at the time of the accident, contrary to the contractual agreement that it would be used only for private purposes. It was only after two years had passed since the claim was repudiated that the applicant instituted legal proceedings. The respondent lodged a special plea of prescription due to the fact that the insurance contract contained a clause stating that any legal proceedings must be instituted within 90 days of the repudiation of a claim. The applicant asked the Court to declare the time limitation clause against public policy due to the fact that it prescribed an unfairly short period of time to institute action and that it infringed upon the right of an insured to seek the assistance of a court.[209] This was contrary to section 34 of the *Constitution,* which affords every person access to courts and a fair trial.

The *Barkhuizen*-case called upon the Constitutional Court to determine the proper approach to constitutional challenges of contractual terms.[210] The case was first heard in the Pretoria High Court,[211] where the time limitation clause in the insurance

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208 2008 JOL 19614 (CC). The *Barkhuizen*-case.

209 Lane 2015 *Without Prejudice* 54 and Millard 2016 *De Jure* 163 and Van Niekerk 2007 *ASSAL* 564.

210 The *Barkhuizen*-case para 22.

211 *Barkhuizen v Napier* 2005 JOL 15446 (T). *Barkhuizen* (T).

contract was declared unconstitutional, after which appeal was heard by the Supreme Court of Appeal, where the appeal was upheld. This led to the applicant' appealing to the Constitutional Court to have the matter resolved.

4.3.1 The High Court ruling[212]

The Pretoria High Court was asked to rule on the special plea that the defendant was relieved from liability due to prescription.[213] The Court ruled only on the applicant's argument that the time limitation clause (the clause) was inconsistent with section 34 of the Constitution, because the applicant had not relied on the argument that the clause was against public policy.[214]

The High Court upheld the applicant's argument and relied on the case of *Mohlomi v Minister of Defence,*[215] where the Court held that a time bar that did not permit the condonation of non-compliance with contractual provisions limited the right to access to courts and that it was not reasonable and justifiable under section 33(1) of the *Interim Constitution*, the predecessor of section 36(1) of the *Constitution*.[216]

The High Court further held that the clause was not a law of general application,[217] as required by section 36 of the *Constitution*, but held that the common-law rule that contracts which are freely concluded are binding must be enforced.[218] The Court found that the clause was not reasonable and justifiable under section 34 of the *Constitution* and dismissed the respondent's special plea.[219]

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212 For this discussion, see *Barkhuizen v Napier* 2008 JOL 19614 (CC) paras 7-10.
213 *Barkhuizen* (T) par 2.
214 Sutherland 2008 *Stell LR* 391.
215 1997 1 SA 124 (CC) and 1996 12 BCLR 1559 (CC).
216 *Barkhuizen* (T) 13, 16, 17.
217 *Barkhuize* (T) 13 and Sutherland 2008 *Stell LR* 392.
218 *Pacta sunt servanda. Barkhuizen v Napier* (T) 9-10.
219 *Barkhuizen* (T) 19 and Sutherland 2008 *Stell LR* 393.

4.3.2 The Supreme Court ruling[220]

The Supreme Court of Appeal accepted the "general premise" that contractual terms are subject to the *Constitution* and that contractual terms which are against public policy are unenforceable.[221] Public policy derives from:

> the founding constitutional values of human dignity, the achievement of equality and the advancement of human rights and freedoms, non-racialism and non-sexism.[222]

The Court held that to determine whether constitutional values were infringed by the clause, based on the "slim"[223] amount of evidence placed before it, was very hard.[224] The High Court's finding that the clause was unfair was not self-evident from the record and the evidence did not allow for such a finding.

A contractual term that is unfair or may operate harshly does not necessarily warrant the conclusion that the term is unconstitutional.[225] The Court further explained that intrusion by Judges on apparently voluntarily concluded agreements between contractual parties is a step that should be taken carefully, especially when they apply their individual conceptions of fairness and justice to parties' individual agreements.[226]

The question considered by the Court was whether the applicant was forced to contract with the insurer on terms that infringed his constitutional rights of dignity and equality that required the Court to develop the common law of contracts so as to invalidate the term in question.[227] The Court held that the *Constitution* does not prevent time bar provisions where agreements are reached voluntarily and that there was no evidence to the effect that the agreement was not reached freely.[228]

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220 For this discussion, see *Barkhuizen v Napier* 2008 JOL 19614 (CC) paras 11-18.
221 *Napier v Barkhuizen* 2006 2 All SA 469 (SCA) par 6 (*Barkhuizen* (SCA) and Sutherland 2008 *Stell LR* 393.
222 *Barkhuizen* (SCA) par 7.
223 *Barkhuizen* (SCA) par 9.
224 *Barkhuizen* (SCA) par 10, 28.
225 *Barkhuizen* (SCA) par 12.
226 *Barkhuizen* (SCA) par 13 and Hutcheson *et al Kontraktereg in Suid-Afrika* 185.
227 Sutherland 2008 *Stell LR* 394.
228 *Barkhuizen* (SCA) par 20.

The appeal was upheld and the decision of the High Court was set aside[229] and replaced by one upholding the special plea with costs. It can be concluded that time bar provisions serve a legitimate purpose, and that they do not infringe on a right that is afforded by the *Bill of Rights*. They merely limit it.

4.3.3 The majority ruling of the Constitutional Court in regard to contractual fairness

The argument that the clause is contrary to public policy and unenforceable[230] gives rise to two different arguments.[231] Firstly, there is the argument that the clause is against public policy for hindering a person's right to seek judicial redress. This argument does not rely directly on section 34, but determines the contents of public policy in order to show that the clause is contrary to public policy. Public policy refers to the legal convictions of the community,[232] the values that our society holds most dear and that are contained in the *Constitution*, and more specifically in the *Bill of Rights*.[233] The second argument relies directly on section 34 to show that the clause limits the rights guaranteed in section 34 and that the limitation is not reasonable and justifiable under section 36(1) of the *Constitution*.[234]

The Court held that the proper approach to the constitutional challenges of contractual terms is to determine whether a contractual term is contrary to public policy by having regard for the values of our constitutional democracy, and more specifically, those contained in the *Bill of Rights*.[235] This would leave room for the principle of *pacta sunt servanda* to operate but would enable Courts to declare contractual terms that are contrary to the constitutional values invalid,[236] even though the parties may have consented to them.[237] This would entail that even though a contract that contains an average clause was freely concluded between

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229 Sutherland 2008 *Stell LR* 393.
230 The *Barkhuizen*-case (CC) para 19.
231 The *Barkhuizen*-case (CC) para 20.
232 Hutcheson *et al Kontraktereg in Suid-Afrika* 32.
233 The *Barkhuizen*-case (CC) para 28 and Hutcheson *et al Kontraktereg in Suid-Afrika* 39-40 and Sutherland 2008 *Stell LR* 394.
234 The *Barkhuizen*-case (CC) para 20.
235 The *Barkhuizen*-case (CC) para 30 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 16.
236 Sutherland 2008 *Stell LR* 394.
237 The *Barkhuizen*-case (CC) para 30.

the parties, a court would have the power to declare the average clause invalid or unenforceable.

Section 34 of the *Constitution* affords every person access to courts and states:

> Everyone has the right to have any dispute that can be resolved by the application of law decided in a fair public hearing before a court…

A term in a contract that deprives a party of access to courts would be contrary to public policy.[238]

All law in our legal system promotes the values of the *Constitution* and is subject to constitutional control, and the law of contract is no exception.[239] The courts are obliged to develop the law in order to bring it in line with the values that underlie our constitutional democracy and when doing so, they must promote the spirit, purport and object of the *Bill of Rights*.[240] Courts may also develop the law by limiting a right afforded by the *Bill of Rights* as long as the limitation is in accordance with section 36(1) of the *Constitution*.[241]

The main argument for the applicant was that the clause limits the applicant's right to access to courts and is thus contrary to public policy.[242] The Court held that time limitations are a common feature in the field of contracts as well as in statutes.[243] In both instances, they limit the right to have a matter heard by a court, once a certain action gets barred because it was not performed within the prescribed time period.[244] In this manner, a time limitation clause limits a persons' right to access a court of law.

Time limitation clauses play an important role in our legal society, in that excessive delays in litigation are not in the interest of justice.[245] The Court held that for this

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238 The *Barkhuizen*-case (CC) para 34.

239 The *Barkhuizen*-case (CC) para 35 and Sutherland 2008 *Stell LR* 394.

240 Section 39(1) of the *Constitution* and The *Barkhuizen*-case (CC) para 35 and Hutcheson *et al Kontraktereg in Suid-Afrika* 39 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 12-13.

241 The *Barkhuizen*-case (CC) para 35.

242 The *Barkhuizen*-case (CC) para 45.

243 The *Barkhuizen*-case (CC) para 46.

244 The *Barkhuizen*-case (CC) para 46.

245 *Mohlomi v Minister of Defence* 1997 1 SA 124 (CC) para 11 and The *Barkhuizen*-case (CC) para 47.

reason it cannot see why time limitation clauses would be against public policy. The *Constitution* itself affords certain circumstances where it would be reasonable to limit the right to seek judicial redress.[246] An average clause also plays an important role in insurance contracts as it limits the amount recoverable by an under-insured insured, where the premiums paid were very small in relation to the true value of the object of risk. An average clause protects the interests of the insurer. It is reasonable (in terms of section 36 of the *Constitution*) to limit the amount recoverable by an insured in instances where the insured is under-insured.

In order for a time limitation clause to be consistent with section 34 of the *Constitution*, it must afford a party a real and fair initial opportunity to exercise its right.[247] Public policy does not allow the enforcement of a contractual term that is unfair and unreasonable.[248] A clause that affords a party an unreasonable and unfair opportunity to seek judicial redress would be contrary to public policy,[249] due to the fact that the values of fairness and reasonableness cannot be separated from public policy.[250] The Court held[251] that:

> In each case, of course, the question will be whether the contract contains a time limitation clause which affords a contracting party an adequate and fair opportunity to have disputes arising from the contract resolved by a court of law. In approaching this question, *a court will bear in mind the need to recognise freedom of contract but the court will not let blind reliance on the principle of freedom of contract override the need to ensure that contracting parties must have access to courts*.[252]

As long as an insured has the right to challenge the application of an average clause in certain circumstances, an average clause will not be contrary to section 34 of the *Constitution*.

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246 The *Barkhuizen*-case (CC) para 48. The limitation of the right to seek judicial redress also constitutes public policy, due to the fact that s 36 of the *Constitution* makes provision for rights to be limited in certain instances.

247 *Mohlomi v Minister of Defence* 1997 1 SA 124 (CC) para 12 and The *Barkhuizen*-case (CC) para 49 and Sutherland 2008 *Stell LR* 410.

248 The *Barkhuizen*-case (CC) para 73 and Hutcheson *et al Kontraktereg in Suid-Afrika* 34 and Sutherland 2008 *Stell LR* 403-404.

249 Sutherland 2008 *Stell LR* 403-404.

250 The *Barkhuizen*-case (CC) paras 51-52.

251 The *Barkhuizen*-case (CC) para 55.

252 Own emphasis.

The double-barreled test to determine fairness of a contractual term mentioned above[253] requires that two essential questions be answered.[254] Firstly, the question must be asked whether the clause itself is unreasonable and the second question is whether a fair contractual term, if the term is fair, must be enforced in light of the circumstances that prevented compliance with the time limitation clause.[255]

The Court held that the first question consists of two considerations. Firstly, public policy requires parties to comply with freely concluded agreements,[256] which promotes the values of freedom and dignity.[257] The ability of people to regulate their own affairs, even to their own detriment, forms an essential part of freedom and dignity.[258] The extent to which an agreement was concluded voluntarily determines the weight that needs to be attributed to the values of freedom and dignity when considering the constitutionality of a contractual term.[259] Secondly, every person's right to seek judicial redress must be considered.[260] This first question is directed at the objective terms of the contract and only if the objective terms are not unconstitutional on their face value will an inquiry be made into the second question.[261]

The first consideration of the first question leads to the conclusion that even though an average clause contained in an insurance contract can have dire consequences for an insured, this does not mean that it will be invalid. People have the right to regulate their own affairs to their own detriment. This promotes the constitutional values of freedom and dignity. The second consideration affords a person the right to challenge the validity of the average clause. Only if both these considerations are fulfilled will the average clause be constitutional and can an inquiry be made into the second question of the double-barreled test.

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253 Under par 4.
254 Lane 2015 *Without Prejudice* 54 and Van Niekerk 2007 *ASSAL* 565.
255 The *Barkhuizen*-case (CC) para 56 and Hutcheson *et al Kontraktereg in Suid-Afrika* 33 and Lane 2015 *Without Prejudice* 54 and Van Niekerk 2007 *ASSAL* 565.
256 The *pacta sunt servanda* maxim.
257 The *Barkhuizen*-case (CC) para 57 and Hutcheson *et al Kontraktereg in Suid-Afrika* 28.
258 The *Barkhuizen*-case (CC) para 57 and Hutcheson *et al Kontraktereg in Suid-Afrika* 28 and Sutherland 2009 *Stell LR* 52.
259 The *Barkhuizen*-case (CC) para 57 and Hutcheson *et al Kontraktereg in Suid-Afrika* 187.
260 The *Barkhuizen*-case (CC) para 57.
261 The *Barkhuizen*-case (CC) para 59 and Hutcheson *et al Kontraktereg in Suid-Afrika* 33.

The second question relates to the circumstances that led to non-compliance with the contractual term.[262] It would be unreasonable to expect compliance with a contractual term, where there were circumstances that prevented a party from complying.[263] The onus rests upon the party that wishes to avoid enforcement of the time limitation clause to prove existential circumstances that prevented him/her from complying.[264] The Court stated that:[265]

> the relative situation of the contracting parties is a relevant consideration in determining whether a contractual term is contrary to public policy. I endorse this principle. This is an important principle in a society as unequal as ours.

If an insured was unaware of the average clause contained in its insurance policy, this could constitute circumstances within which it was not fair to apply the average clause.

The Court held that,[266] when considering the first question, there was no reason for a delay in the institution of action by the applicant, due to the fact that he had all the relevant information and there was no need for further inquiry by him in order to obtain all the information.[267] For this reason the clause was not against public policy. The time afforded by the clause for the institution of action was not unreasonable. The Court held further that, in consideration of the second question, there was no evidence placed before the court that showed that the contract was not concluded freely, or that could justify non-compliance with the clause.[268] For these reasons the Court held that the clause was not unreasonable and unfair and that it would be contrary to public policy to enforce it.[269] The appeal was dismissed.[270]

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262 The *Barkhuizen*-case (CC) para 59 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 188,195.

263 The *Barkhuizen*-case (CC) para 59.

264 The *Barkhuizen*-case (CC) para 59.

265 The *Barkhuizen*-case (CC) para 59.

266 The *Barkhuizen*-case (CC) para 60.

267 Van Niekerk 2007 *ASSAL* 566.

268 The *Barkhuizen*-case (CC) para 66 and Van Huyssteen, Lubbe and Reinecke *Contract General Principles* 195 and Van Niekerk 2007 *ASSAL* 567 and Sutherland 2009 *Stell LR* 56.

269 The *Barkhuizen*-case (CC) para 67 and Hutcheson *et al Kontraktereg in Suid-Afrika* 197 and Van Niekerk 2007 *ASSAL* 566.

270 The *Barkhuizen*-case (CC) para 91 and Hutcheson *et al Kontraktereg in Suid-Afrika* 32.

It is, lastly, also important to mention the *obiter* remark with regards to good faith in contracts. The Court held that good faith is not a self-standing value that is given expression by underlying rules of law, in this case, that impossible contractual terms are unenforceable.[271] Although a good argument can be made for the application of the maxim *lex non cogid ad impossibilia*[272] and for good faith to be applicable to time limitation clauses, the application of these common law principles will largely depend upon the reasons for non-compliance placed before the court, and there is therefore no reason to determine whether these principles are applied to the enforcement of time limitation clauses.[273]

Though the *Barkhuizen*-case dealt with time limitation clauses, the principles laid down in this case are also applicable to other areas of the law. The constitutionality of time limitation clauses is not the only area where the constitutionality of a principle might be questioned. The test laid down in the majority judgment of the *Barkhuizen*-case can find broad application in our law, even where a dispute relating to an average clause arises. A Court would first have to determine whether the specific average clause is reasonable and secondly whether it would be reasonable to enforce the average clause, if it was found to be reasonable, in the specific circumstances surrounding the dispute.

This research will now discuss standard form contracts with specific reference to the minority judgment of Sachs J in the *Barkhuizen*-case. Standard form contracts are of relevance to this research, because most insurance contracts are standard form contracts. This was also the case in the *Barkhuizen*-case.

4.4 Standard form contracts

The era of mass production and the mass consumption of goods and services leads to mass contracting on standardised terms and conditions, which are mostly forced on the other party - in most cases the consumer.[274] A standard form contract is a

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271 The *Barkhuizen*-case (CC) para 82. *Lex non cogit ad impossibilia.* Van Niekerk 2007 *ASSAL* 567.

272 The *Barkhuizen*-case (CC) para 75. *Lex non cogid ad impossibilia* means that no one should be compelled with that which is impossible.

273 The *Barkhuizen*-case (CC) para 83 and Van Niekerk 2007 *ASSAL* 567.

274 Hutcheson *et al Kontraktereg in Suid-Afrika* 26.

contract that contains prescribed clauses that are often written in complicated wording and non-negotiable. These are offered to the "buying" parties.[275] Such contracts are also drafted in advance by suppliers of goods and services.[276] The goal of standard form contracts is to speed up the process of concluding a contract[277] and often systems are in place to enable this, which sometimes require no interaction between parties.[278] This has the result that most of the contract is not agreed upon at all and is heavily in favour of one of the parties.[279]

When it comes to the law of insurance, insurance contracts are nothing other than standard form contracts. This is clear from the previous discussion[280] of the terms in various insurance contracts. These contracts afford the insured the opportunity only to enquire about terms in the contracts that are unclear to them. They have no opportunity to negotiate on the contents of the insurance contract. This creates the impression that if they wished to exclude some of these clauses, they would have to find insurance elsewhere.

In the minority judgment of the *Barkhuizen*-case, Sachs J took a broader approach than that in the majority ruling. In his view the main issue was when taking into account that the clause in question formed part of a standard form document, which was attached to the document and did not form part of the original negotiations, whether the enforcement of the clause would be consistent with public policy and our constitutional dispensation.[281] He sums up the problem with standard form contracts well by stating that:[282]

> As it is impracticable for ordinary people in their daily commercial activities to enlist the advice of a lawyer, most consumers simply sign or accept the contract without

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275 Hutcheson *et al Kontraktereg in Suid-Afrika* 205 and Smith and McCarthy 2008 *Without Prejudice* 32 and The *Barkhuizen*-case (CC) para 135. These terms also often form part of the "fine print" of a contract.

276 The *Barkhuizen*-case (CC) para 135 and Sutherland 2009 *Stell LR* 61.

277 The *Barkhuizen*-case (CC) para 156. Standard form contractual terms are often as inconspicuous as possible in order not to draw attention to themselves.

278 Hutcheson *et al Kontraktereg in Suid-Afrika* 26.

279 The *Barkhuizen*-case (CC) para 156 and Smith and McCarthy 2008 *Without Prejudice* 32 and Sutherland 2009 *Stell LR* 61.

280 Under par 3.4.

281 The *Barkhuizen*-case (CC) para 22 and Van Niekerk 2007 *ASSAL* 568.

282 The *Barkhuizen*-case (CC) para 136 and Smith and McCarthy 2008 *Without Prejudice* 34 and Sutherland 2009 *Stell LR* 56.

> knowing the full implications of their act. The task of endlessly shopping around and wading through endless small print in endless standard forms, would be beyond the expectations that could be held of any ordinary person who simply wished to get his or her car insured. What the insured in fact looks for is a reliable insurer that offers what he or she thinks are reasonable terms as regards cover and premiums. Indeed to expect the would-be purchaser of short-term insurance to seek full legal advice on every term in the standard form contract would both require that the expense of the premium be exceeded many times over, and result in the absurdity of the short term of the cover expiring before comprehensive clarity on each and every provision was obtained.

The fact that every person does not have the means[283] or the time to rummage through and enlist help to understand long standard form contracts which are often filled with legalese[284] is not the only problem. These contracts often weigh heavily in favour of the supplier,[285] in that they exclude the consumer's normal contractual rights and the supplier's normal contractual obligations.[286] The constitutional values of dignity and equality require that parties to a contract must adhere to a minimum threshold of mutual respect, because:[287]

> …'unreasonable and one-sided promotion of one's own interest at the expense of the other infringes the principle of good faith to such a degree as to outweigh the public interest in the sanctity of contracts'. The task is not to disguise equity or principle but to develop contractual principles in the image of the Constitution…

Where unfair contracts can fall foul of the *Constitution*, courts may use the concept of *boni mores* to infuse the law of contract with the concept of *bona fides*.[288] If mass-produced contracts are treated like sanctified legal scripture, this would undermine the moral of contract law, which certainly does not promote the spirit of openness which is central to our constitutional order.[289]

The use of standard form contracts has some advantages. These contracts reduce the transaction costs of contracting, in that it makes available a suitable set of terms

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283 Smith and McCarthy 2008 *Without Prejudice* 33.

284 Sutherland 2009 *Stell LR* 61.

285 The *Barkhuizen*-case (CC) para 156 and McCarthy 2008 *Without Prejudice* 32, 33 and Sutherland 2009 *Stell LR* 61.

286 The *Barkhuizen*-case (CC) para 135.

287 *Mort NO v Henry Shields-Chait* 2001 1 SA 464 (C) p 475 and The *Barkhuizen*-case (CC) para 140 and *Brisley v Drotsky* 2002 JOL 9693 (A) para 22 and Sutherland 2009 *Stell LR* 52.

288 *Mort NO v Henry Shields-Chait* 2001 1 SA 464 (C) p 475 and The *Barkhuizen*-case (CC) para 140 and *Brisley v Drotsky* 2002 JOL 9693 (A) para 22.

289 The *Barkhuizen*-case (CC) para 156 and Sutherland 2009 *Stell LR* 36.

at no extra cost[290] and enables control over contractual arrangements made by employees of financial service providers.[291] They provide a mechanism to control the content of agreements concluded between buyers and sellers.[292] In the law of insurance, a standard form contract provides a mechanism to control the contents of an insurance contract.

To blankly accept or reject the validity of standard form contracts or an *ad hoc* determination by each judge in accordance with his/her own values of what is fair and what is not, would not be reasonable.[293] An objective, principled approach in regard to the principles of contract law and the way in which economic power in public affairs should be regulated to ensure standards of fairness in a democratic society is required.[294]

Freedom of contract is one of the values that lies at the heart of the *Constitution* because it relates to the values of autonomy and dignity, but with the evolution of contract law and the application of the principle of sanctity of contract,[295] it has become less important to enforce this old volition.[296] The development of standard form contracts is one way in which contractual freedom is undermined, due to its "take it or leave it" nature.[297] Public policy is in favor of the utmost freedom of contract.[298]

Certainty in contract law is established through the principle of sanctity of contracts. Parties must abide by their agreements.[299] A contract can be valid only when the agreement signed by the parties is truly their agreement to which they consented,

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290 Smith and McCarthy 2008 *Without Prejudice* 33 and The *Barkhuizen*-case (CC) para 136.
291 Sutherland 2009 *Stell LR* 63.
292 The *Barkhuizen*-case (CC) para 136.
293 The *Barkhuizen*-case (CC) para 146 and Sutherland 2009 *Stell LR* 51 and Sutherland 2009 *Stell LR* 63.
294 The *Barkhuizen*-case (CC) para 146 and Sutherland 2009 *Stell LR* 64.
295 *Pacta sunt servanda*.
296 The *Barkhuizen*-case (CC) para 150.
297 Hutcheson *et al Kontraktereg in Suid-Afrika* 205 and The *Barkhuizen*-case (CC) para 135 and McCarthy 2008 *Without Prejudice* 32.
298 The *Barkhuizen*-case (CC) para 150 and Sutherland 2009 *Stell LR* 50.
299 The *Barkhuizen*-case (CC) para 168.

and that agreement is not in standard form and has been read by them or negotiated by them.[300] Sachs J held that:

> The principle of sanctity of contract carries conviction only if there is a contract in the sense of a full-hearted agreement which is the result of free and equal bargaining.[301]

Unfortunately, in this day and age there are rarely the time and resources to carry on a full-blown contractual negotiation; hence the development of standard form contracts. The boilerplate terms contained in standard form contracts impinges on the contractual freedom of the adhering party.[302] An adhering party cannot prevent the inclusion of form terms in a contract, and a major purpose of these terms is to ensure that the drafting party will prevail.[303] A typical boilerplate term or form term would be the average clause, as it forms part of standard form contracts of the kind that was used in the insurance policies of King Price, OUTsurance and Youi.[304] These clauses were basically exactly the same, apart from the sentences being moved around. All three of them even used the exact same example to explain the application of the average clause. If a dispute regarding the validity of an average clause were to arise, the court would be able to move away from the age-old principle of *pacta sunt servanda,* as public policy today is more in favor of the utmost freedom of contract. It would be possible for an average clause to be declared invalid.

The foundation of the law of contract is to ensure certainty, to protect the expectations of parties and to secure to each party the bargain made.[305] The fact that courts have a reviewing power[306] shows that public policy has moved away from the unquestioning application of standard form contracts to an attitude more in keeping with contemporary constitutional values.[307]

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300 The *Barkhuizen*-case (CC) para 168.
301 The *Barkhuizen*-case (CC) para 168.
302 The *Barkhuizen*-case (CC) para 154.
303 The *Barkhuizen*-case (CC) para 154.
304 Discussed under par 3.4.
305 The *Barkhuizen*-case (CC) para 171.
306 The *Barkhuizen*-case (CC) para 171.
307 The *Barkhuizen*-case (CC) para 174 and Smith and McCarthy 2008 *Without Prejudice* 34 and Sutherland 2009 *Stell LR* 53.

4.5 Conclusion

When interpreting contractual terms, there are various rules of interpretation to help courts determine the true intentions of the contracting parties. In the end, if the court cannot determine the intentions of the parties with certainty, a contract will be interpreted in favour of the party to whose detriment the contract would be if it were enforced.[308] Courts must also interpret contracts and contractual terms in such a manner that they are in line with our constitutional values.

When deciding on the constitutionality of a contractual term, the double-barreled test created by the majority ruling of the *Barkhuizen*-case would leave space for the considerations of Sachs J in the minority judgment to be applied as well. The test consists of two questions, the first of which is whether or not the contractual terms themselves are reasonable. The second question leaves room for the minority judgment to be incorporated, which suggests that the circumstances surrounding the conclusion of the contract and non-compliance with the contractual term should be considered. The reasons for the non-compliance with a standard form contract would then determine the extent to which a standard form contract is enforced.[309] Due to the development of standard form contracts, the principle of *pacta sunt servanda* cannot be enforced blatantly any more, and courts are given a reviewing power to ensure that fairness between contractual parties prevails. Public policy no longer requires the straightforward application of contractual terms, but rather that constitutional values prevail.[310]

The enforcement of standard form terms inevitably impinges on the freedom of contract of the adhering party and ensures that the interests of the drafting party prevail.[311] This does not mean that one may conclude that the enforcement of such terms is completely unconstitutional.[312] Standard form contracts have some advantages to them. Business firms play an important role in our economy and their effectivity depends largely on the use of standard form contracts. For this reason,

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308 The *contra preferentum*-rule.
309 The *Barkhuizen*-case (CC) para 57 and Hutcheson *et al Kontraktereg in Suid-Afrika* 187.
310 The *Barkhuizen*-case (CC) para 174 and Smith and McCarthy 2008 *Without Prejudice* 34.
311 The *Barkhuizen*-case (CC) para 146.
312 The *Barkhuizen*-case (CC) para 147.

the use of standard form contracts is sustainable to a certain extent.[313] One must determine the "tendency" of the provision at issue and the extent to which it vitiates the standards of reasonableness and fairness of the community when it comes to the business firm-consumer relationship.[314]

As mentioned above,[315] insurance contracts are often standard form contracts. It was made clear in the discussion of the average clauses of certain insurance contracts (above)[316] that the average clause is a typical example of a standard form clause that occurs in insurance contracts. Due to the "take it or leave it" nature of standard form contracts, the insured often has no freedom to exclude the average clause from his or her insurance contract, which is in conflict with the individual's right to contractual freedom. The new public policy entails that standard form contracts may be enforced only to the extent to which they adhere to constitutional values. This means that the average clause might not be applied in certain instances, even though it forms part of an insurance contract in certain, such as where a financial advisor did not direct the insured's attention to the fact that the average clause forms part of his/her insurance contract.

The party that gives a standard form contract to another party to sign (in the case of insurance contracts, the representative or financial advisor) must direct the signing party's attention to any contractual terms that a person cannot reasonably expect to encounter in that type of contract.[317] If the signing party is not made aware of the unusual contractual term, he or she can successfully show that as s/he did not expect to find such a term in the contract,[318] the term is not binding upon him or her.[319]

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313 The *Barkhuizen*-case (CC) para 147.

314 The *Barkhuizen*-case (CC) para 147. The standard form term must be examined in relation to the contract as a whole.

315 Under par 4.

316 Under par 3.4.

317 Hutcheson *et al Kontraktereg in Suid-Afrika* 250 and Sutherland 2009 *Stell LR* 66.

318 Smith and McCarthy 2008 *Without Prejudice* 34 and The *Barkhuizen*-case (CC) para 150 and Sutherland 2009 *Stell LR* 66.

319 *Brink v Humphries & Jewel Ltd* 2005 2 SA 468 (SCA) para 2 and Hutcheson *et al Kontraktereg in Suid-Afrika* 250.

This research continues by investigating the consequences for financial advisors of misconduct.

Chapter 5

5 The conduct of a financial advisor

5.1 Introduction

The *FAIS*-act, the *General Code of Conduct, PPR's* and *TCF*-principles are the most important measures according to which the conduct of a financial advisor has to be measured. These measures aim to protect the clients of a Financial Service Provider (an FSP) from being exploited by FSP's. These measures are applicable not only to the FSP as a legal person, but also to the members of the FSP.[320]

With reference to the case study in par 1.3 (Mr. X's case), the conduct of a financial advisor from ABC Insurers who did not disclose all the relevant information regarding an insurance contract to his client (Mr. X) has to be evaluated. The conduct of Mr. X's financial advisor led to Mr. X suffering damages due to the application of the average clause in his insurance policy and ABC Insurers' refusal to pay out the full amount of his claim. The question arises as to whether an FSP or representative thereof can be held liable for the losses of a client, and if so, to what extent.

The *FAIS*-act defines a representative[321] as a person or a person employed or mandated by an insurer, who renders a financial service to a client for or on behalf of an FSP, in terms of a contract of employment or mandate.[322] Mr. X's financial advisor could also be a broker. Reinecke[323] defines a broker as a professional who functions as a middleman or negotiator between principals and normally acts on behalf of the prospective insured. When observing the definition of a broker and a

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320 The Banking association of South Africa date unknown https://www.banking.org.za/consumer-information/consumer-information-legislation/financial-advisory-and-intermediary-services-act/.

321 *FAIS*-act s 1(1).

322 This definition further excludes a clerical, technical, administrative, legal or accounting person or who renders another subsidiary or subordinate service that does not require judgment on the part of the latter person or does not lead a client to any specific transaction in respect of a financial product when making general enquiries.

323 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 517-518.

representative it is clear that they are almost the same. The definition of a broker is just not as comprehensive as that of a representative.[324]

This Chapter critically evaluates the conduct of an FSP's financial advisors in the light of the *FAIS*-act, the *General Code of Conduct,* the *PPR's* and the *TCF*-principles. A brief overview of the *COFI* bill is also presented, as the bill has not yet been promulgated. The aim of this Chapter is to show that Mr. X's financial advisor can be held liable for his damages in the light of the above-mentioned measures.

5.2 *The FAIS*-Act

The aim of the *FAIS*-act is to regulate the rendering of certain financial advisory and intermediary services to clients when it comes to financial products.[325] Reinecke summarises the aim of the *FAIS*-act as being to "regulate the market conduct of the financial service industry".[326] The *FAIS*-act is applicable only in instances where a financial service is rendered on a regular basis to clients who are members of the general public.[327]

In order to determine whether the *FAIS*-act is applicable, one must take note of the definitions provided in section 1 of the *FAIS*-act.[328] It is important to determine whether a person is an authorised financial services provider. In order to qualify as an authorised financial services provider under the *FAIS*-act, a person must possess a licence granted in terms of section 8 of the Act to act as a financial services provider.[329] Further, a financial services provider is defined as any person, excluding a representative, who regularly gives advice as part of his business or gives advice and renders an intermediary service[330] or just renders an intermediary service.[331]

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324 In this research, when reference is made to financial advisor, theterm will alsorefer to a representative and a broker.

325 Millard and Hattingh *The FAIS Act Explained* 11 and Millard 2012 *Obiter* 153.

326 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 511.

327 Millard and Hattingh *The FAIS Act Explained* 11.

328 Millard and Hattingh *The FAIS Act Explained* 11.

329 S 1(1) of the *FAIS*-act.

330 An intermediary service is defined in s 1(1) of the *FAIS*-act as any act, subject to ss 3(b), other than the furnishing of advice performed for or on behalf of a client that enables the client to enter into or offer to enter into an agreement relating to a financial product.

331 S 1(1) of the *FAIS*-act.

The financial advisor-client relationship is based on a contract of mandate[332] that can also be called a "brokerage contract".[333] A brokerage contract requires that the financial advisor agree to advise a client regarding suitable insurance cover.[334] The relationship between the financial advisor and the client is a fiduciary relationship, which obliges the advisor to act in good faith towards his client and ensure that he has the best interest of his client at heart and acts honestly.[335]

It is also important to determine what the *FAIS*-act means when referring to advice and to a financial product. The *FAIS*-act provides a comprehensive definition of a financial product,[336] most of which is not relevant to this research. Only subsection (c) of the definition is applicable. This subsection includes short-term and long-term insurance contracts in the definition of financial products.[337] Section 2 of the *FAIS*-act excludes any financial product exempted from the provisions of the *FAIS*-act by the registrar by notice in the *Gazette.* Advice is defined as:

> subject to subsection (3) (a), any recommendation, guidance or proposal of a financial nature furnished, by any means or medium, to any client or group of clients—
> (a) in respect of the purchase of any financial product; or
> (b) in respect of the investment in any financial product; or
> (c) on the conclusion of any other transaction, including a loan or cession, aimed at the incurring of any liability or the acquisition of any right or benefit in respect of any financial product; or
> (d) on the variation of any term or condition applying to a financial product, on the replacement of any such product, or on the termination of any purchase of or investment in any such product, and irrespective of whether or not such advice—
> (i) is furnished in the course of or incidental to financial planning in connection with the affairs of the client; or
> (ii) results in any such purchase, investment, transaction, variation, replacement or termination, as the case may be, being effected;

The exclusions that do not fall under the definition of advice are contained in subsection 3(a) of the *FAIS*-act. These include advice given on the procedure of entering into a transaction of a financial product, advice on the description of the

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332 Van Niekerk 2013 *SA Merc LJ* 79 and Millard 2012 *Obiter* 154.
333 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 518.
334 Reinecke, van Niekerk and Nienaber *South African Insurance Law* 518.
335 *Another v Independent Municipal and Allied Trace Union* 2002 JDR 0424 (SCA) para 19; Reinecke, van Niekerk and Nienaber *South African Insurance Law* 518.
336 S 1(1) of the *FAIS*-act.
337 As referred to in the *Long-term Insurance Act*, 1998 (Act No. 52 of 1998), and the *Short-term Insurance Act*, 1998 (Act No. 53 of 1998), respectively.

product, and advice given when answering routine questions by clients, only to name a few.

Section 13(1) of the *FAIS*-act prohibits a financial advisor of an FSP from certain conduct. An advisor may not carry on business by rendering financial advice to clients for or on behalf of a person who is not an FSP or exempted from the provisions of the *FAIS*-act by the registrar.[338] Such a person may also not act as a financial advisor of an FSP unless s/he provides evidence that s/he has a valid contract or other mandate with the FSP to act as an advisor, and that the FSP accepts responsibility for the actions of the advisor performed in the scope of his/her contract or mandate.[339] Section 13(1)(b)(iA) also requires such a person to provide evidence that s/he meets the fit and proper requirements. The fit and proper requirements referred to are the following: honesty and integrity, good standing, competence, continuous professional development, operational ability and financial soundness.[340]

Chapter 6 of the *FAIS*-act sets out the procedure for the implementation of the *FAIS*-act by enabling complainants to submit a claim to the *FAIS*-ombud. In certain instances it is possible for a financial advisor of an FSP to be held liable for his/her negligent conduct. An example of such an instance was in the case of *PFC Foods CC v Three Peaks Management (Pty)*[341] (the *PFC Foods*-case).

In this case an insurance intermediary was held liable for the losses of his client after he did not exercise the reasonable skill and care required from him when fulfilling his legal duties towards his client.[342] The plaintiff had a contract of mandate with the defendant[343] and instructed him to obtain insurance cover[344] for the plaintiff's business against loss following the interruption of business caused by fire.[345] The plaintiff requested that the defendant review the insurance to ensure

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338 S 13(1)(a) of the *FAIS*-act.
339 S 13(1)(b)(1)(aa-bb) of the *FAIS*-act.
340 S 4(1) in BN 194 in GG 41321 of 15 December 2017.
341 2012 JOL 29486 (KZD).
342 The *PFC Foods*-case par 77, 98.
343 The *PFC Foods*-case par 6.
344 The *PFC Foods*-case par 7.
345 The *PFC Foods*-case par 9.

that the business had adequate insurance cover.[346] The defendant did not increase the business interruption cover, which led the plaintiff to believe that the amount of R600 000 business interruption cover was adequate.[347] When a fire occurred which caused damage to the premises of the plaintiff's business, a claim was submitted for the business interruption, but the insurer applied the average clause and paid out only a proportion of the claim, due to the plaintiff being under-insured by 32 percent.[348] The plaintiff claimed from the defendant the proportion of the damage, R357 780, she was unable to recover from the insurer. The Court held[349] that the defendant had not acted with the reasonable skill and care in that he did not explain to the plaintiff how a business interruption loss is calculated, he had not obtained the necessary information from the plaintiff in order to advise the plaintiff properly and to ensure that the plaintiff was adequately insured, nor had he properly warned the plaintiff of the consequences of the average being applied if the business was underinsured. The Court held the defendant liable for the damages of the plaintiff due to his negligence.[350]

The financial advisor in the case study[351] can be held liable for Mr. X's damages. The advice provided by the advisor clearly fell within the ambit of the definition of advice provided by the *FAIS*-act, as the advisor provided recommendations and guidance on a financial product which resulted in the purchase of such a financial product. The advice was given on a financial product (a short-term insurance contract) which is specifically mentioned under the definition of a financial product. It could be argued that the advisor did not comply with section 13(1)(b)(iA) of the *FAIS*-act in that he did not meet the fit and proper requirements and that he did not act competently when he did not direct Mr. X's attention to the average clause contained in the insurance policy.

It is important to note that Mr. X has an alternative to following the long and complicated judicial route. A complaint can be submitted to the *FAIS*-ombud under

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346 The *PFC Foods*-case par 26, 64, 74 and Van Niekerk 2013 *SA Merc LJ* 75.
347 Van Niekerk 2013 *SA Merc LJ* 75 and The *PFC Foods*-case par 29.
348 The *PFC Foods*-case par 35 and Van Niekerk 2013 *SA Merc LJ* 75.
349 The *PFC Foods*-case par 98.
350 The *PFC Foods*-case par 99, 101.
351 See par 3.1

chapter 6 of the *FAIS*-act if Mr. X is not satisfied with the conduct of his financial advisor. Similar to the position in the *PFC Foods*-case, Mr. X's advisor may be held liable for his client's damages, due to the fact that he did not make Mr. X aware of the average clause contained in his insurance policy and the consequences of non-compliance with the clause. The advisor did not act in Mr. X's best interest in this regard and can be held liable on the grounds of his negligent conduct. A complaint may be submitted to the *FAIS*-ombud only if it falls within the ambit of the *FAIS*-act and the Ombud-rules,[352] if the person against whom the complaint is lodged is subject to the provisions of the *FAIS*-act,[353] the Ombud-rules must have been in force when the act or omission occurred,[354] and the respondent (Mr. X's advisor) must have failed to address the complaint within six weeks.[355] In order for the *FAIS*-ombud to investigate a complaint, it must be satisfied that the complainant must try to resolve the dispute with the respondent.[356] The *FAIS*-ombud also has a monetary jurisdiction limit of R800 000, meaning that if the amount claimed exceeds R800 000 the Ombud does not have the jurisdiction to hear the complaint, unless the complainant abandons the amount in excess of R800 000 or the person against whom the complaint is lodged agrees to the jurisdiction of the Ombud.[357] The *FAIS*-ombud will also not investigate a claim if the complainant instituted legal action in a court of law prior to or during the investigation of a complaint.[358] It is uncertain why the complaint of the *PFC Foods*-case was brought before a court of law as the monetary value of the claim falls well within the ambit of the *FAIS*-Ombud. It would have been less expensive to lodge the complaint with the *FAIS*-Ombud and have the Ombud hear the matter.

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352 Rule 4(a)(i) of the *FAIS*-Ombud Rules.

353 Rule 4(a)(ii) of the *FAIS*-Ombud Rules.

354 Rule 4(a)(iii) of the *FAIS*-Ombud Rules.

355 Rule 4(a)(iv) of the *FAIS*-Ombud Rules and Millard *The FAIS Act explained* 185.

356 FAIS Ombud Office of the Ombud of Financial Service Providers date unknown https://faisombud.co.za/how-to-complain/pre-requisites/ and Millard *The FAIS Act explained* 184.

357 Rule 4(c) of the *FAIS*-Ombud Rules and FAIS Ombud Office of the Ombud of Financial Service Providers date unknown https://faisombud.co.za/how-to-complain/pre-requisites/ and Millard *The FAIS Act explained* 185.

358 Rule 11(a) of the *FAIS*-Ombud Rules and FAIS Ombud Office of the Ombud of Financial Service Providers date unknown https://faisombud.co.za/how-to-complain/pre-requisites/.

A client of an FSP must be treated fairly by the functionary and with due skill, care, and diligence.[359] To ensure that FSP's and their representatives are informed of what fair conduct entails, chapter 4 of the *FAIS*-act requires the registrar to draft a Code of Conduct for FSP's.[360] The Code of Conduct must be drafted in such a way that it enables clients to make an informed decision about their finances and for that reason, FSP's and their representatives must:

> act honestly and fairly, and with due skill, care and diligence, in the interests of clients and the integrity of the financial services industry;[361]

This research now continues by discussing the *General Code of Conduct*.

5.3 The General Code of Conduct

The *General Code of Conduct* sets out the general and specific duties of FSP's. Under the *General Code of Conduct*, when reference is made to a provider, this means an FSP as well as a representative thereof.[362] The *General Code of Conduct* echoes the *FAIS*-act and places a duty on FSP's to render a service "honestly, fairly, [and] with due skill, care and diligence". The service must also be in the interest of the client and the reputation for the integrity of the financial services industry.[363] The Court also held in *Lappeman Diamond Cutting Works (Pty) Ltd v MIB Group (Pty) Ltd*[364] that when an financial advisor furnishes advice to a client the same degree of skill and care of another member of the profession with the same rank as the advising representative is expected.[365]

Not all of the specific duties of an FSP set out in regulation 3 of the *General Code of Conduct* are of relevance to this research. When a financial advisor provides information to a client, the information must be in plain language which avoids uncertainty or confusion in order to not be misleading.[366] Regulation 7(1)(a) of the *General Code of Conduct* places an obligation on a financial advisor to provide a

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359 Millard *The FAIS Act explained* 120.
360 S 15(1)(a) of the *FAIS*-act.
361 S 16(1)(a) of the *FAIS*-act.
362 Reg 1 in GN 80a of GG 25299 of 3 August 2003.
363 Reg 2 in GN 80a of GG 25299 of 3 August 2003 and s 16(1)(a) fo the *FAIS*-act.
364 2003 4 ALL SA 337 (SCA) par 37.
365 Also see *Durr v ABSA Bank LTD* 1997 3 All SA 1 (A) 460F-464E.
366 Reg 3(a)(ii) in GN 80a of GG 25299 of 3 August 2003.

reasonable and general explanation of a financial product and the material terms contained therein in order to enable a client to make an informed decision. Regulation 7(1)(c) explicitly requires a financial advisor to furnish information regarding special terms contained in a contract by stating that an advisor must give:

> concise details of any special terms or conditions, exclusions of liability, waiting periods, loadings, penalties, excesses, restrictions or circumstances in which benefits will not be provided;

Regulation 7(1)(c)(xiii) requires that representations made to a client must be full and appropriate information relating to risks associated with the product must be provided.

In terms of regulation 8(1)(a) of the *General Code of Conduct,* a financial advisor must also seek information regarding his/her client's experience with financial products. This will enable the advisor to furnish appropriate advice and will inform the advisor as to how much detail s/he should present in relation to the client's experience with financial products. A financial advisor must also take reasonable steps to ensure that his/her client understands the product and can make an informed decision.[367] Regulation 9 of the *General Code of Conduct* also requires an advisor to record all advice given to a client.

In the case of *Botha v R & S Walsh Investment Consultants CC and Others*[368] (the *Botha*-case) a financial advisor was held liable for the damages of his clients. He had advised his clients to invest in a high-risk investment portfolio, whilst their risk profile was in accordance with that of a moderate risk investor. The Ombud held that the financial advisor had not acted in accordance with section 2 of the *General Code of Conduct* by not exercising the necessary skill, care and diligence when advising his client, or he would have advised the client to invest in a moderate risk portfolio. The Ombud held both the advisor and the insurer liable for each of the complainants' damages (R102 148.54 per complainant).

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367 Reg 8(2) in GN 80b of GG 25299 of 3 August 2003.

368 FAIS 06019/08-09/EC1.

Further, the *General Code of Conduct* requires an FSP to have an internal complaint resolution system,[369] whereby a client that wants to lodge a complaint may be requested to lodge the complaint in writing.[370] The FSP must investigate the complaint and respond thereto, and if the problem is not resolved to the satisfaction of the client, the FSP must advise the client as to further steps that may be taken.[371]

As mentioned previously, in Mr. X's case (see 3.1 above) the financial advisor did not act with the proper skill, care and diligence that is expected of him, not only by the *FIAS*-act, but also by regulation 2 of the *General Code of Conduct* under specific requirements. His conduct was not in the interest of his client and did not promote the integrity of his FSP. Another professional with the same expertise as Mr. X's financial advisor would have known that Mr. X's insurance contract contained an average clause, brought it to the attention of their client,[372] and given the client advice thereon. The advisor should have generally explained the insurance contract and the material terms contained therein with specific reference to terms relating to penalties and circumstances in which a benefit would not be provided. This constitute taking a reasonable step to ensure that his client could make an informed decision. Mr. X's financial advisor should have enquired about his experience with financial products in order to know whether he was aware of what an average clause means and the workings thereof. He was supposed to inform Mr. X that ABC Insurers could not be held liable if the average clause found application.[373] All the advice provided to Mr. X by his financial advisor should also have been recorded in terms of regulation 9 of the *General Code of Conduct.*

The advice given by Mr. X's financial advisor was inadequate and inappropriate in terms of what is required under the specific duties of an FSP in regulation 3(a)(ii) of the *General Code of Conduct*. By not informing Mr. X that the insurance policy contained an average clause, he misled Mr. X regarding the payment of damages by ABC Insurers. When the *General Code of Conduct* is read together with the *FAIS*-

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369 Reg 17 in GN 80b of GG 25299 of 3 August 2003.
370 Reg 16(2)(a) in GN 80b 0f GG 25299 of 3 August 2003.
371 Reg 16(2)(d-e) in GN 80b of GG 25299 of 3 August 2003.
372 Which is required by reg 7(1)(a) and 7(1)(c) of the *General Code of Conduct*.
373 Reg 7(1)(c) of the *General Code of Conduct* requires an financial advisor to also inform a client of instances where liability will be excluded.

act, Mr. X must first lodge a complaint with his financial advisor's internal complaint resolution system[374] before he may lodge a complaint with the *FAIS*-ombud. Only if the complaint was not resolved by the financial advisor's internal complaint resolution system to Mr. X's satisfaction may he take further steps such as lodging a complaint with the *FAIS*-ombud.[375]

Apart from the *FAIS*-act and the *General Code of Conduct,* there are further outcomes that regulate the conduct of service providers in the financial sector. These outcomes are embodied in the *TCF*-principles. The *TCF*-principles not only regulate the conduct of a financial service provider but the whole process of concluding a financial contract.[376] Financial firms must ensure that they comply with the *TCF*-principles during all stages of a product's life cycle, which includes the design of the product or service, marketing and promoting, the furnishing of advice, the point of sale, information furnished after the product was sold, and the handling of complaints and claims.[377] This makes room for self-regulation on the part of financial firms to ensure that they comply with the *TCF*-principles.[378]

This research now discusses the *TCF*-principles.

5.4 The TCF *-principles*

There are more outcomes, aside from those set out in the *FAIS*-act and the *General Code of Conduct*, that an FSP has to comply with. These are set out in the *TCF*-principles. The *TCF*-principles are applicable to all firms that provide a financial service, whether they interact directly or indirectly with a customer and whether or not they are involved in all stages of a product life-cycle.[379] Most of these outcomes have already been included in legislation.[380] According to Georgosoli there's nothing

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374 Reg 16(2)(a) and 17 in GN 80b of GG 25299 of 3 August 2003

375 Reg 16(2)(e) in GN 80b of GG 25299 of 3 August 2003.

376 Masthead date unknown https://www.masthead.co.za/treating-customers-fairly/ and Millard and Maholo 2016 *THRHR* 595.

377 Millard and Maholo 2016 *THRHR* 597.

378 Millard and Maholo 2016 *THRHR* 597 and Maholo *Treating Consumers Fairly: A new name for existing principles* 16.

379 Maholo *Treating Consumers Fairly: A new name for existing principles* 11.

380 The Banking Association South Africa date unknown http://www.banking.org.za/consumer-information/legislation/treating-customers-fairly and Millard and Maholo 2016 *THRHR* 595, 596.

new about an FSP's obligation to treat his/her clients fairly.[381] The *TCF*-principles embody a principles-based approach[382] that seeks to regulate and supervise the conduct of FSP's and aim to ensure that financial service customers are treated fairly.[383] Some of the benefits of the *TCF*-principles are that they are easier to comply with and more likely to produce behaviour compatible with the regulatory objectives, because they are more flexible.[384] The *TCF*-principles contain six outcomes that FSP's need to deliver, namely: [385]

- Customers can be confident they are dealing with firms where TCF is central to the corporate culture.[386]
- Products and services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly.[387]
- Customers are provided with clear information and kept appropriately informed before, during and after a point of sale.[388]
- Where advice is given, it is suitable and takes account of customer circumstances.[389]
- Products perform as firms have led customers to expect, and service is of an acceptable standard and as they have been led to expect.[390]
- Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint.[391]

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381 Georgosoli *The FSA's Treating Customers Fairly (TCF) Initiative: What is So Good about It and Why It May Not Work* 2011 The Author Journal of Law Society 408.

382 Millard and Maholo 2016 *THRHR* 596 and Maholo *Treating Consumers Fairly: A new name for existing principles* 9.

383 The Banking Association South Africa date unknown http://www.banking.org.za/consumer-information/legislation/treating-customers-fairly and Millard 2014 *THRHR* 548.

384 Millard and Maholo 2016 *THRHR* 596-197 Maholo *Treating Consumers Fairly: A new name for existing principles* 9.

385 Millard 2014 *THRHR* 549 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10 and Millard 2016 *PELJ* 7.

386 Millard and Maholo 2016 *THRHR* 599 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 16.

387 Millard and Maholo 2016 *THRHR* 601 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 20.

388 Millard and Maholo 2016 *THRHR* 603 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 23.

389 Millard and Maholo 2016 *THRHR* 606 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 27.

390 Millard and Maholo 2016 *THRHR* 608 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 30.

391 Millard and Maholo 2016 *THRHR* 610 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 33.

If financial advisors make the first principle fully part of their firm's culture, the other five outcomes will automatically follow.[392] This leaves room for service providers to evaluate themselves on how effectively they comply with the *TCF*-principles. The second principle ensures that products make provision for the specific needs of the market for which they are created, thus catering for a client's specific needs.[393] In most instances a client is not properly equipped to fully comprehend the nature of a financial instrument.[394] The third *TCF*-principle makes provision for this situation by ensuring that a client receives proper advice prior to, during and after the conclusion of a financial contract. The fourth principle is closely related to the second and third *TCF*-principle, because if a client is supplied with correct and sufficient advice s/he will be able to make an informed decision.[395] In order to comply with the fifth *TCF*-principle a provider must discuss the specific characteristics of a financial product with the client as well as the results and experiences s/he is likely to experience after the financial product is obtained.[396] The last principle is quite simple: a provider must ensure that clients can lodge a claim or complaint with ease, and must advise them on the process to follow and steps to be taken in order to change products.[397]

In Mr. X's case, his financial advisor did not comply with the third and fourth *TCF*-principles. He did not inform Mr. X properly before the conclusion of the contract, nor did he take Mr. X's circumstances into account, otherwise he would have explained to him the average clause contained in his insurance policy.

The *TCF*-principles recognise a contract as a process and lay down measures for the evaluation of the whole process of contracting.[398] These principles have

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392 Millard 2014 *THRHR* 549 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10.

393 Millard and Maholo 2016 *THRHR* 601 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 20.

394 Millard and Maholo 2016 *THRHR* 603 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 23.

395 Millard and Maholo 2016 *THRHR* 606 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 27.

396 Millard and Maholo 2016 *THRHR* 608 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 30.

397 Millard and Maholo 2016 *THRHR* 610 and Maholo *Treating Consumers Fairly: A new name for existing principles* 10, 33.

398 Millard 2014 *THRHR* 566.

no specific date set out for their implementation. They will start to appear more often in legislation and form a core part of investigations by the Financial Services Board.[399] When the new *PPR's* were published, the *TCF*-principles were formally introduced into legislation.

This research now discusses the implications of the new *PPR's* for financial advisors.

5.5 The PPR's

The new *PPR's* were published in the *Government Gazette* of 15 December 2017.[400] The spirit of these rules lies in that they attempt to ensure the fair treatment of consumers, because of their close relation to the *TCF*-principles.[401] One of the main aims of the *PPR's* is to ensure that long- and short-term insurance contracts are entered into, executed and enforced in accordance with the insurance principles and practices in the interest of the parties and the public.[402] Not all the changes brought about by the new *PPR's* are of relevance to this research, therefore only some of the rules will be discussed.

In terms of rule 1, the onus is placed on the financial advisor to act with the necessary skill, care, and diligence when dealing with policyholders.[403] This correlates with regulation 1 of the *General Code of* Conduct, which places the same onus on a financial advisor. When the new *PPR's* were published, the *TCF*-principles were contained in legislation.[404] The six *TCF*-principles are specifically contained in rule 1.4 (a)-(f) of the *PPR's*.[405]

Rule 11 refers to the disclosure of information. The information communicated in regards to a product must be in plain language and not misleading. It must also be

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399 Gilmour 2014 *Personal Finance Newsletter* 14.

400 Joffe date unknown http://www.fia.org.za/media/1064/1-changes-to-the-policy-holder-rules-danny-joffe-v5-pptx.pdf.

401 Kritzinger 2018 https://www.fanews.co.za/article/company-news-results/1/old-mutual/1049/the-new-policyholder-protection-rules-a-group-insurer-s-perspective/23739.

402 Millard 2014 *THRHR* 555.

403 Rule 1.2 in GN 1433 of GG 1433 of 15 December 2017.

404 Millard 2018 *THRHR* 383.

405 Joffe date unknown http://www.fia.org.za/media/1064/1-changes-to-the-policy-holder-rules-danny-joffe-v5-pptx.pdf.

communicated via an understandable medium etc.[406] When determining the level of information that needs to be disclosed, it is also important to consider the knowledge and experience of the client as well as the terms and conditions of the policy relating to its main benefits, exclusions, limitations, etc.[407] An insurer must also take particular care in the explanation of complex terms that a client cannot reasonably be expected to understand.[408] Further, rule 11.4.1 stipulates that a client must be informed of the concise details of any exclusions or limitations contained in the policy. Rule 18.2 also places an obligation on the insurer to have a system in place to deal with complaints as well as to contact the appropriate Ombud, should this be necessary.[409]

Following the judgment in the *Barkhuizen*-case, the legislature intervened and introduced rule 7(4) of the *Policyholder Protection Rules*.[410] Rule 7(4) is contained in rule 17.6.8(b) of the new *PPR's.* This rule states that any time limitation provisions for the institution of legal action may not provide for a period of fewer than 6 months after the expiry of the period mentioned in rule 17.6.3(b). The last-mentioned section states that if an insurer repudiates a claim, notice thereof must be given to the insured, informing him/her that s/he may make representations to the insurer within a period of no less than 90 days after receipt of the notice. This provides that no insurance policy entered into after 1 January 2010 may make provision for a period of fewer than 90 days within which an insured may make representations to the insurer, and it may not make provision for a period of less than six months for the institution of legal action.[411]

From this discussion of the *PPR's,* it is also clear that Mr. X's financial advisor[412] was negligent in his conduct. He did not take Mr. X's experience with insurance products into account when he advised him. If he had, he would have known that Mr. X might not be aware of the existence of an average clause and what it entails. He should have taken time to explain this complicated term, which is a limitation term

406 Rule 11.3.1 in GN 1433 of GG 1433 of 15 December 2015.
407 Rule 11.3.4 (a)-(b) in GN 1433 of GG 1433 of 15 December 2019.
408 Rule 11.3.5 in GN 1433 of GG 1433 of 15 December 2019.
409 Rule 18.10 in GN 1433 of GG 1433 of 15 December 2019.
410 Millard 2016 *De Jure* 164.
411 Millard 2016 *De Jure* 164.
412 See par 3.1.

according to rule 11.3.4 and 11.4.1 of the *PPR's*. Mr. X will be able to lodge a complaint against the financial advisor through his internal complaint resolution system, which he must have in place in terms of rule 18.2 of the *PPR's,* and if no resolution can be found, his financial advisor must inform him of further steps he may take.

The last relevant legislative measure that needs to be discussed in this Chapter is the *Cofi*-bill. Only a brief discussion on the aim of the *Cofi*-bill and the goal thereof suffices as the bill has not been promulgated yet.

5.6 The COFI*-bill*

On 11 December 2018 the National Treasury published the *COFI*-bill together with an explanatory policy paper.[413] The *COFI*-bill, like the legislation previously discussed in this Chapter,[414] intends to regulate the treatment of consumers in the financial market.[415] In the light of the Twin Peaks reform process that is underway in South Africa,[416] two new financial sector regulators were formed, namely the Prudent Authority and the FSCA.[417] The *COFI*-bill is the next phase in the legislative reform.[418] This bill outlines what consumers in the financial industry can expect from financial institutions.[419] The *COFI*-bill will eventually replace conduct provisions in the existing

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413 Masthead 2019 https://www.masthead.co.za/newsletter/draft-conduct-of-financial-institutions-cofi-bill-published/.

414 Under paras 5.2-5.5.

415 S 3 of the *Cofi*-bill and Geldenhuys 2019 https://www.moonstone.co.za/cofi-bill-aims-to-strengthen-regulation-customer-treatment-and-general-market-conduct/ and Masthead 2019 https://www.masthead.co.za/newsletter/draft-conduct-of-financial-institutions-cofi-bill-published/.

416 Millard 2018 *THRHR 275.* On 21 August 2017 the *Financial Sector Regulation Act,* which is also known as the Twin Peaks Act, was signed into legislation. This Act creates a prudential regulator, the Prudential Authority, while the Financial Services Board will be transformed into a dedicated market conduct regulator known as the Financial Sector Conduct Authority. Hence the name Twin Peaks. Millard 2016 *PELJ* 3. The prudential Authority will be responsible to ensure the safety and soundness of financial institutions that provide financial services while the Financial Sector Conduct Authority will ensure fair treatment, integrity and education and also supervise the performance of financial services.

417 Geldenhuys 2019 https://www.moonstone.co.za/cofi-bill-aims-to-strengthen-regulation-customer-treatment-and-general-market-conduct/.

418 Millard 2018 *THRHR* 390 and Geldenhuys 2019 https://www.moonstone.co.za/cofi-bill-aims-to-strengthen-regulation-customer-treatment-and-general-market-conduct/ and on p 8 of the *Cofi*-bill pdf-document.

419 Geldenhuys 2019 https://www.moonstone.co.za/cofi-bill-aims-to-strengthen-regulation-customer-treatment-and-general-market-conduct/ and Masthead 2019

financial sector laws and in doing so streamline the legal framework for the regulation of the conduct of financial institutions.[420]

In terms of section 4(2) of the *COFI*-bill, the act will be applicable to supervised entities and in some instances supervised entities that are not financial institutions. A financial institution must always conduct its business with integrity, honesty and fairly, with due skill, care and diligence as well as in such a way that it prioritises the fair treatment of customers.[421] When these sections of the *COFI*-bill are applied to Mr. X's financial advisor, he may also be held liable for Mr. X's damages due to his own negligence. When the whole discussion of this Chapter is taken into account, it becomes clear that Mr. X's financial advisor was negligent in his conduct and he can be held liable, by a court, for the R250 000 that Mr. X was not able to recover from ABC Insurers.

5.7 Conclusion

The conduct of FSP's and their representatives are finely regulated by various legislative measures contained in the *FAIS*-framework, and the *TCF*-principles. All of these measures aim to ensure the fair treatment of clients of financial institutions by regulation the standard of the conduct of FSP's and their representatives. The *COFI*-bill will, once it is promulgated, replace the whole *FAIS*-framework as well as the *TCF*-principles, and in doing so streamline the legal framework that regulates the conduct of the financial sector.

The next Chapter summarises this research as a whole.

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https://www.masthead.co.za/newsletter/draft-conduct-of-financial-institutions-cofi-bill-published/ and the *Cofie*-bill explanatory policy paper downloadable from https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=2ahUKEwiPnZ6GwMvlAhWaiVwKHYL5ATsQFjAAegQIBBAC&url=http%3A%2F%2Fwww.treasury.gov.za%2Ftwinpeaks%2FCoFI%2520Bill%2520policy%2520paper.pdf&usg=AOvVaw0VT0Y78vgkXRsCsd8KY0wQ.

420 On p 4 of the *Cofi*-bill explanatory policy paper pdf-document and Millard 2018 *THRHR* 390 and Hesse 2019 https://www.iol.co.za/personal-finance/what-is-the-conduct-of-financial-institutions-bill-23720605.

421 S 30(1) and 30(2)(a-b) of the *Cofi*-bill.

Chapter 6

6 Conclusion

The general aim of this research was to establish what the effect of the average clause is in instances where the insured is underinsured. In order to establish this, a study was made of the origin of the modern-day insurance contract and the development that has taken place to the point where the average clause finds application in insurance contracts today. The consequences of the average clause in instances where it finds application were explained in Chapter 3, and a study was made of different average clauses from various insurance policies.[422] This research also aimed to ascertain whether contractual freedom has an influence on the application of the average clause, as well as whether the *FAIS*-framework and the *TCF*-principles influence the conduct of a financial advisor.

The average clause is a standard form contractual term that occurs in modern-day indemnity insurance contracts, and more specifically profit insurance contracts. From the discussion in Chapter 2, paragraph 2.4, it is clear that the average clause found in profit insurance contracts are inserted in order to incorporate the principle of average found in marine insurance, where average is automatically applicable. When an insured incurs damage to an object of risk which was underinsured, the average clause enables an insurer to avoid liability for the full amount of the damage. He will be liable for payment of only a proportion of the damage, while the insured will be deemed his own insurer for the proportion in relation to which he was under-insured.[423]

The rationale behind the average clause[424] cannot be unconstitutional in terms of the first question of the double-barreled test laid down in the *Barkhuizen*-case. The clause in itself is not invalid as the rationale behind the average clause is fair in that it offers protection to insurers in instances that could be detrimental to their businesses had it not been included in their insurance policies. Public policy would,

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422 Under par 3.4.

423 See par 3.3.

424 See par 3.3. To discourage under-insurance and encourage an insured to stay fully insured and enable insurers to earn a higher premium.

however, be more in favour of an average clause in instances where an insurance policy contains a secondary average clause as well, as this enables the policy to be more in favour of the mutual interests of both parties.

The problem arises with the second question of the double-barreled test, as to whether it would be fair to apply the average clause in the circumstances surrounding the average clause. As an insurance contract is a standard form contract, as discussed in Chapter 4 under paragraph 4.4, and the average clause is a standard clause in insurance contracts,[425] a financial advisor must exercise much more care when advising a client. In most instances an insured will have no freedom to exclude an average clause from an insurance policy, which could be to the detriment of the insured. Only in instances where a financial advisor brought the average clause contained in an insurance policy to the attention of the insured and the insured fully comprehended the consequences of the application thereof would it be fair to apply the average clause in terms of the second question of the double-barreled test laid down in the *Barkhuizen*-case. If a financial advisor did not exercise the required skill by properly informing his client of an average clause contained in an insurance policy and the consequences thereof, the advisor may be held liable for the proportion of the damages his client was unable to recover from his/her insurer in terms of the *FAIS*-framework and the *TCF*-principles.

An average clause is a clause inserted into an insurance contract to motivate an insured to stay fully insured for the true value of an object of risk and protect an insurer from being fully liable in instances where an insured is under-insured. To ensure that the mutual interests of both parties to an insurance contract is protected, an insurance contract ought to contain both a primary and a secondary average clause.

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425 This is clear from the discussion under par 3.4.2. The issue also discussed under par 4.5.

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TO WHOM IT MAY CONCERN

19 November, 2019

I hereby certify that I have edited the language of a dissertation by AC van Aardt titled "Under-insurance and the effect of the average clause on insurance contracts."

I am Professor Alan Brimer, DLitt (UPE), Professor Emeritus of UKZN.

Yours faithfully,

Alan Brimer