

**VICTIMS OF CIRCUMSTANCE: ASSURED AND INSURED IN MARINE AND ENERGY
CLAIMS**

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Where specific reference is made to the law it is to English law as at 5 July 2011.

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Victims of Circumstance: Assured and Insurers in Marine and Energy Claims

Unexpected events or unexpected consequences of events routinely produce victims. In terms of Insurance either the insurer or the insured may get a rough deal.

With regard to insurer's business concerns, there are two different issues which are relevant: (1) Inherent vice; which goes direct to policy liability, and (2) Force Majeure and Frustration which, particularly this year, are likely to have an impact on claim levels. While from the insured's perspective there are three relevant issues: (1) whether business interruption coverage will be triggered where there is widespread damage, not just localised property damage as required under the policy, (2) misunderstandings during policy negotiation, and (3) whether seizure of a vessel by pirates constitutes a total loss under the Marine Insurance Act 1906.

Inherent Vice:

Inherent vice represents a principal exclusion in policies on material property but it is a topic which is surrounded by a surprising amount of uncertainty as to what precisely it means. In 2009 the opportunity arose in the case of the "*Cendor Mopu*"¹ to confirm the understanding that seemed to prevail at the time. In fact, however, it turned out that the insurers and the insured in that particular matter interpreted the same apparent understanding of what inherent vice meant in two entirely divergent ways.

The Cendor Mopu was a second hand jack up oil rig intended for service in an oil field off the Malaysian Coast. It consisted of a platform with 3 legs which could be jacked up or down according to the depth of water the rig was working in. The legs were substantial structures. Each consisted of a steel tube 12ft in diameter, over 300ft in length and each weighing 400 tonnes. The whole structure was to be transported from Texas, across the Atlantic, to a half-way point in South Africa and then on across the Indian Ocean to Malaysia.

The owners of the rig obtained cover under an insurance policy incorporating the Institute Cargo clauses A – an all risks policy wording which expressly excluded loss caused by inherent vice. The rig was then prepared for her tow across two oceans and round the Cape of Good Hope.

The assured, sensibly, commissioned a report into the best way to transport the rig given that its legs might be sticking 300ft into the air. The expert engaged advised that stress limits within the legs would be exceeded with a 20 degree roll with a period of ten seconds. Given the tow route, the expert said, and the known weather conditions around the Cape of Good Hope, it was highly probable that these criteria would be met.

Various ideas for the best means of moving the rig were discussed but in the end it was decided to tow the rig just as it was and the rig set off on its journey at the end of July. After a relatively uneventful voyage across the Atlantic the rig reached the Western Coast of South Africa. Before attempting the passage around the Cape the assured had further tests carried out. These tests showed that all three legs had suffered fatigue cracking. The subsequent conclusion was that the legs were close to failure. After undertaking repairs which were intended to alleviate the fatigue cracking

¹ *Global Process Systems Inc and another v Syarikat Takaful Malaysia Berhad, The Cendor MOPU* [2011] UKSC 5

problem the rig set off on the second stage of her journey which now involved the rougher sea conditions around the Cape. A week later all three legs broke off.

The assured made a claim for the loss of the legs. They said, correctly enough, that under an All Risks policy they did not have to identify the precise cause of the loss but they said that the loss was clearly the result of a peril of the sea, in other words the weather conditions. The insurers, having had the benefit of expert advice, responded that the cause of the loss was inherent vice. The insurer's response was perhaps not surprising. As Judge Blair subsequently put it, the expert advice, before the fateful voyage had even begun "correctly predicted what would happen, where it would happen, and why it would happen". The insurers therefore took the view that no fortuity was involved; the loss, and its cause, was exactly as anticipated.

On the face of it the dispute between the insurers and the insured was a fairly straightforward factual issue, but, as it transpired, the parties became embroiled in arguments over what was, in law, a peril of the sea, and what was, in law, inherent vice. The understanding of what those two terms meant, an understanding that had prevailed for about 25 years, came under challenge. Inevitably, in this particular case, the issues of peril of the sea and inherent vice were interlinked.

Both parties accepted the definition of inherent vice provided by Lord Diplock in the 1985 case of *Soya GmbH v White*². In that case Lord Diplock had said that inherent vice meant:

"The risk of deterioration of the goods as a result of their natural behaviour in the ordinary course of the contemplated voyage without the intervention of any fortuitous external accident or casualty".

But having agreed that this was a correct definition of inherent vice, the parties fell-out over what they considered Lord Diplock meant by those words. They were in agreement over the first part of the definition, but they disagreed over the second part – how did one recognise a fortuitous external accident?

The insurers said that the meaning of Lord Diplock's words, was that, to be fortuitous, the sea conditions that had been experienced had to be something in excess of the wind and waves that might be expected during the ordinary course of a voyage.

The assured, however, said that a simple peril of the sea was sufficient to amount to a fortuitous external accident. A peril of the sea did not involve any assessment of how bad the weather might have been, or not been. It was enough that it was the action of the sea; however ordinary the sea state might be that was the cause of the failure. The assured argued that only if damage to the insured property was absolutely inevitable would the all risks cover not be called upon to pay.

That argument swung back and forth at successive levels of judicial assessment before the matter came before the Supreme Court. The Supreme Court decided that the insured were right. The Court said that the insurers approach equated the inherent vice argument to one of unseaworthiness. In other words that the insured property suffered damage as a result of inherent vice in circumstances where the insured property was not fit to withstand the kind of weather that might be expected. The Court said that the problem with that approach was that it did not sit well with the provision in

² *Soya GmbH Mainz Kommanditgesellschaft v White* [1982] 1 Lloyd's Rep 136

Section 40 of the Marine Insurance Act that in a policy on goods or other movables there is no implied warranty that the goods or movables are seaworthy.

The Supreme Court summed up the issue by saying that “virtually all goods are susceptible to loss or damage from the fortuities of the weather on voyage; this does not mean that such loss or damage arises from the nature of the goods; it arises from the fact that the goods have encountered one of the perils of the seas”.

So, the court said “The sole question...is whether the loss or damage is proximately caused, at least in part, by.....any fortuitous external accident or casualty. If that question is answered in the affirmative it follows that there was no inherent vice.

Coupled with the factual findings of Mr Justice Blair in the Court at first instance that the failure of the legs of the rig as it was towed around the Cape was very probable, but not inevitable, that meant, the Supreme Court said, that the insurers could not rely on their defence of inherent vice, because a fortuitous external casualty had occurred; never mind that it had been predicted.

It had been conceded during the course of the trial that if it had been the case that the legs were absolutely bound to have fallen off due to their inherent weakness in face of this kind of transportation, the insurers would not have had to pay even if, as a question of fact the actual breakage and loss was by a peril of the sea. The doctrine of concurrent causes would then come into effect on the insurer’s side. And this rig came very close indeed to that situation. It was only the fact that there remained a slim chance that the legs might not fall off that rendered the insurers liable to pay.

The practical difficulty for insurers in this kind of situation is that the decision places upon them a very high burden of proof, and a difficult one to meet. It is hard to see how, in most cases, insurers will be able to prove that, disregarding sea and weather conditions entirely, goods being transported by sea were inevitably going to suffer damage.

As a result of this decision the inherent vice defence has undoubtedly suffered a serious reduction in its practical availability to insurers.

The insurers in this particular case suffered one final Parthian shot by the Court. The quantum of the assured’s claim for loss of the three supporting legs had been admitted by insurers prior to the trial. In the very last paragraph of the Supreme Court judgement the Court made the observation that:

“...the assured would not have been entitled to recover in respect of the cost of repairing every fatigue crack (that was the damage that had occurred on the first part of the voyage) but only in respect of the loss of the legs.... It is a reasonable inference that some cracking was bound to occur (and so the cracking was a consequence of inherent vice). This point is not however relevant to the issues between the parties if, as the judge noted, quantum is not in dispute”

The point for insurers to keep in mind is that if they take the view that some damage was suffered by the insured property as a matter of inevitability this may not assist them with an inherent vice defence, but it might affect the quantum of the claim.

Force Majeure and Frustration:

The issues of force majeure and frustration are relevant to some of the extended All Risk business interruption policies particularly the non-owned property business Interruption policies, and the marine transit business interruption policies that are available in the London market: they are equally relevant to supply chain liability policies, and they are certain to achieve some prominence during the course of the current claims year in view of events that have occurred over the past six months, notably the floods in Queensland which have caused massive disruption to coal exports, the earthquake and tsunami in Japan which have cut levels of import business into Japan, and civil unrest in North Africa and the Middle East.

The consequences of these three entirely separate catastrophes and war like situations in Australia, Japan, North Africa and the Middle East is that suppliers are going to fail to meet delivery obligations to their buyers. Buyers are going to fail to receive essential materials and components. Both in terms of exposure to liabilities and in terms of direct losses the insureds are going to be looking to their insurers to indemnify.

The circumstances in which these various losses will arise are instances of true fortuity – the policies will mostly be expected to respond. Before underwriters reach for their cheque books however, they ought to give some thought to the liability of their insured for these losses and in some cases should be looking to subrogation issues in so far as potential recoveries are concerned.

The underwriters need to satisfy themselves that their insured are actually liable under their supply contracts when a liability issue is involved. Or, if the insured themselves have suffered loss in consequence of the inability of a supplier to provide essential materials, the underwriters should be looking at the potential for seeking indemnity under rights of subrogation. Insurers ought to have in mind issues of Force Majeure and of frustration, because these may have a major impact on the claims presented.

Force Majeure (a concept of French law) is a contractual creation under which the parties agree and permit failure of performance under certain circumstances. The Courts will not imply a force majeure clause so it must be expressly included in the Contract. These clauses deal with events beyond the parties' control. Usually the claims identify acts of god, strikes, flooding, interruption of services (e.g. electricity) and perhaps curiously, royal demise. They are an effort by the parties to allocate risk and do not apply to events that are within the control of the parties – such as insufficient finance or failure by a third party to fulfil a contract.

Force Majeure clauses are subject to specific requirements in order to be effective.

No party will have a right to rely on “force majeure” to excuse performance of a contractual obligation unless first there is a clause in the contract that clearly covers the particular situation that has occurred or there is wording that excuses performance where any other unspecified events outside that party's control occur; second there is a causative link between the events that have occurred and the party's inability to perform its obligations; and third the notification procedure specified in the clause is followed. If all three requirements are satisfied then the party claiming force majeure is entitled to claim the protection of the clause and that may require the performing party still to perform – but at a later date, or in a different way, or may excuse him from non-performance altogether.

For those who don't have a force majeure clause in their contract, it may be possible to rely on the common law Doctrine of Frustration.

The Doctrine of Frustration applies where an unforeseen event intervenes. So a contract may be discharged by frustration where an extraneous event occurs after the contract is agreed, which is not caused by the fault of one of the parties and is not catered for in the contract and where the event so fundamentally changes the nature (not merely the cost or difficulty) of performing the contract that it would be unjust to require continued performance.

If the party claiming frustration can bring himself within the factual circumstances demanded by law then the contract may be discharged and he will then be excused from his performance obligations. Claims for non-performance can then legitimately be declined.

It is much harder for a performing party to invoke the common law doctrine of frustration than to seek protection of a force majeure clause in his contract (if he has one). Many circumstances may operate to make a contract more difficult or more expensive to perform. No matter. Only if it is impossible to perform the particular contractual obligations will the Courts sanction a defence of frustration.

Business Interruption

The 2010 decision in *Orient Express Hotels v. Generali*³, left the insured without coverage despite the fact that, in any other circumstance, their business interruption loss would have been covered.

Orient Express owned a hotel in New-Orleans, which was damaged during Hurricanes Katrina and Rita in the autumn of 2005. As a result of the more widespread hurricane damage in the surrounding area, a curfew was imposed by authorities on August 27th, followed by the mandatory evacuation of the whole area on August 28th. Meanwhile, the hotel was closed for the whole of September and October to repair the damage it had sustained – finally reopening on November 1st.

Orient filed a claim under its combined property damage and business interruption policy, which indemnified them against loss due to interruption of business arising as a direct-result of damage to the hotel.

The business interruption section of the policy provided that:

“If any property owned by the insured, for the purpose of the business, suffers damage as defined and the business be in consequence thereof interrupted, insurers will pay to the insured the amount of loss resulting from such interruption.”

The policy also contained a trends clause, which provided for adjustments to be made....

³ *Orient-Express Hotels Limited v Assicurazioni Generali Spa (UK)* [2010] EWHC 1186 (Comm)

“to provide for the trend of the business and for variations in or special circumstances affecting the business, so that the figures thus adjusted shall represent as nearly as may be reasonably practicable the results which, but for the damage, would have been obtained”.

Generali responded, that there was no insured interruption because the widespread damage, curfew and evacuation, meant the hotel wouldn't have received visitors anyway.

At arbitration, the key issue for the Panel, was how the policy should respond to the situation, where both damage to the hotel and damage to the wider area were causes of the business interruption loss.

Generali successfully argued, that in accordance with the terms of the policy, Orient could only recover in respect of loss, which it could show would not have arisen “but for” the damage to the hotel and since the damage to the city was a concurrent and major causal factor there could be no indemnity under the business interruption section of the policy.

On Appeal to the High Court, Orient argued that the policy should respond to the situation where both damage to the hotel and damage to the surrounding area were causes of the business interruption loss. Orient relied on a settled principle of English insurance law, that where there are two concurrent proximate causes of a loss, one of which is an insured peril and the other not expressly excluded, then the insured can recover.

Although courts have recognised this principle in cases where the two proximate causes operate inter-dependently, the court in this instance refused to extend it to cover a situation where the concurrent causes were in-dependent.

The High Court deliberated over whether or not the “But for” test was the appropriate mechanism for deciding causation, where there were two concurrent and in-dependent causes. Despite the fact that the court appeared to have some sympathy with Orient's argument, it ruled that the policy wording clearly anticipated a “but for” causation test, and therefore, Orient's claim failed, since it could not be said that “but for” the damage to the hotel, there would have been no business interruption loss.

The court also gave thought to the Trends Clause. Orient argued that the clause should not be construed so as to permit an adjustment for the widespread damage. Once again however, the court gave the terms of the clause their literal meaning, pointing out that there was nothing in the clause to restrict it to circumstances which were entirely independent of the hurricanes. It was noted that the clause was only concerned with indemnifying losses caused by damage to the hotel and that the same events which caused that damage were capable of being “special circumstances” for the purpose of an adjustment under the Trends Clause.

Claims for damage, after a natural disaster frequently involve other types of damage. A prime example is the 1906 San Francisco earthquake where the majority of the property damage was caused by fire following the actual earthquake. The earthquake in Japan, subsequent tsunami and power plant failures - will raise complex questions of causation – and although it is very difficult to get loss adjusters on the ground quickly and effectively following a major catastrophe, insurers must be vigilant in gaining evidence and information as soon as possible after such an event.

Ultimately, once all the information has been gathered, whether the cause is covered or not will depend on the policy language and the jurisdiction!

Misunderstandings and Definitions

KPMG recently published an article outlining the most common problems they deal with in the business interruption forum. One prime area is where there is a misunderstanding as to the definition of a material term in the policy. For example, at renewal time, when the broker sits down with the policy holder to discuss business interruption requirements. The broker will most likely ask, “what will your Gross Profit be?”

Herein lies the first problem – what do both parties understand Gross Profit to mean?

KPMG’s experience tells them that accountants tend to understand gross profit as turnover minus purchases of raw materials, direct labour costs and energy costs, whereas most insurers understand it to be simply turnover minus purchases of raw materials.

So when the policy holder replies to the question, he will likely give a significantly lower figure than he would have given had he known how the broker would calculate gross profit.

Following a major insured event at the policy-holder’s premises, an insurance claim is made – by which time the policyholder has probably realised how gross profit should in fact have been calculated. The insurer is then unprepared for the amount being claimed.

Where the misunderstanding involves a Declaration Linked policy, the policy-holder would have disclosed an Estimated Gross Profit for use in setting the premium. A potentially nasty side effect of a significant under declaration of estimated gross profit is where insurers seek to reject the claim completely and declare the whole policy void on the basis of a material misrepresentation or non-disclosure.

With a Non-declaration linked policy, for example where the sum insured was set at £1 million, but the actual gross profit at risk turns out to be £2 million. A fire then causes 3 months of lost profit. By averaging, the insured would only receive £250,000, instead of the £500,000 he would have been entitled to, had he understood how to calculate gross profit correctly!

These problems could easily be avoided by ensuring that, during the negotiation stage, key terms are clearly defined and understood by both the insurer and the insured.

Vessel Seizure and the concept of Total Loss

Insureds took a major hit with the 2010 decision in *Masefield v. Amlin*⁴. Although the decision in *Masefield* settled central issues of actual and constructive total loss of cargo under the 1906 Marine Insurance Act. The Judgment also touched on wider issues including legality and public policy with regards to the payment of ransoms.

During a voyage from Malaysia to Rotterdam - the vessel, cargo and crew, were seized by Somali pirates in the Gulf of Aden. Theft of cargo, and capture or seizure of the cargo by pirates, was an insured risk under the cargo policy. The vessel was seized on August 19th, 2008. About one month

⁴ *Masefield v Amlin* [2010] EWHC 280 (Comm)

later the cargo owners tendered a Notice of Abandonment to Amlin – seeking \$7 million dollars for the total loss of the cargo. Within 10 days thereafter - a ransom of \$2 million was agreed and paid to the pirates. The vessel along with her crew and cargo were released and later arrived in Rotterdam on October 26.

The court gave considerable thought to the issue of whether, at the time of tender of the Notice of Abandonment, it could be said that the claimant had been irretrievably deprived of the cargo and therefore it had been totally lost within the meaning of section 57(1) of the 1906 Act. The court stated that it was well settled that in order to establish irretrievable deprivation, the assured must show that recovery is impossible. Moreover, the court relied on the resolution of previous seizures by Somali pirates in establishing that in reality the assured had a reasonable hope that the cargo would be returned on payment of a ransom.

Broadly speaking, Somali pirates operate under a conventional model of kidnap and ransom, in which hostages are taken and traded for financial payments. It is generally accepted that, in reality, Somalian pirates are not trying to steal cargo or the vessel itself – they’re trying to take control of the crew so they can ransom them.

Compare this with piracy in Southeast Asia, the kill and sell model is commonly used. For example, the Japanese bulk carrier *Tenyu* was seized by pirates, only to be recovered months later after being renamed, repainted and reflagged. The cargo was gone and the 15 crew-men were presumed dead. No doubt with this in mind, the Judge in *Masefield*, held that without more, mere seizure by pirates could not be said to result in a total loss of the vessel.

The court held that payment of ransoms was not illegal under English law, but - it is perhaps a little surprising that, given the fact that the payment of ransoms is illegal in Somalia in all circumstances, and also in England - should the proceeds end up in the hands of terrorists – the claimant did not pursue the legality argument. Instead, counsel conceded that Somalia law was akin to English law and simply pursued the public policy argument. In conclusion, the claim for total loss, whether actual or constructive, was rejected by the court.

In practical terms, the immediate impact on the insured is that despite paying premiums to gain cover for theft and seizure of vessel, cargo and crew –they must still run the gauntlet of pirate negotiations and ransom drops. Although some say that it is likely that ship-owners would be under pressure to continue to pay ransoms, out of their humanitarian obligations to the crew, even if it were against the law.

The decision in *Masefield* is unsurprising. Had the decision gone the other way, you can be fairly certain that insureds would be abandoning seized vessels and their cargo to the insurers, leaving it for them to deal with ransom negotiations.

When combined with the practical obstacles in Somalia itself, how far does the decision in *Masefield* force the insured to go?

The Somalian government appears to have an inconsistent policy regarding ransom payments. Earlier this year, the Transitional Federal Government is thought to have played a significant role in the release of Rachael and Paul chandler. Yet within a few months of their release - three Brits were arrested and charged with carrying cash intended to pay ransoms. After initially being jailed for between 10-15 years each, they were pardoned and released on June 26 – The Somalian government

did however, “confiscate” the \$3.6 million dollar ransom, and issued hefty fines as well. As far as I understand, the ships have still not been released.

In this recent scenario, where the insured has attempted to pay the ransom, but has fallen foul of the particular country’s legal system – will the seizure of the two ships now be considered a total loss or will the insured be forced to continue negotiations with the pirates and attempt a second ransom drop? Or, following one failed attempt, would it now be fair to say that it is not acceptable to take into account the payment of a ransom as a relevant, legitimate course of action, when calculating the possibilities of recovery, in which case the insured has a very strong argument that they have been irretrievably deprived of possession.

The argument surrounding the point at which it will be considered against public policy to force insureds to undertake a course of action that, not only threatens the freedom of those who undertake them, but in the worst case scenario, their lives as well, has been stirred further by recent legislative involvement.

The US Presidential Order signed on April 13th, 2010, makes criminally punishable any act of providing financial aid, either directly or indirectly, to any person identified by the US government as being a “Specifically Designated National”.

Although, the US Departments of State and Treasury stated that the ban is not “piracy wide”. The reality is that it’s not always possible to know who the ransom is being paid to. Even more concerning, is that the Treasury Department has stated that it would likely find a violation of the Order if an insurer were to compensate a ship owner for payment of a ransom to a barred party. Shortly after the US Order was signed, the European Union Council passed Regulation 356, which is in essence very similar to its American counterpart.

The Executive Order and Regulation 356 come amid much debate on whether pirates should be considered terrorists and to the extent to which their operations overlap with acknowledged terrorists groups.

The UN Monitoring Group has recognized that:

“There is some evidence of linkages between piracy, arms trafficking, and the activities of some armed opposition groups...”

So, if there should be a change of attitude in regards to the prohibition of ransom payments – the current pro-insurer position could be turned on its head, leaving the market having to rethink coverage provided to vessels sailing in pirate waters. Meanwhile, the door has been left wide open, for counsel to make the legality argument, and the recent events and legislative interventions across the US and Europe should provide plenty of substance for their argument.