

**Risk Management in Ship Finance:  
A Marine Insurance Perspective**

Submitted by Chenxuan Li to the University of Exeter  
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## ABSTRACT

The long-standing concept of risk management in the financial sector has attracted more attention after the financial crisis of 2007–2008. In the context of ship finance, marine insurance has proven itself to be an effective tool to transfer certain shipping risks to insurers who are not directly involved in the ship finance projects. This thesis provides original suggestions concerning the role of marine insurance in ship finance, combining a financial perspective, an insurance perspective and a legal perspective.

Marine insurance is a key risk management technique that fits into the general risk management process adopted by ship financiers. However, it is not necessarily the most appropriate technique in every particular case due to its limitations and costs. As a result, insurance gaps are identified to assist financiers in optimising the use of marine insurance and to help insurers to spot business opportunities. Marine insurance is a contract which is to be governed by and construed in accordance with the law. At the same time, marine insurance is a contract rather than a guarantee: if something goes wrong in the ship finance package and there is a marine policy, it should not be assumed that the policy represents money in the bank. Things can go wrong under the policy: apart from the legal risks relating to claims under the policy, the law itself may be a risk.

In the context of ship finance, the risk transfer is not the only role of marine insurance. Other roles include, *inter alia*, reducing capital costs, improving the liquidity of shipowners and shipbuilders, and providing peace of mind for ship financiers. Nevertheless, such roles can only be created and sustained if the insurance contracts are carefully drafted and the legal risks are properly managed.

The intention has been to state the law as it stands on October 28, 2017.

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# CONTENTS

<i>Abstract</i> .....	1
<i>Acknowledgments</i> .....	2
<i>Table of Cases</i> .....	7
<i>Abbreviations</i> .....	13
1. INTRODUCTION .....	15
Background.....	15
1.1 Ambition of this research .....	16
1.1.1 The forgotten problem .....	16
1.1.2 Aim and objectives .....	17
1.1.3 Three lines .....	17
1.1.4 Limitations .....	19
1.2 Methodology and literature review .....	19
1.3 Outcome .....	20
1.3.1 Findings.....	20
1.3.2 Contributions .....	22
1.4 Structure of this thesis .....	22
2. SHIPPING AND SHIP FINANCE.....	25
2.1 Introduction .....	25
2.2 A sketch of shipping.....	26
2.2.1 Shipping business: international and risky .....	26
2.2.2 The peculiarities of maritime law .....	27
2.2.3 The single ship company .....	28
2.2.4 The cyclicity of shipping markets.....	29
2.3 Shipping is a capital intensive industry .....	30
2.4 What is ship finance?.....	31
2.4.1 Source of ship finance.....	31
2.4.2 Debt and equity .....	32
2.4.3 Finding a balance between the return on capital and the risk of loss.....	33

## CONTENTS

2.4.4 Options for raising funds in shipping .....	33
2.4.5 Reflection .....	34
2.5 Why is ship finance special?.....	35
2.5.1 Capital intensity .....	35
2.5.2 Mobility of assets.....	35
2.5.3 Volatility of the cash flow and the value of assets .....	35
2.5.4 A business structure without transparency .....	36
2.6 The structures of ship finance.....	36
2.6.1 Categories of financing structures used in shipping.....	37
2.6.2 Ship financiers: different attitudes towards the risk.....	37
2.6.3 Mortgage-backed bank loans .....	38
2.6.4 Ship leasing.....	45
2.7 Newbuilding finance.....	48
2.7.1 Who insures the ship?.....	49
2.7.2 Pre-delivery finance .....	50
2.8 The conflict of interests.....	52
2.9 Trends in ship finance.....	52
2.10 Conclusion .....	54
3. RISK MANAGEMENT IN SHIP FINANCE:	
THE ROLE OF MARINE INSURANCE .....	56
3.1 Introduction .....	56
3.2 Risk management in ship finance .....	57
3.2.1 What is risk management?.....	57
3.2.2 Why should ship financiers manage risks? .....	58
3.3 The risk management process .....	58
3.3.1 Establish the objectives.....	59
3.3.2 Risks identification and evaluation .....	60
3.3.3 Risk management techniques .....	60
3.3.4 Reviewing the process .....	61
3.4 Objectives of risk management in ship finance .....	61
3.5 Analysing risks in ship finance .....	62
3.5.1 Essential elements .....	62
3.5.2 Risks associated with the operating cash flow .....	64

## CONTENTS

3.5.3 Risks associated with the value of ships .....	66
3.5.4 Risks associated with the shipping market .....	67
3.6 Marine insurance as a risk management tool in ship finance .....	69
3.6.1 What is insurance? .....	69
3.6.2 Insurability .....	70
3.6.3 Functions of insurance .....	72
3.6.4 The benefits and limitations of insurance .....	73
3.6.5 How does marine insurance fit into ship finance? .....	74
3.7 Conclusion .....	76
4. MARINE INSURANCE: INSURABLE RISKS AND COVERAGE .....	78
4.1 Introduction .....	78
4.2 Insurable risks .....	79
4.3 Marine insurance policies .....	81
4.3.1 The insurance of shipowners .....	83
4.3.2 The insurance of shipbuilders .....	90
4.3.3 The insurance of ship financiers .....	91
4.4 Conclusion .....	102
5. MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS .....	0
5.1 Introduction .....	0
5.2 The law of marine insurance .....	1
5.2.1 The law reform .....	1
5.2.2 Characteristics of marine insurance law .....	3
5.3 Marine insurance providers .....	5
5.3.1 Insurance companies and Lloyd's .....	5
5.3.2 Protection and Indemnity clubs .....	5
5.4 Insurable interest .....	9
5.4.1 The latest developments in insurance law .....	10
5.4.2 Who must have an insurable interest? .....	11
5.4.3 What is insurable interest? .....	11
5.4.4 When must insurable interest attach? .....	14
5.4.5 Particular interests .....	14
5.5 Utilising the primary insurance .....	20

## CONTENTS

5.5.1 Duty to insure .....	21
5.5.2 The legal risks faced by ship mortgagees .....	22
5.5.3 As a co-assured .....	25
5.5.4 As a loss-payee .....	29
5.5.5 As an assignee .....	31
5.5.6 Letter of undertaking .....	42
5.6 Subrogation .....	46
5.6.1 The general rule .....	46
5.6.2 Subrogated actions against co-assured .....	47
5.6.3 Waiver of subrogation clauses .....	59
5.6.4 Mortgagees' interest insurance .....	60
5.7 Value to insure .....	62
5.7.1 Valued and unvalued policies .....	63
5.7.2 The measure of indemnity .....	64
5.7.3 Ship valuation .....	70
5.8 The role of insurance brokers .....	73
5.8.1 The issues of the fleet lien .....	74
5.8.2 Arranging contingency insurance with a separate broker .....	74
5.9 Direct access to reinsurance .....	77
5.9.1 Why ship financiers want to have direct access to reinsurance? .....	78
5.9.2 How to have direct reinsurance access? .....	78
5.10 Pollution liability and insurance solutions .....	81
5.10.1 Lender liability for pollution from ships .....	83
5.10.2 The insurance solutions .....	88
5.11 The impact of economic sanctions on ship finance .....	90
5.11.1 The compliance of marine insurers with the sanctions .....	91
5.11.2 The risk of illegality .....	92
5.12 Conclusion .....	98
6. CONCLUSION:	
OPTIMISING THE ROLE OF MARINE INSURANCE IN SHIP FINANCE ....	99
<i>Bibliography</i> .....	102

## TABLE OF CASES

Aktieselskabet Ocean v B Harding and Sons Ltd [1928] 2 KB 371 .....	161
Alexander v Campbell (1872) 41 LJ Ch 78 .....	118
Al-Kishtaini v Shanshal [2001] EWCA Civ 264.....	203
Allison v Bristol Marine Insurance Co (1876) LR 1 App Cas 209.....	126
Amalgamated General Finance Co v Golding & Co [1964] 2 Lloyd's Rep 163 .....	140, 152, 155
American Airlines Inc v Hope [1973] 1 Lloyd's Rep 233 .....	140
Arab Bank Plc v Zurich Insurance Co [1999] 1 Lloyd's Rep 262.....	137, 139
Arash Shipping Enterprises Co Ltd v Groupama Transport [2011] EWCA Civ 620 .....	203, 205
Aron & Co Inc v Miall (1928) 34 Com Cas 18 .....	113
Asfar v Blundell [1895] 2 QB 196 .....	175
Ashley v Ashley (1829) 3 Sim 149 .....	149
Atlasnavios Navegacao LDA v Navigators Insurance Co Ltd (The B Atlantic) [2014] EWHC 4133 (Comm); [2016] EWCA Civ 808; [2018] UKSC 26 .....	98, 179
Bank of New South Wales v South British Insurance Co Ltd (1920) 4 LI L Rep 384 .....	147, 210
Bank of Nova Scotia v Hellenic Mutual War Risks Assn (Bermuda) Ltd (The Good Luck) [1988] 1 Lloyd's Rep 514 .....	96
Bank of Nova Scotia v Hellenic Mutual War Risks Assn (Bermuda) Ltd (The Good Luck) [1992] 1 AC 233 .....	118, 144, 156, 157
Bankers Trust International v Todd Shipyards Corp (The Halcyon Isle) [1981] AC 221 .....	43
Barker v Janson (1867-68) LR 3 CP 303 .....	176, 180
Beresford v Royal Insurance Company [1938] AC 586.....	206
Black King Shipping Corp v Massie (The Litsion Pride) [1985] 1 Lloyd's Rep 437 .....	142
BMBF (No 12) Ltd v Harland & Wolff Shipbuilding & Heavy Industries Ltd [2001] EWCA Civ 862 .....	51
Broadgrain Commodities Inc v Continental Casualty Co [2017] ONSC 4721 .....	126
Bunge SA v Kyla Shipping Co Ltd (The Kyla) [2012] EWHC 3522 (Comm); [2013] EWCA Civ 734 .....	184, 185
Cape Distribution Ltd v Cape Intermediate Holdings Plc [2016] EWHC 1119 .....	143
Castellain v Preston (1883) 11 QBD 380 .....	126, 128
Central Insurance Co Ltd v Seacalf Shipping Corporation (The Aiolos) [1983] 2 Lloyd's Rep 25 .....	149, 159
Cepheus Shipping Corp v Guardian Royal Exchange Assurance Plc (The Capricorn) [1995] 1 Lloyd's Rep 622 .....	125
China Shipbuilding Corp v Nippon Yusen Kabukishi Kaisha and Galaxy Shipping PTE Ltd (The Seta Maru) [2000] 1 Lloyd's Rep 367.....	53



## TABLE OF CASES

Christie v Taunton Delmard Lane & Co [1893] 2 Ch 175 .....	150
Clark v Scottish Imperial Insurance Co (1879) 4 SCR 192 .....	127
Colonia Versicherung AG v Amoco Oil Co [1995] 1 Lloyd's Rep 570; [1997] 1 Lloyd's Rep 261 .....	137, 142
Colonial Mutual General Insurance Co Ltd v ANZ Banking Group (New Zealand) Ltd [1995] 2 Lloyd's Rep 433 .....	141, 143, 149
Commonwealth Construction Co Ltd v Imperial Oil Ltd [1978] 1 SCR 317 .....	160
Compania Maritima San Basilio SA v The Oceanus Mutual Underwriting Association (Bermuda) Ltd (The Eurysthenes) [1976] 2 Lloyd's Rep 171.....	117
Connect Shipping Inc v Sveriges Anfgartygs Assurans Forening (The Sweedish Club) [2016] EWHC 1580 (Comm) .....	178, 179
Continental Illinois National Bank & Trust Co of Chicago v Bathurst (The Captain Panagos DP) [1985] 1 Lloyd's Rep 625 .....	passim
Conway v Gray (1809) 10 East 536 .....	124
Co-operative Retail Services Ltd v Taylor Young Partnership Ltd (2001) 3 TCLR 4 (CA); [2002] 1 WLR 1419 (HL) .....	161
Crossley v City of Glasgow (1876) 4 Ch D 421 .....	149
Darrell v Tibbitts (1880) 5 QBD 560 (CA) (fire insurance).....	127
Davitt v Titcumb [1990] Ch 110 .....	147
Dearle v Hall (1828) 3 Russ 1 .....	134, 149, 150
Direct Line v Khan [2002] Lloyd's Rep IR 364 .....	138
Dornoch Ltd v Westminster International BV (The WD Fairway) [2009] 2 Lloyd's Rep 191 ....	159
DVB Bank SE v Shere Shipping Co Ltd [2013] EWHC 2321 (Ch) .....	203
Dyster v Randall & Sons [1926] Ch 932.....	137
Eagle Star Insurance Co v Games Video Co (The Game Boy) [2004] 1 Lloyd's Rep 238.....	184
Ebsworth v Alliance Marine Insurance (1872-73) LR 8 CP 596 .....	128
Eide UK Ltd v Lowndes Lambert Group Ltd [1998] 1 Lloyd's Rep 389 .....	136, 139, 160, 186
Empresa Cubana de Fletes v Kissavos Shipping Co SA (The Agathon) (No 2) [1984] 1 Lloyd's Rep 183.....	116
Euro-Diam Ltd v Bathurst [1988] 2 All ER 23 .....	114
Exp Kensington (1813) 2 V & B 79.....	149
Feasey v Sun Life Assurance Corporation of Canada [2003] Lloyd's Rep IR 637 .....	122, 129
Firma C-Trade v Newcastle Protection and Indemnity Association (The Fanti) [1990] 2 Lloyd's Rep 191.....	117
First National Bank of Chicago v West of England Shipowners Mutual P&I Association (Luxembourg) (The Evelpidis Era) [1981] 1 Lloyd's Rep 54 .....	119, 143, 145, 146
First National Commercial Bank Plc v Barnet Devanney (Harrow) Ltd [1999] Lloyd's Rep IR 43; [1999] Lloyd's Rep IR 459.....	137, 160
Flint v Flemyng (1830) 1 B & Ad 45 .....	91
Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory) [2013] EWHC 2199 (Comm); [2015] EWCA Civ 16; [2017] UKSC 35 .....	passim
GD Construction (St Albans) Ltd v Scottish & New Castle [2003] EWCA Civ 16.....	167

## TABLE OF CASES

General Accident Fire and Life Assurance Corp Ltd v Midland Bank Ltd [1940] 2 KB 388.....	139
Glafki Shipping Co SA v Pinios Shipping Co (No 1) (The Maira) (No 2) [1984] 1 Lloyd's Rep 660 .....	183
Glafki Shipping Co SA v Pinios Shipping Co (No 1) (The Maira) (No 2) [1986] 2 Lloyd's Rep 12 .....	128
Global Process Systems Inc v Syarikat Takful Malaysia Berhad, The Cendor Mopu [2011] UKSC 369 .....	98
Graham Joint Stock Shipping Co Ltd v Merchants Marine Insurance Co Ltd (The Ioanna) (No 1) [1924] AC 294 .....	142, 147
Green v Ingham (1866-67) LR 2 CP 525 .....	149
Gurnell v Gardner (1863) 66 ER 857 .....	149
Haberdashers' Aske's Federation Trust Ltd v Lakehouse Contracts Ltd [2018] EWHC 558 (TCC) .....	136, 137
Hall v Hayman [1912] 2 KB 5 .....	178, 179
Hall v Knight [1914] p 1 .....	206
Hanak v Green [1958] 2 QB 9 (CA).....	150
Handelsbanken ASA v Dandridge (The Aliza Glacial) [2002] EWCA Civ 5 .....	99
Heath Lambert Ltd v Sociedad de Corretage de Seguros [2004] 1 Lloyd's Rep 495.....	151
Heesens Yacht Builders BV v Cox Syndicate Management Ltd (The Red Sapphire) [2006] Lloyd's Rep IR 476.....	83
Helmville Ltd v Yorkshire Insurance Company Ltd [1965] 1 Lloyd's Rep 361.....	179
HLB Kidsons v Lloyd's Underwriters [2007] EWHC 1951 (Comm) .....	139
Hopewell Project Management Ltd v Ewbank Preece Ltd [1998] 1 Lloyd's Rep 448.....	137
Hughes v Tindall (1856) 18 CB 98 .....	118
Humble v Hunter (1848) 12 QB 310 .....	137
In re Bergsoe Metal Corp 910 F2d 668 (9th Cir 1990).....	200
Inglis v Stock (1885) L.R. 10 App. Cas. 263 .....	126
Inversiones Manria SA v Sphere Drake Insurance Co, Malvern Insurance Co and Niagara Fire Insurance Co (The Dora) [1989] 1 Lloyd's Rep 69.....	183
Ionides v Pender (1873-74) LR 9 QB 531 .....	183
Iraqi Ministry of Defence v Arcepey Shipping Co SA (The Angel Bell) [1979] 2 Lloyd's Rep 491 .....	passim
Irving v Manning (1847) 1 HL Cas 287.....	176, 177
Irving v Richardson (1831) 2 B & Ad 193 .....	128
Islamic Republic of Iran Shipping Lines v Steamship Mutual Underwriting Association (Bermuda) Ltd [2010] EWHC 2661 (Comm) .....	203, 206, 208, 209
Jackson v Mumford (1902) 8 Com Cas 61, affirmed (1904) 9 Com Cas 114 .....	83
James Yachts v Thames & Mersey Marine Insurance Co [1979] 1 Lloyd's Rep 206.....	83
John Edwards & Co v Motor Union Insurance Co Ltd [1922] 2 KB 249 .....	159
John W Pryke & Others v Gibbs Hartley Cooper Ltd [1991] 1 Lloyd's Rep 602.....	185
Keighley, Maxsted & Co v Durant [1901] AC 240. ....	137
Keith v Burrows (1876) 1 CPD 722 .....	42

## TABLE OF CASES

Kelley v Environmental Protection Agency 15 F3d 1100 (DC Cir 1994); 513 US 1110 (1995).	200
King v Brandywine Reinsurance Co (UK) Ltd [2004] Lloyd's Rep IR 554; [2005] Lloyd's Rep IR 509 .....	138
King v Victoria Insurance Co Ltd [1896] AC 250 .....	159
Kuwait Airways Corp v Kuwait Insurance [1996] 1 Lloyd's Rep 664 .....	180
Kyzuna Investments Ltd v Ocean Marine Mutual [2000] 1 Lloyd's Rep 505 .....	175, 176
Laming & Co v White Seater and Others (1889) 16 R 828 (Sess).....	132
Laurie v West Hartlepool Steam Ship Thirds Indemnity Association and David (1899) 43 Com Cas 322.....	144
Law Guarantee and Trust Soc v Russian Bank for Foreign Trade [1905] 1 KB 815.....	132
Lewis v Rucker (1761) 2 Burr 1167 .....	176
Lidgett v Secretan (No. 2) (1870-71) LR 6 CP 616 .....	180, 183
Linelevel Ltd v Powszechny Zaklad Ubezpieczen SA (The Nore Challenge) [2005] EWHC 421 (Comm) .....	130
Lion Mutual Marine Insurance Association v Tucker (1883) 12 QBD 176.....	116
Lloyd v Fleming (1872) LR 7 QB 299 .....	113
Loders & Nucoline v Bank of New Zealand (1929) 33 LI L Rep 70 .....	175
Lonsdale & Thompson v Black Arrow [1993] Ch 361 .....	120
Lucas (L) v Export Credits Guarantee Department [1973] 1 WLR 914 .....	158, 171
Lucena v Craufurd (1806) 2 Bos & PNR 269 .....	121, 122, 124, 125
Macaura v Northern Assurance Co (The Macaura) [1925] AC 619 .....	129, 130
Marsh v Robinson (1802) 4 Esp 98 .....	125
McMahon v AGF Holdings (UK) Ltd [1997] LRLR 159.....	192
Meacock v Bryant & Co [1942] 2 All ER 661 .....	158
Moran Galloway & Co v Uzielli [1905] 2 KB 555 .....	129
Morris v Ford Motor Co Ltd [1973] QB 792 .....	159
Muscat v Smith [2003] EWCA Civ 962 (CA). .....	150
National Bank of Greece SA v Pinios Shipping Co No 1 (The Maira) (No 3) [1989] 3 WLR 185 .....	132
National Oilwell (UK) Ltd v Davy Offshore Ltd [1993] 2 Lloyd's Rep 582.....	passim
Netherlands v Youell [1997] 2 Lloyd's Rep 440 .....	138
New Hampshire Insurance Co v MGN Ltd [1997] LRLR 24 .....	138, 160
New India Assurance Co Ltd v Dewi Estates Ltd [2009] HKCFI 845 .....	138
Newcastle P&I Association v Ships (USA) Inc [1996] 2 Lloyd's Rep 515 .....	160
Newfoundland v Newfoundland Railway Co (1888) 13 App Cas 199 (PC).....	150
North of England Pure Oil Cake Co v Archangel Maritime Insurance Co (1874-75) LR 10 QB 249 .....	121, 145
North-Eastern 100A Steamship Insurance Association v Red 'S' Steamship Company (1905) 10 Com Cas 245 (KB); (1906) 12 Com Cas 26 (CA) .....	144
O'Kane v Jones (The Martin P) [2004] 1 Lloyd's Rep 389 .....	123, 124, 129
Outhwaite (Richard Henry) v Commercial Bank of Greece SA (The Sea Breeze) [1987] 1 Lloyd's Rep 37 .....	147

## TABLE OF CASES

P Samuel and Company v Dumas [1924] AC 431 .....	passim
Parker v National Farmers Union Mutual Insurance Society Ltd [2012] EWHC 2156 (Comm) 137	
Petrofina (UK) Ltd v Magnaload Ltd [1984] QB 127 .....	160, 161
Phillips v Nairne (1847) 4 CB 343 .....	178
Pickersgill v London and Provincial Marine Insurance Co [1912] 3 KB 614 .....	142
Promet Engineering (Singapore) Pte Ltd v Sturge (The Nukila) [1997] 2 Lloyd's Rep 146.....	83
Prudential Insurance Co v Inland Revenue Commissioners [1904] 2 KB 658 .....	72
Quorum AS v Schramm [2002] 1 Lloyd's Rep 249.....	176
Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I) [2001] 1 Lloyd's Rep 597 .....	passim
Rathbone Brothers Plc v Novae Corporate Underwriting Ltd [2013] EWHC 3457 (Comm); [2014] EWCA Civ 1464 .....	passim
Re Blyth Shipbuilding & Dry Docks Co [1926] Ch 494 .....	51
Re Lancashire Plate Glass, Fire and Burglary Insurance Co Ltd [1912] 1 Ch 35 .....	190
Re Wilson and Scottish Insurance [1920] 2 Ch 28.....	113
Reed v Cole (1764) 3 Burr 1512 .....	126
Rhesa Shipping v Edmunds, The Popi M [1985] 2 All ER 712.....	98
Rozanes v Bowen (1928) 32 Ll L Rep 98.....	186
Said v Butt [1920] 3 KB 497 .....	137
Schiffshypothekenbank Zu Luebeck AG v Norman Philip Compton (The Alexion Hope) [1987] 1 Lloyd's Rep 60; [1988] 1 Lloyd's Rep 311 (CA) .....	95, 129
Sea Glory Maritime Co v Al Sagr National Insurance Co (The Nancy) [2013] EWHC 2116 (Comm) .....	passim
Searle v AR Hales & Co Ltd [1995] CLC 738.....	185
Sharp v Sphere Drake Insurance [1992] 2 Lloyd's Rep 501 .....	124, 129, 130
Shaw v Foster (1871-72) LR 5 HL 321.....	149
Shawe v Felton (1801) 2 East 109 .....	176, 177
Simpson v Thomson (1877) 3 App Cas 279 .....	159, 160
Siu Yin Kwan v Eastern insurance Ltd [1994] 1 All ER 213 .....	137
Sparkes v Marshall (1836) 2 Bing NC 761 .....	113
Steamship Balmoral Co v Marten [1902] AC 511.....	180
Strive Shipping Corp v Hellenic Mutual War Risks Association (The Grecia Express) [2002] 2 Lloyd's Rep 88 .....	183
Suez Fortune Investments Ltd v Talbot Underwriting Ltd [2015] EWHC 42 (Comm) .....	178
Sunport Shipping Ltd v Tryg Baltica International (UK) Ltd (The Kleovoulos of Rhodes) [2003] EWCA Civ 12 .....	98
Svenska Handelsbanken AB v Dandridge (The Aliza Glacial) [2002] 2 Lloyd's Rep 421 .....	129
Talbot Underwriting v Nausch Hogan & Murray (The Jascon 5) [2006] Lloyd's Rep IR 531....	137
Tephens v Australasian Insurance Co (1872) LR 8 CP 18 .....	126
Thames & Mersey Marine Insurance Co Ltd v Gunford Ship Co Ltd [1911] AC 529 176, 182, 183	
The CMA Djakarta [2004] 1 Lloyd's Rep 460. ....	168
The Manor [1907] P 339.....	132

## TABLE OF CASES

The Marine Sulphur Queen [1973] 1 Lloyd's Rep 88 (US).....	158, 171
The Shizelle [1992] 2 Lloyd's Rep 444 .....	42
The Surf City [1995] 2 Lloyd's Rep 242.....	172
The Yasin [1979] 2 Lloyd's Rep 45 .....	161
Thomas & Co v Brown (1899) 4 Com Cas 186 .....	158, 171
Thor Navigation v Ingosstrakh Insurance [2005] 1 Lloyd's Rep 547 .....	176
Turnbull v Woolfe (1861) 66 ER 336 .....	118, 144
Tyco Fire & Integrated Solutions (UK) Ltd (formerly Wormald Ansul (UK) Ltd) v Rolls Royce Motor Cars Ltd (formerly Hireus Ltd) [2008] EWCA Civ 286.....	161, 162, 163, 167
United States v Fleet Factors Corp (The Fleet Factors) 901 F2d 1550 (11th Cir 1990) .....	199
Vavasseur v Vavasseur (1909) 25 TLR 250 .....	149
Venetico Marine SA v International General Insurance Company Ltd [2013] EWHC 3644 (Comm) .....	178
Versloot Dredging BV v HDI Gerling Industrie Versicherung AG (The DC Merwestone) [2016] UKSC 45 .....	133
Volkswagenwerk AG and Wolfsburg Transport Gesellschaft MBH v International Mutual Strike Assurance Co (Bermuda) Ltd [1977] 2 Lloyd's Rep 503.....	117
Williams v Atlantic Assurance [1933] 1 KB 81.....	145, 148
Wilson v Jones (1866-67) LR 2 Ex 139.....	122, 130
Wilson v Nelson (1864) 5 B & S 354 .....	175
Woodside v Globe Marine Insurance Co Ltd [1896] 1 QB 105 .....	176
Woolcott v Sun Alliance [1978] 1 Lloyd's Rep 629.....	136, 137, 160
Wunsche Handelsgesellschaft International mbh v Tai Ping Insurance Co [1998] 2 Lloyd's Rep 8 .....	126
Yorkshire Insurance Co Ltd v Nisbet Shipping Co Ltd [1962] 2 QB 330 .....	159
Young v Turing (1841) 2 Man & G 593 .....	178
Zurich General Accident and Liability Insurance Co v Rowberry [1954] 2 Lloyd's Rep 55. ....	186

## ABBREVIATIONS

1925 Act	Law of Property Act 1925
1930 Act	Third Parties (Rights against Insurers) Act 1930
1992 CLC	1992 International Convention on Civil Liability for Oil Pollution Damage
1999 Act	Contracts (Rights of Third Parties) Act 1999
2001 Bunker Convention	2001 International Convention on Civil Liability for Bunker Oil Pollution Damage
2007 Nairobi International Convention	2007 Nairobi International Convention on the Removal of Wrecks
2010 Act	Third Parties (Rights against Insurance) Act 2010
2015 Act	Insurance Act 2015
Asset Conservation Act	Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996
ATL	Actual Total Loss
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act
CIDRA 2012	Consumer Insurance (Disclosure and Representations) Act 2012
CTL	Constructive Total Loss
EPA	Environmental Protection Agency (US)
H&M	Hull and Machinery
IG	International Group of P&I Clubs
IOI	Innocent Owners Insurance
ITH-95	Institute Time Clauses – Hulls (1/11/95)
IUA	International Underwriting Association of London
IV	Increased Value
LII	Lessors' Interest Insurance
LIIBA	London and International Insurance Brokers' Association
LMA	Lloyd's Market Association
LMBC	London Market Insurance Brokers' Committee

## ABBREVIATIONS

LNG	Liquefied Natural Gas
LOH	Loss of Hire
LOU	Letter of Undertaking
MAP	Mortgagees' Additional Perils Insurance
MAPP	Mortgagees' Additional Perils (Pollution) Insurance
MARPOL	International Convention for the Prevention of Pollution from Ships
MIA 1906	Marine Insurance Act 1906
MII	Mortgagees' Interest Insurance
MLI	Maritime Lien Insurance
MOA	Memorandum of Agreement
MRI	Mortgage Rights Insurance
MSA 1995	Merchant Shipping Act 1995
NEWBUILDCON	BIMCO Standard Newbuilding Contract
OPA-90	Oil Pollution Act 1990
P&I	Protection and Indemnity
SAJ Form	Shipbuilders' Association of Japan Form
SMI	Ship Mortgage Indemnity Insurance
SOLAS	International Convention for the Safety of Life at Sea
SPAC	Special Purpose Acquisition Company
SPV	Special Purpose Vehicle
The 1986 Institute Clauses	Mortgagees' Interest Clauses – Hull (30/5/86)
The 1997 Institute Clauses	Mortgagees' Interest Clauses – Hulls (1/3/97)

## CHAPTER 1

### INTRODUCTION

#### **Background: at the intersection of ship finance and marine insurance**

Marine insurance is as old as marine trade. Chinese merchants were practising the risk sharing principle by deliberately spreading cargo shipments among several ships as far back as 3,000 B.C.<sup>1</sup> Turning to Europe, marine insurance arguably originated from bottomry, a conditional loan repayable with interest upon successful completion of the voyage but retained if the ship was lost.<sup>2</sup> The bottomry loan was normally secured by a pledge over the financed ship.<sup>3</sup> Such a pledge would affect the lender's remedies: if the voyage was successful but the loan was not repaid, the lender could acquire the title of the ship.<sup>4</sup> Since bottomry went some way towards providing a sharing in the risk of trading by sea and made the lender both a financier and an insurer, representing the first intersection of ship finance and marine insurance.

The two seem distinct concepts, though they coincide again in modern times. Broadly speaking, ship financiers accept the risk of loss arising from funding the acquisition of ships in exchange for the return on capital,<sup>5</sup> while marine insurers promise to provide indemnity against the risk of loss caused by maritime perils (in accordance with the insurance contract) in return for the premium (i.e. the price paid for this indemnity).<sup>6</sup> Both ship finance and marine insurance, as a part of the modern financial system, are essentially trading risks derived from the shipping industry, and the system diverts these risks from person to person in

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<sup>1</sup> See CC Northrup (ed), *Encyclopaedia of World Trade: From Ancient Times to the Present* (Taylor and Francis 2005) 518. Splitting cargo shipments among several ships to reduce potential losses applied the basic principle of insurance (i.e. risk sharing). It might, however, be classified as a form of loss control technique in the modern risk management framework.

<sup>2</sup> HE Raynes, *A History of British Insurance* (Sir Isaac Pitman & Sons 1948) 4-6; JE Sloggett, *Shipping Finance: Financing ships and Mobile Offshore Installations* (Fairplay 1984) 22; Northrup (n 1) 518.

<sup>3</sup> A similar arrangement creating a security interest in the cargo is called a *respondentia*.

<sup>4</sup> Y Maruno, 'Practice and Law of International Ship Finance' (PhD thesis, University of Southampton 1979) 7-8.

<sup>5</sup> See Chapter 2, section 2.4.3 (Finding a balance between the return on capital and the risk of loss).

<sup>6</sup> Marine Insurance Act 1906 s. 1.



accordance with certain rules and contracts (or promises) where the parties' rights are recorded. It then arouses curiosity as to how the system works.

### **1.1 Ambition of this research**

#### **1.1.1 The forgotten problem**

Risks arising from shipping flow between shipowners, shipbuilders, ship financiers and marine insurers (Figure 1.1);<sup>7</sup> financiers accept risks only if such risks are predictable,<sup>8</sup> so they can decide whether to take these risks and what returns on capital can be expected. A combination of sophisticated shipping risks, cyclical shipping markets, and peculiar maritime law, however, not only creates unique risks for financiers but also increases the difficulty of risk calculation. In the light of this, financiers, with the help of lawyers and other professionals, have adopted a wide range of techniques (including marine insurance) to manage those risks. For example, shipping loan agreements generally state the borrower's obligation to insure the financed ship and to reimburse the lender's cost in respect of all contingency insurances. Marine insurance in the context of shipping has been examined in numerous studies, in the fields diverse as history, business, and law.<sup>9</sup> In the context of ship finance, no comprehensive study on marine insurance has previously been carried out, although financiers (in particular mortgagees and lessors) and their lawyers use marine insurance to offset against a variety of risks in every single transaction.

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<sup>7</sup> Apart from shipowners, shipbuilders, financiers and insurers, a wide range of parties who participate in shipping transactions also share risks derived from the shipping industry, the position of those parties is beyond the scope of this research unless otherwise provided.

<sup>8</sup> See Chapter 2, section 2.4.3 (Finding a balance between the return on capital and the risk of loss).

<sup>9</sup> On the history of marine insurance, generally, see: F Martin, *The History of Lloyd's and of Marine Insurance in Great Britain* (Macmillan 1876); on the business of marine insurance, generally, see: Drewry Shipping Consultants, *Risk Management in Shipping* (Drewry 2006); on the law of marine insurance, generally, see: J Gilman and others, *Arnould: Law of Marine Insurance and Average* (18th edn, Sweet & Maxwell 2013) (hereafter in this chapter, 'Arnould').

## INTRODUCTION

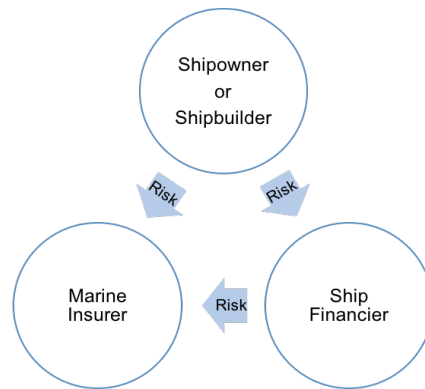


Figure 1.1

### 1.1.2 Aim and objectives

This research aims to explore the role of marine insurance in ship finance, providing insights for both academics and practitioners interested in this area. In the light of this, the main objectives are as follows:

- (1) To consider the difference between ship finance and other forms of finance and possible reasons for such a difference.
- (2) To classify different types of financier by their respective risk appetites considered.
- (3) To identify and evaluate the major risks in relation to ship finance projects.
- (4) To provide insights on how marine insurance might fit into ship finance.
- (5) To consider what types of risk in relation to ship finance may be covered by existing marine insurance policies, then to identify insurance gaps.
- (6) To identify what types of financier may directly participate in the shipowner's and shipbuilder's marine insurance.
- (7) To examine the way of financiers (as identified in point 6) utilise the shipowner's and shipbuilder's marine insurance and reinsurance.
- (8) To explore the potential legal risks arising out of using marine insurance to manage ship finance related risks.

### 1.1.3 Three lines

This research offers a fresh approach to examine the role of marine insurance in ship finance, combining a financial perspective, an insurance perspective and a legal perspective. While legal arguments will be prioritised in this research, as it is being submitted for a law degree, this research would be inconsistent and incomplete if legal issues were examined without considering financial and

## INTRODUCTION

insurance practices. The legal analysis does account for the majority of this research.

To create this unique approach, the arguments follow three distinct but complementary lines (Figure 1.2). First, it argues insurance is a key risk management technique that fits into the general risk management process adopted by ship financiers. Apart from the benefits of insurance there are limitations, thus insurance is not necessarily the most appropriate technique in every particular case. Moreover, costs (i.e. premiums) will be incurred for managing risks. Accordingly, when and how to use insurance to manage risks in relation to ship finance projects are two important questions to be addressed in this research.

Second, it demonstrates that marine insurance may shift a wide range of risks away from ship finance projects but not all the risks. As a result, identifying insurance gaps could assist financiers in optimising the use of marine insurance and to help insurers to spot business opportunities.

Third, it suggests marine insurance is, in essence, a contract which is to be governed by and construed in accordance with the law. At the same time, marine insurance is a contract rather than a guarantee: if something goes wrong in the ship finance package and there is a marine policy, it should not be assumed that the policy represents money in the bank. Things can go wrong under the policy: apart from the legal risks relating to claims under the policy, the law itself may be a risk. All insurance contracts, therefore, must be carefully drafted, and the legal risks should be properly managed.

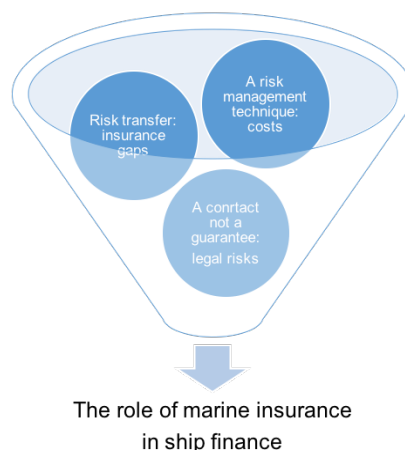


Figure 1.2

### 1.1.4 Limitations

This research has several limitations. First, it purports to examine the role of marine insurance in ship finance – both debt and equity – but some arguments may not apply to equity finance, with reasons noted in context.<sup>10</sup> Second, it focuses on the position of related parties when English law applies, unless otherwise provided.<sup>11</sup> If the financial instrument and/or insurance contract are governed by another law, the position is different. Third, finance structures described in this research are highly simplified for the sake of example, such structures are much more complex in reality. Fourth, some parts of this research are based on personal experience and understanding of shipping and the financial system; disagreements may arise if a person holds different views.

### 1.2 Methodology and literature review

Given the interdisciplinary nature of this research, it employs both doctrinal methods and social-legal methods. Chapter 5 and some parts of chapter 4 mainly focus upon the law itself, deriving principles and values from statutes and decided cases. Other parts of this research have employed a mixture of social science methods.

As mentioned above, no comprehensive study on marine insurance in the context of ship finance has previously been carried out. Thus this research has to consult to a wide range of research across disciplines of finance, insurance and law. There is a book *The Insurance Aspects of Shipping and Offshore Financing*<sup>12</sup> that provide insights on how marine covers for ship financiers are arranged by brokers, which is widely used by ship finance lawyers. Three leading books – *Ship Sale and Purchase*,<sup>13</sup> *The Law of Shipbuilding Contracts*<sup>14</sup> and *The Law of Ship Mortgages*<sup>15</sup> – are valuable for facilitating the understanding of the involvement of marine insurance in their respective areas. There are several maritime economics books that provide insights into shipping and its connection

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<sup>10</sup> For example, shareholders cannot utilise the primary insurance for lacking insurable interests. See Chapter 5, section 5.4.5.4 (shareholder) and section 5.5 (utilising the primary insurance).

<sup>11</sup> See Chapter 5, section 5.10.1.2 (Lender liability under US law).

<sup>12</sup> P Mellett (ed), *The Insurance Aspects of Shipping and Offshore Financing* (Bankserve 2013).

<sup>13</sup> I Goldrein, M Hannaford and P Turner, *Ship Sale and Purchase* (6th edn, Informa 2012).

<sup>14</sup> S Curtis, *The Law of Shipbuilding Contracts* (4th edn, Informa 2012).

<sup>15</sup> G Bowtle and KP McGuinness, *The Law of Ship Mortgages* (Informa 2001); D Osborne, G Bowtle and C Buss, *The Law of Ship Mortgages* (2nd edn, Informa 2016).

## INTRODUCTION

with a wider economic framework, in particular, *Maritime Economics*<sup>16</sup> and *The Handbook of Maritime Economics and Business*.<sup>17</sup> A number of books consider financial issues and legal issues in relation to ship finance transactions, among which four books stand out – *Shipping Finance*<sup>18</sup> and a more recent *Shipbuilding, Sale and Finance*<sup>19</sup> on legal issues, *HSBA Handbook on Ship Finance*<sup>20</sup> and a more recent *The International Handbook of Shipping Finance*<sup>21</sup> on financial issues. There are books examining the relationship between risk management and insurance in general.<sup>22</sup> As regards legal issues in respect of marine insurance, they refer to primary sources (i.e. cases and statutes) where possible. In the absence of primary sources, they turn to secondary sources, in particular, established literature on marine insurance law,<sup>23</sup> insurance contract law,<sup>24</sup> general contract law,<sup>25</sup> and maritime law.<sup>26</sup>

### 1.3 Outcome

#### 1.3.1 Findings

Generally speaking, shipping business is inherently capital intensive and is highly depended on funding from outside, thus this research considers ship finance as one of the engines of shipping. Financiers who provide funds for the acquisition of ships are known as ship financiers, including both debt providers and equity investors. Ship financiers take the risk of loss in exchange for the return on

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<sup>16</sup> M Stopford, *Maritime Economics* (3rd edn, Routledge 2008).

<sup>17</sup> CT Grammenos (ed), *The Handbook of Maritime Economics and Business* (2nd edn, Lloyd's List 2010).

<sup>18</sup> Stephenson Harwood (ed), *Shipping Finance*, (3rd edn, Euromoney 2006).

<sup>19</sup> B Soyer and AM Tettenborn (eds), *Ship Building, Sale, and Finance* (Informa 2016).

<sup>20</sup> O Schinas, C Grau and M Johns (eds), *HSBA Handbook on Ship Finance* (Springer 2015).

<sup>21</sup> MG Kavussanos and ID Visvikis (eds), *The International Handbook of Shipping Finance: Theory and Practice* (Palgrave Macmillan 2016).

<sup>22</sup> SE Harrington and GR Niehaus, *Risk Management and Insurance* (2nd edn, McGraw-Hill Higher Education 2003).

<sup>23</sup> SJ Hazelwood and D Semark, *P&I Clubs Law and Practice* (4th edn, Informa 2010); FD Rose, *Marine Insurance: Law and Practice* (2nd edn, Informa 2012); Arnould (n 9); R Merkin (ed), *Marine Insurance Legislation* (5th edn, Informa 2014).

<sup>24</sup> MA Clarke, *The Law of Insurance Contracts* (6th edn, Informa 2009); J Birds, S Milnes and B Lynch, *MacGillivray on Insurance Law* (13th edn, Sweet & Maxwell 2015); R Merkin, *Colinvaux's Law of Insurance* (11th edn, Sweet & Maxwell 2016); J Birds, *Bird's Modern Insurance Law* (10th edn, Sweet & Maxwell 2016).

<sup>25</sup> M Chen-Wishart, *Contract Law* (5th edn, OUP 2015); E McKendrick, *Contract Law: Text, Cases and Materials* (7th edn, OUP 2016).

<sup>26</sup> CDL Rue and CB Anderson, *Shipping and the Environment* (2nd edn, Informa 2009); R Coles and E Watt, *Ship Registration: Law and Practice* (2nd edn, Informa 2009); A Mandaraka-Sheppard, *Modern Maritime Law Volume 1 & Volume 2* (3rd edn, Informa 2013); Y Baatz (ed), *Maritime Law* (4th edn, Informa 2017).

## INTRODUCTION

capital, but they are directly or indirectly exposed to a wide range of shipping risks apart from the common risks associated with financing activities, because of the idiosyncratic nature of shipping and peculiarities of maritime law. In the light of this, ship financiers are strongly motivated to and interested in managing such shipping risks for achieving the risk-yield balance.

Risks are unavoidable but manageable, among a wide range of risk management techniques, marine insurance is an important one. Consequently, marine insurance is deemed as a part of the risk management process adopted by ship financiers. It then follows to consider the role of marine insurance in assisting the success of ship finance projects. In the context of ship finance, the role of marine insurance is not only limited to risk transfer but also includes reducing capital costs, improving the liquidity of shipowners and shipbuilders, as well as providing peace of mind for ship financiers. In addition, marine insurers may act in the similar role of risk managers, conduct research and education on marine risks, or invest in shipping with the large amount of money generated from providing insurance.

In terms of the risk transfer role of marine insurance, it indemnifies the financial consequences of marine losses if appropriate marine policies are properly arranged. It then raises questions of “What types of marine policy are appropriate?” and “How is marine insurance properly arranged?” After examining the types of risk covered by existing marine policies, it concludes that purchasing marine insurance may shift a wide range of shipping risks from shipowners (or shipbuilders) and their financiers to the insurance pool (albeit with certain limitations).

Turning to the second question, it argues marine insurance is a contract, thereby the general principles of contract law apply. Not all types of ship financier may directly benefit from marine insurance, because the law of marine insurance requires insurable interest. For example, a pure shareholder has no insurable interest in the property of the company in which it holds shares. Mortgagees and lessors may participate in the shipowner’s and shipbuilder’s marine policies as either a co-assured, or an assignee, or a loss-payee, thereby directly benefiting from marine insurance. Nevertheless, marine insurance is a contract rather than a guarantee, thus it may be void or voidable, and things can go wrong under the policy; that is, a variety of legal risks may appear during the operation of marine insurance including (but are not limited to) risks in respect of subrogation, ship

valuation, broker, the insurer's insolvency, pollution liability and economic sanctions targeted at shipping. These legal risks must be carefully managed as well.

### **1.3.2 Contributions**

The conservative nature of shipping has decided that shipping industry is reluctant to embrace changes, but traditional bank lending has become more careful and selective under the pressure imposed by regulators and supervisory authorities.<sup>27</sup> For this reason, a significant percentage of shipowners have to turn towards international capital markets to raise funds beyond traditional bank debts. Identifying the role of marine insurance in ship finance could assist financiers to effectively utilise marine insurance (if any) to protect their investments and insurers to identify insurance gaps and spot business opportunities, while also encouraging financiers and their clients (i.e. shipowners and shipbuilders) to cooperate on risk management, promoting the success of their ship finance projects. In addition, exploring legal rules that govern the operation of marine insurance in ship finance while also identifying relevant legal risks could contribute to the development of the law in this area.

## **1.4 Structure of this thesis**

This thesis is structured into five chapters.

Chapter 1 provides an introduction. As mentioned above, it sets out the background, aim and objectives, approach, limitations, as well as outcomes of this research.

Chapter 2 provides an overview of shipping and ship finance, which lays a foundation for the arguments in the following chapters. The principal task of Chapter 2 is to explore the way ship finance works, and then to demonstrate the importance of marine insurance to ship finance. It argues ship financiers are faced with unique risks as a result of the idiosyncratic nature of shipping and peculiarities of maritime law. A range of finance structures are examined: particular emphasis is placed on the mortgage-backed bank loan and leasing. In

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<sup>27</sup> For example, the pressure introduced by Basel III. Basel III is an international regulatory accord that introduces a set of reforms designed to improve the banking sector's ability to deal with financial stress, improve risk management, and strengthen the banks' transparency.

## INTRODUCTION

addition, newbuilding finance is considered separately, with particular focus on the pre-delivery finance. Marine insurance issues are considered along with an examination of various finance structures to demonstrate the importance of marine insurance to ship finance. This chapter ends with discussions of the potential conflicts between ship financiers and shipowners, as well as the trends in ship finance.

Chapter 3 explores the role of marine insurance in ship finance. It describes a formal risk management process and considers marine insurance as an important type of risk management technique. Three groups of shipping risks that may impact the ship finance projects are identified and evaluated, including risks associated with operating cash flows, with values of ships, and with shipping markets; this is closely linked with discussions in next chapter. Valuable insights are provided into the role of marine insurance in ship finance. Beyond the traditional risk transfer role, marine insurance plays other roles such as reducing capital costs, improving liquidity, providing peace of mind, funding research and education (on marine risks), and as a source of ship finance.

Chapter 4 aims to answer two questions: what types of marine risk are insurable in theory and what forms of marine policy can be used to facilitate ship finance transactions in practice? Three groups of marine policies are considered in this chapter, including the shipowners' insurance, the shipbuilders' insurance and the ship financiers' insurance. This chapter ends with a summary in which the insurance gaps are identified.

Chapter 5 relates to two themes: how to properly arrange marine insurance under the current legal framework and what are the potential legal risks associated with such arrangements. Marine insurance is a contract, which is to be governed by and construed in accordance with the law. This chapter starts from considering the law which applies to marine insurance contract in England and Wales, including recent law reform. The providers of marine insurance are identified, with particular emphasis on the special rules of Protection and Indemnity (P&I) clubs. It examines the concept of insurable interest for the purpose of identifying the types of financier that may participate in the shipowner's and shipbuilder's marine insurance (i.e. primary insurance). There are mainly three ways for financiers to utilise the primary insurance, including be a co-assured, be a loss-payee, or be an assignee, with advantages and disadvantages respectively. Marine insurance is a contract rather than a



## INTRODUCTION

guarantee, if something goes wrong in the ship finance package and there is a marine policy, it should not be assumed that the policy represents money in the bank. Given things may go wrong under the policy, a variety of legal risks in respect of subrogation, ship valuation, broker, direct access to reinsurance, pollution liability and economic sanctions targeted at shipping are examined, with suggestions on how to manage such legal risks.

## CHAPTER 2

# SHIPPING AND SHIP FINANCE

### 2.1 Introduction

Shipping has played a central role in the world economy since the first cargoes were transported by sea 5,000 years ago. Today, over 90% of global trade is carried by ships. Ships, as the most important units of shipping, can be acquired by contracts: new ships through shipbuilding contracts and second-hand ships through sale and purchase contracts. Ship acquisition in the present day is heavily dependent on outside funding. A wide range of finance structures can be used to facilitate such transactions. Financiers will always require certain forms of security to protect their investments, regardless of which is chosen.

The purpose of this chapter is to examine the way ship finance works and then to demonstrate the importance of marine insurance to ship finance, thereby laying a foundation for arguments in the following chapters. It starts with considering the idiosyncratic nature of shipping and the peculiarities of maritime law (section 2.2), which will facilitate the understanding of the uniqueness of ship finance. In order to provide insights into the way ship finance works, this chapter goes on to consider the capital intensive nature of shipping (section 2.3), the framework of ship finance (section 2.4), and the factors distinguishing financing ships from financing other asset-backed industries (section 2.5). Subsequently, a range of ship finance structures are described, particular emphasis is placed on the mortgage-backed bank loan (section 2.6.3) and the ship leasing (section 2.6.4), with a demonstration of the importance of marine insurance to ship finance. Financing newbuildings is considered in a separate section (section 2.7), because it is distinguished from financing second-hand ships in many ways. The potential conflicts between ship financiers and shipowners (section 2.8) are noted, providing a background for further arguments. This chapter ends with a discussion of trends in ship finance (section 2.9).

## 2.2 A sketch of shipping

### 2.2.1 Shipping business: international and risky

No business is more exciting than shipping: the temper of the sea is unpredictable, and sailing has always been a game for the brave. Although the design of ships, sailing technologies and organisation of shipowners have significantly evolved over the years, some distinctive flavours of shipping seem immutable, particularly its international and risky nature.

Shipping is indeed a global industry, carrying cargo and bridging commerce between continents. As the most important units of shipping, ships are physically mobile, so a large part of their lives are spent outside any particular jurisdiction. The modern ship registration system allows shipowners considerable freedom in choosing legal jurisdictions, and thus corresponding tax schemes and financial environments. The international feature of shipping also reflects on its participants—parties involved in shipping transactions almost inevitably hold different nationalities. In a newbuilding scenario, a ship may be built in China for a Greek owner with the fund borrowed from a German bank and insured in the London market. Therefore, it is not uncommon to find multiple legal systems involved in a single shipping transaction, often leading to the conflict of laws. In spite of this complex legal relationship, shipping has become an integral part of the globalisation process more than ever before. This indicates that any crisis in other markets may result in a domino effect on shipping. The most recent financial crisis of 2007–2008 has well demonstrated this point.

Ocean-going ships, unlike houses on the land, are internationally mobile in a perilous environment. The perils facing ships include, *inter alia*, fire, collision, piracy, war and terrorism, cargo and hull damage, and environmental accident. Consequently, ships may not only be damaged or lost at sea but also can incur liabilities to third parties, passengers and crews. In order to be protected from a range of risks associated with owning and/or operating a ship, the shipowner will usually purchase insurance against these risks. Not all risks, however, are insurable. In spite of the sophistication of modern insurance markets, some risks are uninsurable in nature and some risks are uninsurable for the impractical cost. In addition, the forms of risk keep changing. The safety of navigation has been significantly improved due to a combined efforts of innovative technology, better ship design, higher quality crew training, as well as established national and

international shipping regulations. Nevertheless, emergent risks appear to challenge the shipping industry. It may be a traditional risk in a new form, such as modern piracy or terrorism; it may also be a brand new risk, such as a cyber-attack. The shipping business is in transition due to a series of social, economic and political developments: environmental regulations on shipping have become stricter,<sup>28</sup> funds provided by banks are drying up, and the more frequent use of economic sanctions in last twenty years is introducing greater political risks. All participants in the shipping industry shall fully know these changes and cautiously manage such emergent risks.

### **2.2.2 The peculiarities of maritime law**

Broadly speaking, maritime law is a distinct corpus of law governing the business of carrying goods and passengers by water including (but are not limited to) maritime commerce, navigation, salvage, transportation of passengers and goods by sea. Maritime law is distinguished from other areas of law in many ways, among those peculiarities, this section only considers “ship registration” and “actions *in rem*” for the purpose of this research.

#### *2.2.2.1 Ship registration*<sup>29</sup>

A ship must register with an individual state in order to enjoy the freedom of the high seas,<sup>30</sup> as a stateless ship (i.e. a ship without registration) falls out of the protection of international law. Ship registration is, in general, a process by which a ship is documented and given the nationality of a state. Such registrations constitute the official record, providing access to all information related to registered ships for the public.

The functions of registration under public law and under private law are different because of the various relations they adjust. Under private law, shipping

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<sup>28</sup> See, e.g. the International Convention for the Control and Management of Ships' Ballast Water and Sediments (entered in to force on 8 September 2017). This convention aims to prevent the spread of harmful aquatic organisms from one region to another, by requiring signatory states to ensure that ships flagged by them comply with certain standards and procedures in respect of ballast water and sediments.

<sup>29</sup> See, generally, R Coles and E Watt, *Ship Registration: Law and Practice* (2nd edn, Informa 2009) (hereafter in this chapter, '*Ship Registration*').

<sup>30</sup> Convention on the High Seas (Geneva, 29 April 1958, entered into force 30 September 1962) 450 UNTS 82 art. 5.

registration mainly serves two purposes:<sup>31</sup>

- (1) providing *prima facie* evidence of the title of the registered owner; and
- (2) protecting the title, preserving and ranking priorities between persons holding security interests over the ship (e.g. ship mortgagees).

The current legal framework of UK has no mandatory requirement to register a ship.<sup>32</sup> In practice, however, a lender inevitably requires the financed ship to be registered to make sure that a mortgage can be registered against the ship, creating a security interest over the ship.

### 2.2.2.2 *Actions in rem*

Another distinct feature of maritime law is that a ship can be claimed *in rem*. This is a special class of legal actions against ships, in which the defendant would be a ship in such a claim. In the UK, only the Admiralty Court has the jurisdiction to proceed against ships for particular claims (claims arising from mortgages and charges disputes included).<sup>33</sup> The Admiralty jurisdiction applies to all ships (not only British-owned ships) in relation to all claims wherever they occur.<sup>34</sup> In practice, the *in rem* proceeding is a sharp weapon for claimants, because it can easily lead to the arrest of ships, and therefore can obtain security for the claims.

While the arrested ship is under the Admiralty Court's custody, no one shall move her without the Court's permission.<sup>35</sup> Therefore, there will be an interruption in shipping operations following the arrest. The owners of the arrested ship then have to decide whether to provide the required security to the court. The ship will be released upon satisfying all security requirements, but if the owners have chosen to not provide any security, the ship might be sold and the claimants could be paid out of the sale proceeds.

### 2.2.3 The single ship company

In shipping, it is common to set up separate companies for each ship in the owner's fleet, which are known as single ship companies. The purpose of creating a single ship company is legal risk management: such a corporate structure is

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<sup>31</sup> *Ship Registration* (n 29) para 1.24.

<sup>32</sup> Merchant Shipping Act 1995 s. 9.

<sup>33</sup> Senior Courts Act 1981 s. 20(2).

<sup>34</sup> *Ibid* s. 20(7).

<sup>35</sup> Civil Procedure Rules rule 61.5(9).

particularly useful when financing under a mortgage-backed loan structure. By using the single ship company, a mortgaged ship can be isolated from any claim against other ships in the owner's fleet, which means the security obtained by the mortgagee is safer in general. However, a significant drawback of such a corporate structure is that there are no other traceable assets of owners except the mortgaged ship, her earnings and other receivables. In the light of this, whether a mortgage can be enforceable is of great importance to the mortgagee, thus a proper arrangement of other forms of security is necessary, such as taking an assignment of the mortgaged ship's earnings and insurances.

### **2.2.4 The cyclicity of shipping markets**

The lifetime of a ship can be divided into three phases:

- (1) the first phase, a new ship is built and sold in the newbuilding market;
- (2) the second phase, a second-hand ship is traded in the sale and purchase market;
- (3) the third phase, a ship is scrapped in the demolition market at the end of her service.

Each phase creates a separate market: newbuilding, sale and purchase, and demolition. In addition to these markets, there is a fourth market – the freight market – where the sea transport is traded.

The shipping industry is highly reliant on capital. The freight market plays a role of cash generator and money flows in the industry by providing shipping services. Scrapping ships is another major source of funds, which brings money in especially during periods of recession. In contrast, money flows out in the newbuilding market, paying for materials, labour, and profit. It is more like a zero-sum game in the case of the sale and purchase market: money only changes hands between different shipowners without affecting the total amount of cash held by the industry. Cash flows in and out of various shipping markets, driving the shipping market cycles. One important function of market cycles is squeezing inefficient companies out of the market, so that the industry's efficiency will be improved.

Market cycles pervade the shipping industry. Although cycles are not uncommon in any competitive market, shipping is often affected by cycles more than other industries. As a consequence, the earnings and values of ships are

extremely volatile. The volatility feature of shipping has attracted a lot of speculative investors, turning ships from a pure transportation vehicle to an investment vehicle. However, financiers often experience difficulty in assessing the investment risk of shipping, because of the unpredictable shipping market cycles.

### **2.3 Shipping is a capital intensive industry**

Shipping business is inherently capital intensive. Ships, as the most important units of shipping, tie up a large amount of capital. Building a container ship or a tanker in modern days often costs up to \$150 million,<sup>36</sup> and some gas ships cost more than \$300 million each.<sup>37</sup> Traditionally, it is the retained earnings from shipowners that serve as the primary fund for ship acquisitions. However, markets demand more tonnage as a result of the rapid growth in global trade, thus modern ships have increased significantly in both size and price. Consequently, the extensive capital requirements to purchase newbuildings as well as second-hand ships can no longer be sustained by the private funds of owners, and shipowners will have a constant need to raise external capital.

In general, shipping is a high-risk/low-return industry. It appears to be unappealing to any serious lender or investor, since the shipping companies often fail to tick those criteria valued by financiers, *inter alia*, predictable earnings, transparent corporate structures, and steady growth of the company.<sup>38</sup> However, a paradox of shipping is that this industry has generally suffered from too much finance. In spite of much evidence documented in shipping history,<sup>39</sup> the recent shipping boom has well illustrated it. The great shipping boom lasted five years, from 2003 to 2008, a period in which the Chinese economy was fast growing. Due to the rapid growth of the Chinese economy, demand for raw materials was driven up by a series of infrastructure developments, leading to a severe shortage of tonnage since autumn 2003. As a result, tanker freight rates and bulk carrier freight rates hit a new record.

The opportunities in shipping were perceived by financiers, thus a large amount of investment flowed into shipping during that five years, a significant

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<sup>36</sup> M Stopford, *Maritime Economics* (3rd edn, Routledge 2008) 269.

<sup>37</sup> Clarkson, 'The Tramp Shipping Market' (March 2015) 4.

<sup>38</sup> Stopford (n 36) 269.

<sup>39</sup> Stopford (n 36) 269-270.

percentage of which was speculation. When the music stopped, the shipping industry had been heavily struck, and it is still trying to absorb the overheated investments from that period.

### **2.4 What is ship finance?**

Finance, in its most general definition, is a process by which providing an individual or a company with money (not limited to cash money) so as to support them in achieving personal or commercial goals.<sup>40</sup> By using the tool of finance, companies can purchase products or expand businesses out of immediate reach, achieving their expected commercial goals. If one applies the above definition to shipping, any activity which provides funds for ship acquisitions can be categorised as ship finance. Ship acquisitions may take various forms, including the construction of a new ship, resale of a newbuilding contract, as well as sale and purchase of a second-hand ship. Funds provided may consist of other forms besides cash, for example, the ship in the case of ship leasing. The brief definition of ship finance has demonstrated its function of providing funds for ship acquisitions. Then we may be curious and ask questions like: “Where do the funds come from?”, “What are the objectives of those funds?” and “What do shipowners have to do to get those funds?”. These questions are considered in this section.

#### **2.4.1 Source of ship finance<sup>41</sup>**

To answer the question of “Where do the funds come from?”, we shall think out of shipping. The source of investment funds is primarily savings from companies and individuals. Some companies and individuals may handle savings themselves (by lending or investing), while a larger amount of savings are usually handed to the institutional institutions for management. There is a range of institutional institutions, *inter alia*, the insurance companies, pension funds, saving banks, trust funds, and finance houses. The advantage of a professional institutional investor is that it can bypass the financial market, directly placing funds with companies who need finance. This has been known as “private placement”, which can be structured either in debt or equity. Only large shipping

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<sup>40</sup> A Hudson, *The Law and Regulation of Finance* (2nd edn, Sweet & Maxwell 2013) para 1-03.

<sup>41</sup> See, generally, Stopford (n 36) 276-282.



companies with high investment value have access to the private placement funds in reality.

As an alternative, savings flow into the financial market where financial assets are traded. The common financial assets include stocks, bonds, commodities, derivatives as well as currencies. The financial market can be further divided into the money market and the capital market, and the capital market consists of both the bond market and the equity market. The money market is used to trade short-term debt instruments – typically for assets with a term of less than one year – such as deposits, collateral loans, acceptances and bills of exchange. In contrast, the capital market is a platform for trading long-term assets, which are assets with maturity greater than a year.

Both companies and governments can issue bonds in the bond market, but bonds without credit ratings are not permitted to be traded. Only companies can raise money from the equity market by issuing shares (also known as stocks). It is usually the investment banks arranging the process of issuing shares, and such a process is regulated by rigid rules, given its high-risk nature. Bonds and stocks dominate the capital market, which are collectively called “securities”. Securities are essentially standard packaged investments: stocks are packaged equities and bonds are packaged debts. The superiority of securities is that people can buy and sell them without specialised knowledge in the invested subjects, thus creating convenience for trading.

Companies have access to investment funds in the financial market through arrangers (i.e. someone who arranges for a loan between a borrower and a syndicate of lenders, typically a financial institution) beyond their access to funds directly placed via private placement. The arrangers are mainly done by various financial institutions; some institutions like commercial banks will provide capitals themselves, while other institutions like investment banks will underwrite finance for companies. In the context of ship finance, the common arrangers are commercial banks, investment banks, ship credit banks, finance houses, leasing companies and shipbuilding credit schemes.

### **2.4.2 Debt and equity**

Two different routes are available for a company that seeks to raise finance—via debt or equity. Broadly speaking, debt must be paid back with a rate of interest

in exchange for the right of borrowing, and while, equity does not need to be paid back, it relinquishes ownership to the investors.

If a company raises funds via the route of debt, the providers of funds are creditors and the recipients are debtors. Debt must be paid back in accordance with the terms of the contract under which it has been incurred, and the primary forms of debt are bank loans and debt securities. Turning to equity, shares are the principal equity instruments. Buyers of shares become shareholders who are entitled to share profits and vote on strategic decisions of the company, according to company law and the company's articles of association. Both creditors and shareholders are stakeholders of the company, however, creditors will be paid in priority to equity investors in the event of the company's winding up. If creditors have taken security, such a priority position may be further improved.

### **2.4.3 Finding a balance between the return on capital and the risk of loss**

Financial institutions are essentially running a business by taking the risk of loss in exchange of a return on their capital. In the light of this, finance is essentially an art of finding a balance between the return on capital and the risk of loss from the perspective of financiers. This objective may be achieved by using a range of financial instruments.

Opportunities are always accompanied by risks. Financial institutions will calculate risks before taking any business in order to decide a favourable ratio of risk and return. The credit risk (i.e. the risk of non-payment of debts) is a major risk for creditors, which has often resulted from the debtors' insolvency. Accordingly, creditors will naturally hope to reduce the solvency risk of debtors to a minimum, but if the risk does occur, creditors will want to be ensured that they will be paid in priority to other stakeholders of the debtor. Taking security is an effective way to obtain a priority position. For shareholders, the performance or profitability of the company in which they hold shares is their chief concern. Thus shareholders will be more interested in the upside of a business compared with creditors.

### **2.4.4 Options for raising funds in shipping**

Turning to the last question of what shipowners should do to raise funds, given the nature of shipping, owners mainly have three options:

## SHIPPING AND SHIP FINANCE

- (1) borrowing: either borrow money or borrow assets (e.g. ships);
- (2) providing cash flows: issuing bonds or other payable promises to raise funds; and
- (3) providing equities: selling a proportion of the company to investors (this option is normally only available for big shipping companies with high credit ratings).

Shipowners will have to provide security whichever option they choose, and there are generally three types of security that a shipowner could provide: the ship, the cash flow and the corporate recourse (in particular the balance sheet). A ship, as the security, is meaningless if she has been lost, damaged or incurred huge liabilities. Liabilities may attach to a ship for reasons of collisions and/or pollutions, and the *in rem* claims make the ship herself liable for potential unlimited liabilities. Therefore, taking ships as the security may expose financiers to unique risks that not have been seen in other industries. The balance sheet is basically a summary of financial balances of a company. It measures the company's assets, liabilities as well as the owner's equity, and the company's assets are always equal to the company's liabilities plus the owner's equity. Providing a balance sheet as security means that investors can evaluate a company by its published balance sheet. The statement of cash flow shows all cash receipts and payments made by the company during a year, indicating its cash position. The earnings of ships represent a major source of the cash flow in a shipping company, and any activity of issuing bonds will be reported in the statement as the cash flows out. It is through the statement that investors could evaluate whether a company is capable of repaying its debts.

### **2.4.5 Reflection**

Financing ships involves a large amount of capital, the rewards may be great but the risks are real. For ship financiers who are eager for success, it is essential to equip a good knowledge of the shipping industry, analyse the risk exposure thoroughly and manage those risks cautiously. Shipping markets are cyclic, considering shipping investments normally range from medium to long term, it is inevitable for ship financiers to come across one or more market cycles during the term. In the light of this, ship financiers should be well prepared to meet challenges arising from changes in the world's financial conditions,

transformations of shipping markets and emergent shipping risks. It is advisable that ship financiers hold a holistic view of the shipping industry rather than crash in for the hot money during booming periods, managing potential risks on an ongoing basis.

### **2.5 Why is ship finance special?**

The shipping industry has often been seen as a separation of all different branches of transportation where normal rules do not apply, and financing of the industry appears to be no exception. Although financing ships employs no more financial techniques than other sorts of financing, it requires specialised knowledge and a more flexible approach. The idiosyncratic nature of shipping<sup>42</sup> shows itself in a number of issues touched upon in this section, which arguably makes ship finance different in certain aspects from other asset-backed industries, such as the real estate and the aviation industries. These issues are considered in the following paragraphs.

#### **2.5.1 Capital intensity**

Shipping is a capital-intensive industry and the external funds needed are large, not only in absolute terms, but also in the amount that accounts for a high percentage of the total value of assets.

#### **2.5.2 Mobility of assets**

Unlike houses which stand on the land, ships are internationally mobile in a perilous environment. Unpredictable marine perils may result in a partial or total loss of the ships and cargoes, endanger earnings and other pecuniary benefits, and even incur liabilities of the ships, owners and other related parties (e.g. ship financiers) to the third parties, passengers and crews.

#### **2.5.3 Volatility of the cash flow and the value of assets**

In shipping, the cash flow and the value of assets are highly volatile. Although no competitive industry could avoid the fluctuation of the global economy, the shipping industry is sensitive to any minor change. Given that shipping

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<sup>42</sup> See Chapter 2, section 2.2 (A sketch of shipping).

investments normally range from medium to long term, the volatility of the cash flow and ship value produces significant risks for ship financiers.

### **2.5.4 A business structure without transparency**

Shipping companies often use a “single ship company” structure to manage certain operational risks and legal risks. However, such a structure is uncommon in other businesses that employ a similar amount of capital, where more formal corporate structures are usually mandatory. The structure of single ship company, under which the financed ship will be the only traceable asset of that company, is generally not in favour of ship financiers. Thus, any decline in the ship’s value may increase the credit risk; such declines can be caused by market fluctuations, damage to the ship, and liabilities attached to the ship.

## **2.6 The structures of ship finance**

Ship finance has a long history that can be dated back to the sixteenth century. The modern ship finance started in the UK from a widely spread “sixty-fourth shares company”<sup>43</sup> structure in the 1850s. It then develops from “joint stock company” in the second half of eighteenth century, the “charter-backed finance” in the 1950s and 1960s, the “asset-backed finance” in the 1970s, the “ship funds” and “limited partnership” in the 1980s, to the “corporate finance” in the 1990s.<sup>44</sup> A recent development of ship finance is that it has access to the financial market, beyond that, most techniques used to financing ships remain the same. In practice, mortgage-backed loans are dominating the ship finance market, but there is an array of alternative financing instruments, *inter alia*, ship leasing, high yield bonds, mezzanine finance, public offering of shares, and special purpose acquisition companies (SPACs). In the present research, no attempt has been made to analyse ship finance techniques in detail: a number of books can be referred if there is any interest in this topic.<sup>45</sup> The following discussions are

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<sup>43</sup> The practice of dividing a ship’s ownership into 64 shares is purported to start in medieval Italy where these shares were used to raise funds towards building and sailing of ships. This practice is still a norm today — the ownership of a British ship is divided into 64 shares.

<sup>44</sup> Stopford (n 36) 270-276.

<sup>45</sup> See, e.g. Stopford (n 36) Chapter 7; O Schinas, C Grau and M Johns (eds), *HSBA Handbook on Ship Finance* (Springer 2015) (hereafter in this chapter, ‘HSBA’).

necessarily selective, selecting on the basis of the involvement of marine insurance.

### **2.6.1 Categories of financing structures used in shipping**

A wide range of ship finance structures are available in the market, which can be categorised in different ways. The most common category is dividing those structures into debt finance, equity finance and mezzanine finance. In this research, ship finance structures are classified into four groups:<sup>46</sup>

- (1) Private funds, including shipowner's earnings from business and equities or loans from individuals.
- (2) Bank finance, including mortgage-backed loans secured by a mortgage on the ship, corporate loans secured against the company's balance sheet, shipyard credits for newbuilding finance, mezzanine finance and private placement.<sup>47</sup>
- (3) Capital markets, including public offering of shares and issuing bonds.
- (4) Special purpose vehicles (SPVs), which is the technique of using SPVs as the means to hold ownership of ships and raise funds, and it includes SPACs, limited partnerships (such as Norwegian KS and German KG), leasing and securitization.

### **2.6.2 Ship financiers: different attitudes towards the risk**

The ways of capitals generating profits are different under various financing structures, therefore, ship financiers' views towards the risk are diverse. Under the asset-backed finance structures, particularly the ship leasing and the mortgage-backed loan, revenues generated by the financed assets will repay debts and service interest payments. That is, the security for repayment of loans will primarily be based on assets which have being financed. Thus the value and liquidity of the assets are critical in the risk assessment of such a structure. In the context of shipping, an asset-backed finance structure will generally be successful if the financed ship is held a high value and a long effective operating life. Turning to the corporate loan structures, whether a company is creditworthy

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<sup>46</sup> Stopford (n 36) 282-310.

<sup>47</sup> Given the private placement in ship finance is often arranged by investment banks, it is included in the bank finance group.

becomes the most important evaluation factor, and the credit risk is the major risk of this structure. Loans are contracted case by case, which may be varied in their, *inter alia*, terms, covenants, and repayment methods. Nevertheless, structuring loans is essentially about assessing the company's cash flow and evaluating the company's ability of serving liabilities on the financed assets.

The providers of both asset-backed finance and corporate finance are lenders; in spite of the slight differences in their approaches to assess risk, any lender will be interested in a sound business. In other words, when advancing money to the shipowners, lenders will need to be ensured that the security is sufficient to protect themselves from the borrower's insolvency, the loss (if it occurs), and other creditors' attachments of the ship.

In contrast, attitudes of an investor towards the risk are entirely different from those of a lender. Taking the public offering of shares structure as an example, shareholders (unlike lenders) will not be repaid their investment capital, but they can share the company's profits. Accordingly, shareholders will be more interested in an upside of the business, which is the profitability of their investments. In the light of this, the volatility feature of shipping has become the main obstacle for shipping companies raising equity from stock markets. What shareholders chiefly expect is the consistent profit growth of the company which they have invested in, though few shipping companies can meet this criterion.

### **2.6.3 Mortgage-backed bank loans**

Shipowners often set up a single ship company to raise funds and hold ownership of the financed ship, so that any claim arising out of other ships in the owner's fleet can be isolated from the financed ship. However, such corporate structures increase the difficulty of taking security from the perspective of lenders. Securing investments are the top priority of lenders, and an underlying principle of holding security is that the sale proceeds of the secured assets can adequately cover the outstanding loans at any time. If applying this principle to the mortgage-backed ship finance transactions, an extensive list of covenants in respect of the ship's ownership, flag, classification, seaworthiness, employment as well as insurance will be contracted in the loan agreements to make sure that, in the event of owner's defaults, the sale proceeds of the financed ship can cover the outstanding loans.

If a lender (usually a bank) has considered a potential borrower's credit risk is acceptable, the funds will often be provided against a first priority mortgage on the financed ship, which is called the mortgage-backed bank loan. Ship mortgages are the cornerstones of the lenders' security package under the mortgage-backed loan structure, allowing lenders to claim against the ship in addition to their personal rights against the shipowners. Accordingly, in the case of the borrower's defaults, a mortgagee can take possession of the mortgaged ship and sell her for satisfying the outstanding debt. In spite of a first priority mortgage, lenders will also require other forms of security. This typically includes (a) an assignment of the ship's earnings (notably, charter-hire or freight); (b) an assignment of the shipowner's insurance, such as hull and machinery (H&M) insurance, war risks insurance and protection and indemnity (P&I) insurance; and (c) contingency insurances, which are specially designed to protect the mortgagees' interests, such as mortgagees' interest insurance (MII) and mortgagees' additional perils insurance (MAP). The purpose of taking an assignment of the ship's earnings and shipowner's insurance is to ensure that, in the event of owner's defaults, any income of the owner can be collected by the lender to satisfy its debts. These incomes normally include, *inter alia*, earnings, charter-hires, insurances, and requisition compensations. Contingency insurance required by lenders protect them against the risk of the claims under the shipowner's insurance being void, not payable, or exceeding the insured limits.

Taking security to protect the secured loans is not a case of "more is better" for several reasons. First, the burden of security may disrupt the owner's normal operations, which may result in a drop in the ship's earnings. Second, there is a fear of a secured lender being deemed in some cases as the actual controller of the financed ship, resulting in the lender's potential liabilities towards certain marine incidents (in particular environmental liabilities).<sup>48</sup>

### 2.6.3.1 Ship mortgage<sup>49</sup>

In order to create a fixed security, lenders will always require a first priority mortgage on the ship and a registration of the mortgage when using the

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<sup>48</sup> See Chapter 5, section 5.10 (Pollution liability and insurance solutions).

<sup>49</sup> See, generally, D Osborne, G Bowtle and C Buss, *The Law of Ship Mortgages* (2nd edn, Informa 2016) (hereafter in this chapter, '*Ship Mortgagees*'); SD Norton and C Chiste, 'Legal



mortgage-backed loan structure. By taking a mortgage on the ship, the lender becomes the mortgagee whereas the borrower turns to be the mortgagor.

(a) The nature of statutory mortgages

A statutory mortgage in the UK can be created only if a ship has been registered in accordance with the Merchant Shipping Act 1995 (MSA 1995) Part I or Part II (with full registration), other mortgages on a ship are either a common law (legal) mortgage<sup>50</sup> or an equitable mortgage (in the case of a subsequent mortgage), and there are two competing theories as regards the legal nature of the registered statutory mortgage.<sup>51</sup> The first theory is about the title transfer,<sup>52</sup> which means the title of a ship will be transferred from the mortgagor to the mortgagee, but the mortgagor will hold a right in equity to have the title being transferred back upon repaying the secured debt. However, an alternative and currently prevailing theory is about the statutory charge.<sup>53</sup> According to this theory, the ownership of a ship remains with the mortgagor, but the mortgagee has rights to take possession of the ship and exercise its power of sale to enforce the security in the event of mortgagor's defaults.

No matter which theory applies, however, mortgagees of the registered statutory mortgage are excluded from statutory liabilities under section 16(3) of the MSA 1995.<sup>54</sup> They also have insurable interests in the mortgaged ship according to section 14(1) of the Marine Insurance Act 1906 (MIA 1906). In the UK, a ship under construction cannot be the subject of statutory mortgages because she cannot be registered in accordance with the MSA 1995. It is not the same case in some other jurisdictions such as Germany, where taking mortgages on a ship under construction is permitted.

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Aspects of Ship Mortgages' in MG Kavussanos and ID Visvikis (eds), *The International Handbook of Shipping Finance: Theory and Practice* (Palgrave Macmillan 2016).

<sup>50</sup> See *The Shizelle* [1992] 2 Lloyd's Rep 444 (Adm) at 450.

<sup>51</sup> *Ship Mortgagees* (n 49) Chapter 1.

<sup>52</sup> See *Keith v Burrows* (1876) 1 CPD 722. Although the decision at first instance was reversed on appeal, the legal nature of a ship mortgage was not an issue in the higher courts.

<sup>53</sup> See, e.g. A Clarke, 'Ship Mortgages' in N Palmer and E McKendrick (eds), *Interests in Goods* (2nd edn, LLP 1998); H Beale and others, *The Law of Security and Title-Based Financing* (2nd edn, OUP 2012) para 14.40; L Gullifer, *Goode on Legal Problems of Credit and Security* (5th edn, Sweet & Maxwell 2013) para 2-21.

<sup>54</sup> Merchant Shipping Act 1995 s. 16(3), which excludes any mortgagee from the liability imposed on persons beneficially interested in a ship.

(b) The registry of ship mortgages

The registry of ship mortgages is important for the reason that the claims arising out of registered mortgages are ranked ahead of unregistered mortgages; it does not matter who has first created the mortgage or whether the registered mortgagee has knowledge of other mortgages on the ship.<sup>55</sup> Where more than one mortgage has been registered against the same ship or share, the registry order or time of mortgages will determine the ranking of these registered mortgages.<sup>56</sup> In the light of this, lenders always require a registered first priority mortgage on the financed ship to perfect their security.

(c) Maritime liens

Claims arising out of maritime liens<sup>57</sup> give rise to actions *in rem* against the ships and rights to arrest the ships, which are essentially in prejudice of the mortgagees' interests. Accordingly, there are potential conflicts between claims arising out of ship mortgages and maritime liens. Among those claims, maritime lien claims are ranked ahead of ship mortgages;<sup>58</sup> even maritime liens are attached to the ships after the creation of ship mortgages.

(d) The power of sale and insurance considerations

The MSA 1995 provides registered mortgagees the power of sale.<sup>59</sup> That is, in the event of shipowner's defaults, the registered mortgagees have rights to apply to the court for arresting and selling the mortgaged ships for paying off the outstanding loans. However, such rights are meaningless if the mortgaged ships have been damaged or lost. In the light of potential damages and losses of the ships, lenders usually require taking a full assignment of the shipowner's insurance (i.e. primary insurance). Once mortgagees have taken possessions of the mortgaged ships, it is essential to notify both insurers and Protection and Indemnity (P&I) clubs about such changes, or the insurance covers may be lost.<sup>60</sup>

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<sup>55</sup> Merchant Shipping Act 1995 Schedule 1, para 8(1).

<sup>56</sup> *Ibid* Schedule 1, para 8(2).

<sup>57</sup> Under English law, maritime liens only arise in relation to claims for collision damage, salvage, seamen's wages and master's wages and disbursements, see: *Bankers Trust International v Todd Shipyards Corp (The Halcyon Isle)* [1981] AC 221 (PC) at 232-233 (Lord Diplock).

<sup>58</sup> Under English law, mortgage claims are ranked beneath maritime and possessory liens and above statutory liens.

<sup>59</sup> Merchant Shipping Act 1995 Schedule 1, para 9.

<sup>60</sup> See, e.g. Gard AS, *Gard Rules 2017* (2017) rule 25(1)(a) <<http://www.gard.no/Content/>

## SHIPPING AND SHIP FINANCE

Mortgagees take over all the assured's rights after possession, who will therefore be subject to any action or counterclaim which would otherwise have been brought against mortgagors by third parties.

(e) How to manage the risk of declines in the value of ships?

A ship mortgage is an effective form of security for protecting the lender's interests, but it cannot secure the ship's value. In the light of extreme volatility in the ship's value, sale proceeds of the mortgaged ship may be insufficient to pay off the outstanding loans, especially during recessions. Assuming the ship's value has fallen by a certain percentage relative to the size of loans, the ship mortgagee may experience difficulty in deciding whether to exercise its power of sale or keep the ship and operate by itself, since sale proceeds of the ship can only cover part of the debt.

The idea of operating the mortgaged ship is apparently not attractive for lenders, thus they have developed two approaches to manage the risk of declines in the ship's value. The first approach is inserting a "value maintenance" clause into the loan agreement, of which requires the ship's market value being kept at a certain level in relation to the size of loans, or the mortgagee has rights to take certain measures.

The second approach is to take out ship mortgage indemnity insurance (SMI) which covers the risk of outstanding loans exceeding amounts raised through the ship disposal. This form of insurance is actually a type of financial insurance, providing indemnity for primary mortgagees in the event of shipowners fail to repay the debts for the reason of mezzanine loans (i.e. loans underwrite the subordinate or mezzanine level of debts),<sup>61</sup> which has the similar function of the mortgage indemnity guarantees. Where shipowners are seeking loans at a higher than usual loan-to-value level, as the case of mezzanine loans, the primary mortgagees often require SMI as hedges against the repayment default of shipowners.<sup>62</sup> In ship finance practice, normal loans provided by the primary mortgagees are accounted for 60 to 70 percent of the ship's value only, and shortfalls in funding may be raised through mezzanine loans which are, in

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22786698/Rules\_2017\_web.pdf> accessed 30 October 2017.

<sup>61</sup> PM Eggers, 'Mortgagees' Interest Insurance' in B Soyer and AM Tettenborn (eds), *Ship Building, Sale, and Finance* (Informa 2016) 182.

<sup>62</sup> PM Eggers and A Marriott, 'Ship Mortgages and Insurance Issues' (1998) 8 JIML 251, 257-258.

essence, second mortgages on the ship.<sup>63</sup> If shipowners have contracted with the mezzanine loans, servicing of such subordinate debts is costly so that may endanger the owners' cash flow, which in turn will impact the viability of the venture and cause negative consequences for the primary mortgagees. Although SMI provides assistance to the primary mortgagees in the event of shipowners' defaults for reasons of signing to the mezzanine loans, this form of insurance is very expensive with a premium cost can be substantial at 6 to 7.5 percent of the sum insured.<sup>64</sup>

### 2.6.3.2 *Insurance issues*

A loan agreement encloses the terms and conditions of finance, setting out parties' rights and obligations. Accordingly, a shipping loan agreement normally includes covenants relating to both the borrower and the ship, in which the borrower pledges to do certain things and not to do others.<sup>65</sup> The covenants are designed to impose contractual limits on the borrower's actions which can be divided into the positive covenants and the negative covenants. Under the positive covenants, the borrower pledges to comply with the terms and conditions of financial and other obligations, register the ship, maintain the condition and class of the ship, disclose any event of default promptly, and, in particular, ensure the ship's value always exceeds the outstanding loan at a certain percentage.<sup>66</sup> In contrast, the negative covenants limit the third party debt, cash dividends and pledge of assets to third parties.<sup>67</sup> From the perspective of lenders, the primary function of covenants is to ensure the ship's condition and operation are maintained to an appropriate standard throughout the entire loan term, as initially assessed by the lenders.

The insurance forms an essential part of covenants. Looking back to the nineteenth century, developments in the sophistication of marine insurance must have contributed to the popularity of secured shipping loans at that time.<sup>68</sup> A mortgaged ship with proper insurance covered allows lenders having direct access to the proceeds payable on a total loss, which is an obvious advantage

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<sup>63</sup> *Ibid.*

<sup>64</sup> *Ibid.*

<sup>65</sup> See *HSBA* (n 45) 61, which provides an example of covenants contained in a loan agreement.

<sup>66</sup> See, e.g. *Stopford* (n 36) 288; *HSBA* (n 45) 64.

<sup>67</sup> *Ibid.*

<sup>68</sup> *Ship Mortgagees* (n 49) 6-7.

## SHIPPING AND SHIP FINANCE

over the bottomry bond. In modern mortgage-backed finance, the fact that a mortgaged ship is often the borrowers' only asset contributes to the importance of insurance for ship mortgagees. If the borrower commits an event of default, the primary remedy for a ship mortgagee in practice is exercising the power of sale, thus the mortgagee's security interest in the ship will be diminished or eliminated in the event of the mortgaged ship being damaged, lost or subject to third parties' claims. In other words, the mortgage is of benefit to a mortgagee if only the mortgaged ship continues existing, preferably in an undamaged condition.

Ship mortgagees have substantial commercial interests in being satisfied that the mortgaged ships are properly insured against risks of loss or damage to an extent that the insurance proceeds can make up for the lack of or reductions in the sale proceeds. For example, the mortgagee may have to look at insurance in the case of a total loss of the mortgaged ship, because there will be a great danger that the borrower will not repay its debt. Ship mortgagees want to be ensured that the insurance proceeds are sufficient to repay the secured debt, and such insurance payments will be paid to the mortgagees directly and promptly. If the mortgaged ships have been damaged, mortgagees want to be ensured that the repair costs of ships can be fully covered by insurance. If the damage claims have exceeded a certain amount, mortgagees also require the insurance proceeds being paid to them directly. In addition, mortgagees want to be ensured that the risk of liabilities to third parties has been fully covered by insurance, otherwise there are risks that the mortgaged ship being arrested by third parties whose claims may rank ahead of the mortgagees' claims.

It is a common practice that the covenants state the borrower's obligation to insure the ship and to keep the ship insured throughout the loan period. The usual coverage required is for the ship being insured against, *inter alia*, the hull and machinery (H&M) risk, the war risk, the protection and indemnity (P&I) risk, and the fire risk. In addition, the borrower is often required to reimburse the lender's costs of taking out contingency insurance such as MII and MAP, and it is important for lenders placing the lender's insurance via their own brokers. If the borrower has taken out the lender's insurance through the same broker of the primary insurance, claims under the lender's insurance may be declined for the reason of potential conflict of interests faced by the borrower's insurance

broker.<sup>69</sup> A security interest over the insurance can be created by the means of assignment under English law, but it has to be a legal assignment in order to be effective.<sup>70</sup> In spite of the means of assignment, the mortgagee can participate in the primary insurance as a co-assured.<sup>71</sup>

### **2.6.4 Ship leasing**

Leasing is a technique, originating in the property business, which separates the use and ownership of assets. Under the ship leasing structure, a lessor (i.e. the legal owner of the assets) provides the assets to a lessee for use as if they are its own in exchange for regular lease payments over contractual periods. Such a technique has been widely used for financing the acquisition of ships, by which the ships are usually purchased by financial institutions (i.e. the lessor) and are then leased to shipping companies (i.e. the lessee) under fixed-term agreements. The lessee has complete control of the use and operation of the ships, but the ownership of the ships is vested in the lessor, who can therefore provide the ship and her title to other financial institutions (usually a bank) to obtain additional funding. Such funding is usually secured by a mortgage on the ship. In some lease agreements, particularly finance leases, it is common for the lessee to have an option/obligation to buy the ship at the end, or during, the leasing period.

#### *2.6.4.1 Types of lease*

There are two main types of lease structure: the operating lease and the finance lease. The finance lease has been more frequently used in ship finance. The lessee takes on all responsibilities for maintaining and operating the ship under the finance lease structure. Although the lessor legally owns the ship, most risks and costs arising out of holding the ownership can be absorbed by the lease. Accordingly, the role of the lessor in the finance lease structure is merely that of a financier, and it is the lessee who takes on the ship's residual value risk. In the UK, the Accounting Standards Board defines a finance lease as one that substantially transfers all the risks and awards of the ownership of assets to the

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<sup>69</sup> See Chapter 5, section 5.8.2 (Arranging contingency insurance with a separate broker).

<sup>70</sup> See Chapter 5, section 5.5.5 (As an assignee).

<sup>71</sup> See Chapter 5, section 5.5.3 (As a co-assured).

lessee.<sup>72</sup> The finance lease is often used to raise long-term finance, for instance financing liquefied natural gas (LNG) tankers and cruise ships, which will generally appear on the lessee's balance sheet.<sup>73</sup>

In contrast, it is the lessor who normally carries out the maintenance of ships over the lease term under the operating lease structure. The ship will be returned to the lessor at the end of the lease, and the lessee has the right to terminate the lease before its expiration. Given that the ship's residual value risk usually rests with the lessor under the operating lease structure, the lessor in some cases takes this as a speculative opportunity and expects significant returns from realising the ship's residual value. This type of lease is typically used to finance container ships,<sup>74</sup> representing off-balance sheet financing.

#### *2.6.4.2 Tax benefits of the finance lease structure*

Finance lease structures were historically popular in ship finance mainly for reasons of their tax benefits. In most jurisdictions, lessors are entitled to claim tax deductions for debt finance costs and equipment depreciation.<sup>75</sup> In order to boost investments, in some jurisdictions the government will provide tax incentives such as accelerated tax depreciation.<sup>76</sup> Many institutions have been tempted into the ship leasing business for such tax benefits, therefore collecting tax benefits is the primary motive of such lessors, and a proportion of the tax benefits obtained by the lessor may be passed on to the lessee in the form of a reduced charter hire. Consequently, the total cost of loans will be lower than other types of commercial loan, which is the main attraction for shipowners in raising funds by means of finance lease techniques. Such transactions of passing tax benefits from the lessor to the lessee are often known as "tax leveraged".

Ship leasing was very popular in the UK when the lessors were entitled to capital allowance, especially from 2002 to 2004.<sup>77</sup> Such forms of finance are now seen much less frequently, since the change in the tax position,<sup>78</sup> and the tax

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<sup>72</sup> See Statements of Standard Accounting Practice (SSAP) 21: Accounting for Leases and Hire-Purchase Agreements.

<sup>73</sup> Stopford (n 36) 308.

<sup>74</sup> Ibid.

<sup>75</sup> HSBA (n 45) 251-252.

<sup>76</sup> Stopford (n 36) 308.

<sup>77</sup> HSBA (n 45) 252.

<sup>78</sup> The change to the capital allowances position was made by the Finance Act 2006, Schedule 8.

authorities are now imposing more rigid requirements as regards tax benefits collection. Under current UK taxation rules, the lessor has to assume significant residual risks in transactions to claim tax benefits, provided that the lease was entered into on or after 1 April 2006, or the tax scheme available to a lease is the same as to other commercial loans (e.g. mortgage-backed loans).<sup>79</sup> In the light of there being no tax advantage to a lease compared with other commercial loans, UK banks are reluctant to adopt ship leasing.

### 2.6.4.3 Insurance issues

The ownership of a financed ship is the lessor's primary security, which is supplemented by a series of guarantees from the lessee. Ship leasing transactions may be based either on bareboat charters or time charters. The lessor is normally responsible for crewing, maintaining and insuring the ship if it is a time charter, while it is the lessee who is fully responsible for operating and insuring the ship (to a standard satisfactory to the lessor) under a bareboat charter.

Liabilities and responsibilities may arise for the lessor as a result of holding the ship's ownership: for example a lessor as the ship's registered owner bears responsibilities imposed by its flag state, and takes on statutory liabilities in relation to, *inter alia*, wreck removal, damage to port installations, and pollutions.<sup>80</sup> Lessors also face strict liability for oil pollution under the 1992 International Convention on Civil Liability for Oil Pollution Damage (1992 CLC),<sup>81</sup> and strict liability for bunker spills under the 2001 International Convention on Civil Liability for Bunker Oil Pollution Damage (2001 Bunker Convention).<sup>82</sup> Accordingly, lessors have interests in ensuring that all insurances have been properly taken out in respect of the ship and her associated liabilities, and the lessor will take an assignment of the lessee's insurance if the ship is insured by the lessee.

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<sup>79</sup> S Baughen, 'Lease Finance and Demise Charters' in B Soyer and AM Tettenborn (eds), *Ship Building, Sale, and Finance* (Informa 2016) 188.

<sup>80</sup> M Davis, *Bareboat Charters* (2nd edn, Informa 2005) para 35.2.

<sup>81</sup> 1992 International Convention on Civil Liability for Oil Pollution Damage art. 1.3. See also Chapter 5, section 5.10.1.1 (Lender liability under international conventions).

<sup>82</sup> 2001 International Convention on Civil Liability for Bunker Oil Pollution Damage art 1.3. See also Chapter 5, section 5.10.1.1 (Lender liability under international conventions).



## 2.7 Newbuilding finance

Shipbuilding plays a significant role in the economies of many countries. It creates a large number of jobs, so the government often directly or indirectly provides financial support for newbuilding projects. Accordingly, newbuilding finance involves a mixture of financial, commercial and political factors. The provision of financial support for shipbuilding originated in western countries in the late 1980s and 1990s, with a view to boosting the industry and increasing employment. East Asian countries are now actively supporting the shipbuilding industry and providing it with many favourable policies, such as export credits.

The construction of ships can be broadly divided into the pre-delivery stage and the post-delivery stage, and this distinction is important for two reasons. Firstly, the title of – and risk of loss or damage to – the ship normally rests with the builder before the the ship's delivery. Article VII of the Shipbuilders' Association of Japan (SAJ) form stipulates:

Title to and risk of loss of the VESSEL shall pass to the BUYER only upon delivery and acceptance thereof having been completed as stated above; it being expressly understood that, until such delivery is effected, title to and risk of loss of the VESSEL and her equipment shall be in the BUILDER....<sup>83</sup>

Similarly, clause 31 of the BIMCO Standard Newbuilding Contract (NEWBUILDCON) provides:

Title and risk of loss or damage to the vessel shall rest with the builder until exchange of the Protocol of Delivery and Acceptance is effected, immediately upon which title and risk shall pass to the buyer. At the time of delivery the vessel shall be free of all liens, claims, charges, mortgages and other encumbrances.<sup>84</sup>

It is possible to vest the title of the ship in the buyer during the construction period if the parties have agreed to do so, but this is not very common in practice.<sup>85</sup>

Secondly, there is a significant difference between the pre-delivery finance and the post-delivery finance. Newbuilding projects involve a large amount of capital, and despite the funds that will be obtained by the builder from its own source, the

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<sup>83</sup> SAJ form art. VII, para 5.

<sup>84</sup> NEWBUILDCON cl. 31.

<sup>85</sup> *Re Blyth Shipbuilding & Dry Docks Co* [1926] Ch 494 (CA); *BMBF (No. 12) Ltd v Harland & Wolff Shipbuilding & Heavy Industries Ltd* [2001] EWCA Civ 862. Title transfer during construction has been seen in Europe in contracts based on the Association of West European Shipbuilders form.

pre-delivery instalments payable by the buyer will be the primary source of funds to fulfil the projects. As a result, buyers have to raise funds before the ships are built, which creates particular problems for financiers in respect of the security in the case of pre-delivery finance. Unlike a completed ship, which can be used as the security for financing, a ship under construction is usually not available as the collateral.

### **2.7.1 Who insures the ship?**

The risk of loss or damage to the ship normally remains with the builder before the delivery to, and acceptance by, the buyer. The builder will, therefore, under normal circumstances, insure for construction risks and the buyer's supplies. Both parties to the contract will want to be ensured that risks of loss or damage to the ship have been adequately insured. The buyer particularly wants to be ensured that the builder's insurance has been properly taken out, in case the builder does not have enough funds to repair damages or to refund the buyer's advance payments, in the event of a partial or total loss of the ship. If such repairs should be uneconomic, then the insurance proceeds are an important source of funds. However, shipbuilders who are overconfident in their abilities and financial conditions to carry out the repair work or to make the refund may be reluctant to arrange builders' risks insurance, and this is not to the benefit of buyers.<sup>86</sup>

Most standard shipbuilding contracts contain clauses in respect of the builder's obligation to insure. Under the SAJ form, the loss risk of a ship rests with the builder until she has been delivered and accepted by the buyer, excepting risks of war, earthquakes and tidal waves.<sup>87</sup> Article XII of the SAJ form provides details as regards the builder's obligation to insure: insurances shall be taken out in the name of the builder and all losses under the policies shall be payable to the builder, and the excepted risks can be insured at the buyer's cost, provided that this has been requested by the buyer.<sup>88</sup> The builder is also obliged to insure a ship before delivery under the NEWBUILDCON, in particular clause 38(a) provides:

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<sup>86</sup> Interview with Jim James, Consultant, Norton Rose Fulbright (Hong Kong, PR China, June 2014).

<sup>87</sup> SAJ form art. VII, para 5.

<sup>88</sup> SAJ form art. XII.

## SHIPPING AND SHIP FINANCE

From the time of the first steel cutting or equivalent (or delivery of the buyer's supplies, whichever is the latter) until the vessel is completed, delivered to and accepted by the buyer, the builder shall (in joint names (as assureds) of builder and buyer) effect and maintain at no cost to the buyer, the Builder's Risk insurance for the vessel and the Buyer's supplies.<sup>89</sup>

In addition, clause 38(a)(ii) of the NEWBUILDCON requires the builders' risks insurance to be taken out on terms no narrower than those of the Institute Clauses for Builders' Risks (1/6/88), including war and strike clauses. The risks covered should include both physical and financial loss or damage to the insured ship.

If the builder's insurance is taken out in the name of the builder alone, the shipbuilding contract often provides that the builder shall execute in favour of the buyer an assignment of the shipbuilder's insurance, as a security for the pre-delivery instalments. However, it is not sufficient merely to attach a loss payable clause to the policy stating that the total loss claims will be paid to the buyer. In *The Angel Bell*,<sup>90</sup> Donaldson J expressed the view that 'a loss payable clause gives no rights to the loss payee unless it also constitutes or evidences an assignment of the assured's rights under the policy or evidences the fact that the designated person is an original assured'.<sup>91</sup>

The buyer can take out insurance separately for risks that may not be covered by the builders' risks policy, or for risks that may arise in the event of rescission of the contract. In particular, the buyer shall obtain covers for the ship's latent defects that may not be discovered during the guarantee period and that may be excluded from the builder's obligations under the guarantee.<sup>92</sup> The risk of loss or damage to a ship will be transferred to the buyer after the delivery of the ship, as will be the insurance obligation. Ship financiers normally require that the ships are insured with reputable insurers for their H&M and war risks, and with trustworthy P&I clubs for their third party liabilities.

### 2.7.2 Pre-delivery finance

Given the substantial costs and time-scales for building a ship, financing is crucial for the success of the newbuilding project. Funds may be raised by the buyer

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<sup>89</sup> NEWBUILDCON cl. 38(a).

<sup>90</sup> *Iraqi Ministry of Defence v Arcepey Shipping Co SA (The Angel Bell)* [1979] 2 Lloyd's Rep 491.

<sup>91</sup> *Ibid* at 497.

<sup>92</sup> See *China Shipbuilding Corp v Nippon Yusen Kabukishi Kaisha and Galaxy Shipping PTE Ltd (The Seta Maru)* [2000] 1 Lloyd's Rep 367.

## SHIPPING AND SHIP FINANCE

only, or by both the buyer and the builder at the pre-delivery stage. Some governments provide subsidy programmes to assist local shipbuilders in securing newbuilding orders, which go beyond finance based on the general commercial terms.<sup>93</sup>

The situation varies from project to project in respect of who owns the ship over the period of construction. If the ship's title remains with the builder until delivery (as it does under usual circumstances), the builder's security interest in the ship (i.e. ownership of the ship) prevails over those of other creditors. The buyer's pre-delivery instalments will therefore normally be secured by refund guarantees. The refund guarantee is vital in a shipbuilding project which secures the buyer's non-payment risk in the case of the builder failing to deliver the ship on time or becoming insolvent. It is commonly accepted that such a security will be provided by means of a bank guarantee from the builder's bank in favour of the buyer.

In many jurisdictions, including the United Kingdom, it is not possible to create statutory mortgages on a ship under construction, even to an extent that the ship's title may be passed to the buyer during the construction period. As previously discussed,<sup>94</sup> statutory mortgages can only be taken on a registered ship in the UK, and a ship must be used in navigation to be eligible for registration. As a result, the standard security package which is used by lenders to finance second-hand ships cannot work in newbuilding finance. The lender will have to seek other types of security instead of mortgages on the ship. These normally include an assignment of the shipbuilding contract, an assignment of the insurance and an assignment of the refund guarantee. In the event that the buyer defaults, an assignment of the shipbuilding contract will enable the lender to continue with the ship's construction, take delivery of the ship and sell it to pay off the outstanding loans.

However, lenders have no interest and/or experience in performing the role of shipowner. Moreover, an assignment of the shipbuilding contract cannot protect against the non-return of pre-delivery instalments risk if the builder fails to deliver the ship on time or becomes insolvent, but the strength of an assignment of the refund guarantee can be countered with the weakness of an assignment of the

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<sup>93</sup> For example, the export credit.

<sup>94</sup> See Chapter 2, section 2.6.3.1 (a) (The nature of statutory mortgages).

shipbuilding contract. In addition, refund guarantee insurance is commercially available, and it covers the risk of a default on the part of the guarantors who guarantee the refund of advance payments made under shipbuilding contracts.

### **2.8 The conflict of interests**

The interests of ship financiers and shipowners may in conflict, despite their mutual interest in the success of the finance project, and such conflicts lead to different perceptions of risk. A shipowner, on the one hand, whose objective is to maximise returns with the least investments, will naturally want to limit the financier's interference and keep the greatest flexibility in operating the ship. On the other hand, the ship financier will want the shipowner to invest as much of its own capital as possible, so as to reduce the financial risk of the project. Financiers may prevent shipowners from taking business risks under some circumstances for the safety of their investments but, if they apply too many restrictions, then this may slow the growth of the shipping companies. In the light of this, it is important for financiers to keep a balance between securing their investments and granting the shipowners sufficient flexibility in their ship operations. Likewise, ship financiers and shipowners are not always expecting the same as regards the way of insuring the financed ships. Even if all the policies required by ship financiers have been properly taken out, and all the gaps between the insurance covers have been carefully checked, the financed ship may still fall out of the protection of insurance under certain circumstances. These issues will be discussed in the following chapters.<sup>95</sup>

### **2.9 Trends in ship finance**

Traditionally, shipowners used a combination of retained earnings and secured borrowings from commercial banks to finance the purchase of newbuildings and second-hand ships, therefore a typical transaction involved a bank advancing loans to an SPV with the support of a range of security. The principal types of security included a first priority mortgage on the financed ship, an assignment of all the ship's earnings, an assignment of all the insurances, as well as a personal

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<sup>95</sup> See, generally, Chapter 5 (Marine insurance: general rules and legal risks).

## SHIPPING AND SHIP FINANCE

or parent company guarantee.<sup>96</sup> As a result, ship finance was a game between participants who all knew each other and was heavily dependent on trust and reputation.

However, the market has seen changes since a sharp rise in ship prices and charter rates in 2003.<sup>97</sup> In response to huge economic incentives, shipowners had actively adopted alternative ship finance techniques, such as leasing, public equity offerings, subordinated debts and high yield bonds.<sup>98</sup> In addition, capital markets had expanded their investments in shipping, because the shipping industry had shown strong cash flow while benchmark interest rates were sluggish across Europe and America.<sup>99</sup> A combination of new entrants and innovations in financial products had made the ship finance market more transparent than it once was. Notwithstanding, the increase in investment had pushed up the value of ships, and the industry had consequently attracted a lot of speculators.

By 2007, traditional shipping banks were underwriting or syndicating loan transactions of US \$1 billion or more.<sup>100</sup> Unfortunately, the shipping capitals dried up soon after the liquidity crisis in banking in 2007.<sup>101</sup> In 2008, the bankruptcy of the Lehman Brothers and the collapse of the securitization market had resulted in a large recession of the world economy, and its reflection in shipping was huge declines in freight rates and ships' values.<sup>102</sup> As a consequence, a lot of European banks withdrew from the shipping industry. Even those who chose to stay in shipping narrowed their shipping business significantly. Indeed, the volume of shipping bank loans shrunk by two-thirds between 2007 and 2009, and by 2014 it had only recovered to about half its volume in 2007.<sup>103</sup> Meanwhile, the banking system was experiencing pressure from Basel III and stricter supervision from the governments.<sup>104</sup> Accordingly, the bank lending is expected, in future, to

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<sup>96</sup> Stephenson Harwood (ed), *Shipping finance*, (3rd edn, Euromoney 2006) Chapter 8 and Chapter 9.

<sup>97</sup> OECD, 'Report on Ship Financing' (June 2007) 3.

<sup>98</sup> *Ibid.*

<sup>99</sup> *Ibid.* 4.

<sup>100</sup> L Rutkowski 'Global Overview' in L Rutkowski (ed) *Ship Finance 2014* (Law Business Research 2014).

<sup>101</sup> *Ibid.*

<sup>102</sup> *Ibid.*

<sup>103</sup> *Ibid.*

<sup>104</sup> See n 27.

be more careful, selective, conservative (relative to commercial risks undertaken), and ultimately scarcer.

In an environment of recessions, the capital-intensive feature of shipping seems immutable, the periodic renewal demand of fleets remains, and global trade is still heavily dependent on shipping. Although commercial bank loans remain the most important source of capital for shipping today, institutional investors in shipping such as private equity investors and hedge funds have attracted considerable attention over recent years. In particular, private equity investors are actively buying shipping loans from commercial banks.

### **2.10 Conclusion**

This chapter has laid the foundation for the arguments in the following chapters. On one hand, financiers investing in shipping seek a balance between the risk of loss and return on capital, just as they do when investing in other industries. On the other hand, financing ships is distinct from the financing of other asset-backed industries, mainly for reasons of capital intensity, mobility of assets, volatility of cash flow and values of assets, as well as business structures without transparency. As a result, apart from the common risks associated with financing activities, ship financiers are directly or indirectly exposed to a wide range of shipping risks. In the practice of ship finance, marine insurance forms an integrated part of the financiers' security packages, since it may transfer certain types of risk in relation to ship finance projects to marine insurers. However, for legal and practical reasons, it is usually shipowners or shipbuilders who insure the financed ships, while financiers participate in the primary insurance in certain ways. This raises the questions as to "what types of risk may be insured" and as to "how to participate in the primary insurance", which will be considered in chapter 4 and chapter 5 respectively.

Ship financiers, against the background of their exposure to various shipping risks, naturally hope to minimise the likelihood of adverse effects on the overall performance of the financed projects. In view of taking risks is inevitable for obtaining business opportunities, managing risks forms a key part of day-to-day operations. The following chapter will take an insight into the risk management process of ship financiers; within that framework, it will further examine the

## SHIPPING AND SHIP FINANCE

contribution of marine insurance, as a risk management tool, to the success of ship finance projects.



## CHAPTER 3

# RISK MANAGEMENT IN SHIP FINANCE: THE ROLE OF MARINE INSURANCE

### 3.1 Introduction

We live in a world of risk and uncertainty and risks are a part of daily life, not only for individuals but also for companies. No business is risk-free; shipping companies carry risks from the acquisition and operation of their ships. Similarly, ship financiers are faced with substantial business risks in the course of making shipping investments. These risks range from defaults on loan agreements, to declines in the ships' market values, to changes in regulation. Such risks are considerable and, in some cases, potentially ruinous. Risks are costly, but they come with opportunities. If a company does not take risks, it may also be avoiding all business opportunities. In the light of this, ship financiers who desire huge economic rewards have to expose themselves to considerable business risks.

Risk is unavoidable but manageable. As individuals, we manage risks daily both consciously and unconsciously. Risk management is a practice that could be traced back to the cavemen, while modern risk management has developed into a scientific process. Modern risk management aims to identify and manage risks faced by companies or organisations, for the purposes of assisting them in achieving their business or development goals. Although insurance is arguably its predecessor, modern risk management is much broader than mere insurance purchases. Nonetheless, insurance buying continues to be an important part of managing business risks. In fact, the concept of risk management is not unfamiliar to financial markets, and financiers have a long history of using various mathematical models to calculate risk and build it into the prices of their products; for example, bankers often use a 5C model<sup>105</sup> to assess business risks.<sup>106</sup>

This chapter provides original suggestions concerning the role of marine insurance in ship finance. For this purpose, it first examines the whole of the risk

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<sup>105</sup> 5C: namely collateral, capital, conditions, character and capacity.

<sup>106</sup> O Schinas, C Grau and M Johns (eds), *HSBA Handbook on Ship Finance* (Springer 2015) 42.

management process as carried out by ship financiers, including establishing objectives (section 3.4), as well as identifying and evaluating risks (section 3.5). Turning to the implementation of risk management techniques, it argues that insurance (including marine insurance) is a tool of risk management, with benefits and limitations (section 3.6.4). In the light of this, marine insurance has an important role in the general risk management process of ship financiers, as an effective tool to transfer certain shipping risks to insurers who are not directly involved in the ship finance projects (section 3.6.5).

## **3.2 Risk management in ship finance**

### **3.2.1 What is risk management?**

There is no universal definition of “risk management”, and so its meaning will be interpreted in accordance with specific contexts. For individuals, risk management may mean managing risks associated with fluctuations in earnings, since an individual’s income productivity may decline due to death, disability, ageing, or changes in technology. Measures to manage these risks include, *inter alia*, purchasing insurances (such as pensions and life insurances), developing sidelines, and investing savings. For companies, risk management broadly refers to a practice utilising many tools and techniques (insurance included) to manage a wide variety of risks regarding the business. Risks which have been commonly seen in businesses include fire, employee injuries and product liabilities (or professional liabilities) which also combine some more sophisticated exposures such as environmental impairments, financial risks (e.g. risks arising out of interest rates, foreign exchange rates and derivatives) and emerging risks (e.g. cyber risks). Risk management has arguably evolved from the concept of insurance management, but modern risk management practices consist of a much broader scope of activities and responsibilities than this. However, insurance purchase remains an effective tool in managing risks, in particular managing pure risks.

Companies take risks to obtain business opportunities, but they may also have to face undesirable outcomes. Some risks are predictable and under control, whereas others may be unpredictable and uncontrollable. Accordingly, risk management is essentially about companies identifying and accepting those risks which they have a core competency to handle, while identifying and transferring

risks outside of their core competencies. The principle of risk management is based on the nature and core needs of the specific business, and on being aware of which risks to exploit and how to exploit them. In general, a reasonable risk management process must ensure that, at any time, risks taken by the business are commensurate with its capital base and/or present limits and/or other criteria laid down by the regulatory bodies, insurers and the company itself.

### **3.2.2 Why should ship financiers manage risks?**

Shipping carries special characteristics which distinguish it from other asset-based industries,<sup>107</sup> and these characteristics contribute to a particularly dynamic environment with high risks of loss of investment capital. In the light of this, financiers who invest in shipping shall evaluate a broad range of different parameters in order to limit the risk of loss on one hand, and in order to keep an efficient risk-yield balance on the other hand. Risk management has played an increasingly important role in ship finance in recent years, which is partly because the risks involved in the shipping business are fast changing – for instance, environmental liabilities have become stricter (e.g. liabilities related to ballast water and air pollution), there are emerging risks (e.g. cyber risks) and economic sanctions are more frequently put in place. Another reason is that many new entrants have joined the ship finance sector, and they are more likely to increase the risks in shipping, due to lack of experience and/or knowledge in respect of the industry. There is no standard risk management process; such processes vary from case to case and may change over time. Nevertheless, it is a prudent policy for both lenders and investors to evaluate their risk exposures and implement an effective risk management strategy, especially for those new entrants who have not experienced a whole shipping cycle in such a cyclical industry.

## **3.3 The risk management process**

In practice, all players in the ship finance chain will have their own risk management strategies. Some may implement a formal policy into their business strategy. Some will probably adopt *ad hoc* measures, when necessary. Others

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<sup>107</sup> See Chapter 2, section 2.2 (A sketch of shipping).

may act unconsciously by responding to crises. Despite the variety of risk management approaches, a formal risk management process commonly involves several key steps:<sup>108</sup>

- (1) Establish the objectives of risk management.
- (2) Identify and evaluate risk exposures.
- (3) Select and implement appropriate risk management methods.
- (4) Monitor and review performance on an ongoing basis.

### **3.3.1 Establish the objectives**

The first step (determining objectives) is vital. It sets out what ship financiers expect from the risk management process, and financiers using different finance structures may have various expectations of the risk management process. Obviously, lenders and investors are distinguished from each other in respect of their expectations. As discussed in the previous chapter,<sup>109</sup> the attitudes of lenders and investors towards risks are different, although both are averse to risks which can lead to unexpected negative fluctuations in the project's cash flow or the asset's value. The primary goal of a lender is to be promptly and adequately repaid with interest, so the lender's focus is on the soundness of a project. In contrast, an investor can share the company's profits, thus the investor has more interest in the upside of a business. That is, investors always ask how profitable the investment is, while lenders often evaluate the soundness of a business.

Objectives of risk management can only be established according to the specific situations of the specific financier. As a result, such objectives vary not only from financier to financier but also from project to project. In shipping, risk management objectives set for financing second-hand ships on the one hand, and for financing pre-delivery instalments for newbuildings on the other hand, will be very different. Although it is impossible to identify the objectives for all ship financiers, this research will address some general issues.

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<sup>108</sup> See SE Harrington and GR Niehaus, *Risk Management and Insurance* (2nd edn, McGraw-Hill Higher Education 2003) 8-9 (hereafter in this chapter, '*Risk Management*'). See also CA Williams, ML Smith and PC Young, *Risk Management and Insurance* (8th edn, McGraw-Hill 1998); A Punter, *Risk Financing and Management* (2nd edn, IFS 2007); GE Rejda and MJ McNamara, *Principles of Risk Management and Insurance* (12th edn, Pearson 2013).

<sup>109</sup> See Chapter 2, section 2.6.2 (Ship financiers: different attitudes towards the risk).

### 3.3.2 Risks identification and evaluation

Risks obviously stand at the centre of the risk management process, therefore the second step in the process will be the risk identification and the risk evaluation. A combination of tools is often used to assist the practice of risk identification, *inter alia*, insurance policy checklists, inspection of the ships, and analysis of shipping markets. This is a very challenging task because risks are not static. For example, risks will obviously be different to the norm for a ship sailing in a war zone, sanctions may be imposed as political leverage at any time, and changes in environmental regulations may require the ships to upgrade to a new (i.e. greener) standard. In essence, identifying risks is about gathering information, and this information should be up to date. The collected information will be evaluated following the identification of risks. Such evaluation mainly considers the “potential size of the loss” and the “probability of the risk occurrence”. Risks can be prioritised in accordance with the evaluation result; some risks may have significant impacts on the success of the business, while others may not.

### 3.3.3 Risk management techniques

Once the risks have been identified and evaluated, appropriate approaches will be put into place to deal with different risks. Broadly speaking, risk management techniques can be classified into two categories:<sup>110</sup>

- (1) Risk control—taking steps to change the profile of risks by reducing the frequency and/or severity of risks, with a focus on minimising the risk of loss to which the business is exposed;
- (2) Risk financing—actions of financing the consequences of risks to the extent of ensuring adequate funds to pay for or offset losses.

To be specific, risk control consists of risk avoidance and risk reduction, while risk financing can be further divided into the risk retention and the risk transfer. Risk avoidance (or loss prevention) involves taking measures to prevent a loss from occurring by means such as employee safety training. Risk reduction (or loss reduction) is taking steps to reduce the probability or the severity of a loss, for example, installing fire sprinklers. Risk retention (referred to as self-insurance)

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<sup>110</sup> See *Risk Management* (n 108) 9-12. See also CA Williams, ML Smith and PC Young, *Risk Management and Insurance* (8th edn, McGraw-Hill 1998); A Punter, *Risk Financing and Management* (2nd edn, IFS 2007); GE Rejda and MJ McNamara, *Principles of Risk Management and Insurance* (12th edn, Pearson 2013).

involves setting up a special account or fund to be used in the event of losses. Finally, risk transfer refers to the practice of placing responsibility for losses on other parties by means of the contract. Examples of risk transfer include insurance contracts which allow companies to pay a premium in exchange for certain risks being insured, hedging (with derivatives), and a variety of forms of contractual risk transfer.

It is worth noting that there will always be a cost for managing risks. For example, if insurances have been purchased against certain risks, then there will be premiums charged by insurers as in return for accepting these risks. There will be a cost even if risk managers have chosen to do nothing (normally with insignificant risks), because it is possible that risks do actually occur which will certainly cost the business. In the light of this, there is no “good or bad” as regards risk management techniques, and the appropriate risk management approach for the particular context is the best one.

### **3.3.4 Reviewing the process**

The risk management process shall be reviewed on an ongoing basis, and such review is essential for two main reasons. First, the risk profile may change, under which circumstances the risk management process must restart from the risk identification step. Second, the risk management techniques that have been chosen and implemented may turn out to constitute an inappropriate approach, in which situation changes will need to be made as soon as possible.

## **3.4 Objectives of risk management in ship finance**

Risk management is important in ship finance because there is a variety of shipping related risks which have adverse impacts on the shipping companies' financial performances and solvency, and such risks will ultimately weaken financiers' future business opportunities.<sup>111</sup> Broadly speaking, the purpose of ship financiers' risk management is to define limits for the risks which they are going to take. In other words, ship financiers will manage risks in such a way as to ensure that the risks they are going to take are affordable within their present financial limits, at any time.

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<sup>111</sup> See, e.g. Danish Ship Finance, 'Annual Report 2016' (2016) 26-40  
<<http://www.shipfinance.dk/media/1706/aarsrapport-2016-uk.pdf>> accessed 30 October 2017.

Different ship financiers' expectations towards risk management outcomes are varied. In general, the goal of investment funds is essentially to maximise returns, and the returns must justify the risks. As discussed in the previous section,<sup>112</sup> investors and lenders require different justifications: investors have more interest in boosting profits, while lenders are more focused on securing their investments. Beyond that, different institutions have different understandings as regards the meaning of "return"; even the same institution may not always have the same view of return when providing finance for different clients, when it comes to different types of business or different periods. For example, the meaning of a "good return" may be different when a bank provides funds for clients with varied credit-ratings. The bank may be willing to lend with a low-interest rate to a creditworthy borrower, while it may not accept business from borrower with a poor credit-rating, even on a high-interest rate. However, the fundamental objective of risk management is to minimise the cost of risks. This should be interpreted more broadly than merely the cost of expected losses (direct or indirect), but should also include loss control cost, loss financing cost, internal risk reduction cost and residual uncertainty cost (for example, costs arising out of the risk's impacts on shareholders and other stakeholders).<sup>113</sup>

### 3.5 Analysing risks in ship finance

Risk analysis is complex systematic work, since the risk profiles vary from project to project. Shipping companies are undoubtedly exposed to substantial risks, *inter alia*, risks arising out of operations, risks associated with financial structures, and risks resulting from regulation changes. These risks impact the financing project's overall performance, and such effects will ultimately reflect on the ship financiers' capital returns.

#### 3.5.1 Essential elements

Not all risks, in reality, can be measured by models, but certain financial models are very helpful in assisting financiers in recognising their risk exposures. For example, banks often use a 5C model to summarise the main set of risks associated with providing loans, which will include collateral, capital, conditions,

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<sup>112</sup> See Chapter 3, section 3.4 (Objectives of risk management in ship finance).

<sup>113</sup> *Risk Management* (n 108) 16-20.

charterer, and capacity. However, if we think outside of the existing models, the starting point of risk identification is to identify the fundamental weaknesses of the shipping industry for both debt providers and equity investors. There is no straightforward answer. However, as discussed in the previous chapter,<sup>114</sup> the features of ship finance have indicated that any risk relating to the cash flow, the value of ships and the shipping market shall be taken into account.

The primary concern of both debt providers and equity investors will be the cash flow. Repayments of interests and principals are mainly dependent on the shipowners' earnings, thus the sufficiency of low cash flow in covering interest and full debt services will be of constant concern to debt providers, especially in an industry as volatile as shipping. Similarly, the average returns of equity investors are significantly affected by cash flow, so any risk related to cash flow will naturally attract the investors' attention. Another cornerstone of ship finance is the ship herself. Given that a ship is always the principal – and sometimes the only – asset of a shipping company, the ship's value is of great importance to those investments directly secured by the ship, such as the mortgage-backed finance and ship leasing. In addition, the performance of a ship has a considerable impact on the cash flow, given the ship is the major cash generator of a shipping company. As a result, the ship must be maintained in good condition to ensure a steady cash flow. Beyond risks in respect of the cash flow and value of ships, risks related to the shipping market should not be underestimated, shipping market risks are directly linked with economic cycles.

Consequently, the following sections propose a framework for identifying and evaluating the most important risks generally tied to ship finance projects, covering not only financing with debt structures but also financing with equity structures. However, it is worth noting that there will never be an exhaustive list of such risks. In addition to the following mentioned risks, other risks of which respective project companies are currently unaware, or risks that are currently considered to be non-material but which may materialise at a later stage ought not to be underestimated. Therefore a risk analysis, in reality, needs to be

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<sup>114</sup> See Chapter 2, section 2.5 (Why is ship finance special?).



conducted in the context of a particular project during a specific period. In this research, the identified risks<sup>115</sup> are classified into three groups, namely:

- (1) risks associated with the operating cash flow;
- (2) risks associated with the value of ships; and
- (3) risks associated with the shipping market.

### **3.5.2 Risks associated with the operating cash flow**

Risks associated with cash flow arising out of variations in both output price and input price. The output price risk generally refers to changes in the prices that a company can demand for its goods and services, whereas the input price risk refers to changes in the prices that a company needs to pay for labour, materials and other inputs of production.<sup>116</sup> In shipping, cash flow risks include the following four examples: the freight rate risk, the operational risk, the operating and voyage cost risk and the counterparty risk. In the case of financing newbuilding projects, there is often a delay in delivery risk, which also affects the shipowner's cash flow.

#### *3.5.2.1 The freight rate risk*

The freight rate risk refers to the risk of shipping company's earnings fluctuating. Shipping companies generate cash mainly by providing shipping services and freight contribute to the most important income source of shipping companies. As a result, the volatility of freight rates considerably impacts shipping companies' performances. Such risks will subsequently impact ship financiers in two main ways: (a) by affecting the likelihood of debt providers being repaid adequately and promptly; and (b) by affecting the expected profitability for equity investors.

#### *3.5.2.2 The operational risk*

The operational risk, in general, refers to the risks that affect ship operations. It may include pure risks in relation to lives, cargoes and ships, and these are considered later.<sup>117</sup> The term also covers the risks of disruption to the transport chain and failure to meet customers' demands: for example, the off-hire risk, the

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<sup>115</sup> See, generally, M Stopford, *Maritime Economics* (3rd edn, Routledge 2008) 284; O Schinas, C Grau and M Johns (eds), *HSBA Handbook on Ship Finance* (Springer 2015) 43-54; Danish Ship Finance, 'Annual Report 2016' (2016) 28-40.

<sup>116</sup> *Risk Management* (n 108) 4-5.

<sup>117</sup> See Chapter 3, section 3.5.3.2 (The pure risk).

charterer's reputation risk, and the port state detention risk due to non-compliance with regulations (in particular, those regulations in respect of navigation safety and environmental responsibility).

### *3.5.2.3 The operating and voyage cost risk*

Broadly speaking, the operating and voyage cost risk includes risks in relation to, *inter alia*, fuel cost, crew cost, port cost, repair cost, and insurance cost. Changes in operating costs have impacts on the input price, so may affect shipping companies' cash flow. Fuel cost (or bunker cost) contributes a significant percentage of the whole operating cost. However, oil markets are even more volatile than shipping markets, thus risks arising out of fluctuating fuel costs must be cautiously managed. Insurance cost is also a major type of operating cost, and some specialist insurance covers can be very expensive. In addition, the interest rate risk and the currency risk are substantial for shipping ventures. Most ship finances are based on floating rate bank loans, under which circumstances changes in interest rates will directly increase the financial cost and may indirectly affect the ship's value at the time of sale. Given that USD is the typical reference currency in shipping, companies outside the US are often exposed to the currency risk. That is to say fluctuations in currency can affect the ship's net value when the reference currency (i.e. USD) is converted into local currency.

### *3.5.2.4 The counterparty risk*

The counterparty risk refers to the risk of other parties in the shipping transaction chain failing to perform their obligations. However, the investment returns' calculation is largely dependent on the possibility of other counterparties fulfilling their obligations. The types of counterparty in shipping are diverse: for example, shipowners and charterers under a charter, shipowners and bunker suppliers under a bunker supplies contract, and shipowners and shipyards under a shipbuilding contract. Both the willingness and the aptitude of counterparties are crucial in fulfilling contracts, and default on the part of any counterparty may have domino effects on other related transactions. The counterparty risk can lead to fluctuations in cash flow, consequently increasing the shipowner's default risk.

#### *3.5.2.5 The delay in delivery risk*

Delays in delivery are not uncommon in the cases of newbuilding finance, but an array of problems will arise out of such delays. For example, such delays may cause a reduction in charter rates, or even cause the charters' legitimate cancellation. However, owners of newbuildings need to generate revenue from charters. Should the new ships be delayed in delivery, the shipowner's cash flow will be affected, and so too will the financiers' investments.

### **3.5.3 Risks associated with the value of ships**

The importance of ships to both lenders and investors is undoubtedly in ship finance. This research has identified two types of risk which have significant impacts on the ship's value, including the ship price risk and the pure risk.

#### *3.5.3.1 The ship price risk*

The prices of ships generally fluctuate within the economy. Beyond the impact of market cycles, competitiveness within the market will also contribute to the fluctuations in a ship's values. Competition exists not only in the same segment market; there is competition from different types of ship, and even from other modes of transportation. In addition, a ship's price normally decreases as her age increases, since the risks carried by a ship will change over time. For example, a new ship carries a high capital cost thus she is vulnerable to the capital cost risk, while an old ship carries a lower capital cost but she is vulnerable to the operational risk. The fluctuations in ships' values affect shipping companies from two aspects: first, they affect the shipping companies' balance sheets; and second, they affect the shipping companies' credit-ratings. The ship price risk is a chief concern of lenders in particular, who take the financed ships as collateral.

#### *3.5.3.2 The pure risk*

The pure risk refers to the risk of loss of – or physical damage to – ships. It may arise out of circumstances including (but not limited to) marine disasters, war, terrorism or piracy, political actions, environmental incidents, mechanical failures and human error. On one hand, the pure risk increases the shipowner's operating costs, so impacting its cash flow; on the other hand, the pure risk can decrease the ship's values. In addition, the pure risk includes legal liability risks to ships,

such as those arising out of collisions or oil spillage incidents. The consequences of environmental incidents may be ruinous for shipping companies, not only because of the related environmental liabilities incurred, but also because of potential damages to the companies' reputation, which ultimately decreases its future earning capacity. In the event of financing being under a single ship company structure, the environmental liabilities incurred may pierce the corporate veil, rendering financiers directly responsible for such liabilities.

Although most of the pure risk can be managed by purchasing insurances, there is an array of problems in relation to buying insurances: for example, insurance covers may turn out to be inadequate, insurance claims may be declined, a particular risk may be uninsurable and certain forms of insurance policy may be too expensive.

### **3.5.4 Risks associated with the shipping market**

Investing in shipping involves a large amount of capital and significant risks, and ship finance exists as a separate branch of the asset-backed finance for many reasons.<sup>118</sup> Consequently, ship financiers are often faced with unique risks which may threaten their capital returns, costing financiers all or part of their investment. In the light of this, three types of risk in relation to the shipping market are identified here, including the cyclical risk, the political risk and the regulatory risk.

#### *3.5.4.1 The cyclical risk*

The shipping market is cyclical in nature, and this feature of the market is reflected in the volatility of freight rates and charter hire rates, and will also be reflected in the ship's residual value. The shipping cycles are essentially driven by changes in the supply and demand in shipping capacities. However, the factors which impact the supply and demand in shipping capacities are complex. From a macro perspective, such changes may be caused by transitions within global and regional economies; whereas, from a micro perspective, such changes may arise out of fluctuations in bunker prices. A common feature of these factors is that they are beyond the shipping companies' control. Although shipping companies cannot do much to affect the shipping cycles, implementing

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<sup>118</sup> See Chapter 2, section 2.5 (Why is ship finance special?).

effective risk management strategies can reduce the damage of such market cycles on the companies' performance and profitability.

#### 3.5.4.2 *The political risk*

Ships operate globally by calling at ports in different countries around the world. As a result, shipping companies are exposed to the political risk, which refers to the risk of loss caused by events in a particular country that are controlled (to some extent) by the local government. For example, a shipping company is exposed to the risks of political unrest, terrorist attack, and various forms of instability (e.g. military and economic). The consequences of political risks on shipping include (but are not limited to) the disruption of operations and businesses, difficulties with law enforcement authorities in certain jurisdictions, operating cost increases and an increase in the charterer's default risk.

Among those political risks, the piracy risk has significantly threatened the shipping industry ever since the dawn of merchant shipping. Somali piracy, which occupied headlines for a long time, has quietened, with such activity off the coast of Somalia having fallen, by late 2015, to just 1% of its level in 2011.<sup>119</sup> Pirates generally approach ships while firing at them with light weapons, in an attempt to hijack them. Once a ship has been hijacked, the pirates usually request a large ransom in exchange for the safe return of the crew, the ship and cargoes on board. Such a "hijack for ransom" model is essentially fostered from onshore factors, such as political instability in particular areas. Turning to the terrorism issue which is a "baby crime" compared with piracy,<sup>120</sup> but has shown itself to have the potential to be destructive beyond any other forms of political risk. Such terrorist attacks can easily turn a ship into an explosive weapon if she has carried dangerous goods on board, or they may be carried out in new forms such as cyber-attacks to automatic ships in the near future.

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<sup>119</sup> T Hart, 'Risk Map 2016: Maritime Risk Outlook' (*ControlRisks.Com*, December 2015) <<https://www.controlrisks.com/en/our-thinking/analysis/maritime-risk-outlook>> accessed 30 October 2017.

<sup>120</sup> Maritime piracy has arguably been a crime committed at sea for as long as the oceans were plied for commerce — the documented piracy instances can be dated back to the 14<sup>th</sup> century B.C. In contrast, maritime terrorism is a relatively new crime while a growing threat to global trade. The reported terrorist attacks at sea including, *inter alia*, the hijacking of cruise liner *Achille Lauro* in 1985, and the attack against *USS Cole* in 2000.

#### 3.5.4.3 *The regulatory risk*

The shipping industry has been extensively regulated, not only by international conventions but also by national laws. The shipping companies' compliance costs can be very high: for example, the extra expense incurred in upgrading ships and/or operating procedures to a greener standard, or the additional insurance expense incurred in complying with higher environmental or safety requirements. It is difficult to predict regulation changes in the long-term, but a recent trend at international level has been the requirement for shipping to be greener. Shipping companies have to take measures to comply with any formally adopted new law, in order to pass the annual survey and/or to obtain insurance covers from the market. However, such compliances may result in the financed ship's economic life becoming shorter, or may increase operating costs to the extent of weakening the shipping company's financial conditions.

### **3.6 Marine insurance as a risk management tool in ship finance**

Ship financiers should select and implement appropriate risk management techniques to protect themselves from the abovementioned shipping risks, since these risks have adverse impacts on their ship finance projects. There is a range of techniques that can be employed in this process, among which insurance is an essential one. Where risks are insurable, shipowners and/or financiers may use insurance to transfer those unacceptable risks from the finance projects to the insurance pools. The effectiveness of other risk management techniques is undoubtedly, but it is not practicable to consider all kinds of technique here. This section focuses on marine insurance as a tool of risk management. Particular emphasis is placed on its role in managing risks in relation to ship finance projects. Before considering the role of marine insurance in the context of ship finance, it is necessary to address the nature of insurance in general.

#### **3.6.1 What is insurance?**

Under English law, Channell J summarised the characteristics of insurance contracts in *Prudential Insurance Co v Inland Revenue Commissioners*,<sup>121</sup> as follows:

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<sup>121</sup> [1904] 2 KB 658.

When you insure a ship or a house you cannot insure that the ship shall not be lost or the house burnt, but what you do insure is that a sum of money shall be paid upon the happening of a certain event. That I think is the first requirement in a contract of insurance. It must be a contract whereby for some consideration, usually but not necessarily in periodical payments called premiums, you secure to yourself some benefit, usually but not necessarily the payment of a sum of money, upon the happening of some event. Then the next thing that is necessary is that the event should be one which involves some amount of uncertainty. There must be either uncertainty whether the event will ever happen or not, or if the event is one which must happen at some time there must be uncertainty as to the time at which it will happen. The remaining essential is...that the insurance must be against something. A contract which would otherwise be a mere wager may become an insurance by reason of the assured having an interest in the subject matter – that is to say, the uncertain event which is necessary to make the contract amount to an insurance must be an event which is *prima facie* adverse to the interest of the assured.<sup>122</sup>

Accordingly, insurance can generally be defined as a contractual relationship between two persons, under which one person (i.e. the assured) is obliged to pay premiums to another (i.e. the insurer) and, upon the happening of an insured peril, the insurer is obliged to pay a sum of money or its equivalent to the assured in order to mitigate the latter's loss.

### **3.6.2 Insurability**<sup>123</sup>

Not every risk is insurable, and the nature of insurance has determined that insurable risks shall have certain features, which are set out in this section.

#### *3.6.2.1 Pure risks only*

The pure risk can only result in a loss to the assured: for example, the risk of fire, theft and liabilities. In contrast, the speculative risk, such as risks arising out of providing credit, can result either in a loss or a gain. Permitting a speculative risk to be insured may lead to moral hazards, since the downside of a speculative risk will be eliminated by the insurance, yet its upside remains.

#### *3.6.2.2 Measurable in monetary terms*

The insured loss must be measurable in monetary terms because the purpose of insurance is to secure the assured's financial position upon the happening of an

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<sup>122</sup> Ibid at 663.

<sup>123</sup> See R Thoys, *Insurance Theory and Practice* (Taylor & Francis 2010) 15-18.

insured risk, rather than to avoid the happening of such a risk. For instance, loss of good character cannot be insured. If it is difficult to calculate the monetary value of a loss (e.g. value of life), a reasonable monetary value can be pre-agreed.

#### *3.6.2.3 A fortuitous loss*

The loss must be accidental or unintentional from the perspective of the assured. If an assured deliberately brings about a loss and claims for it, then this may constitute fraud.

#### *3.6.2.4 Homogeneity and independence*

The business of insurance is dependent upon the law of large numbers. Therefore, an insurer must be able to collect a reasonably large group of potential assureds who are all faced with the similar type and level of risk, in order to create an insurance pool. In the meantime, an insurance pool can be sustained only if a minority of assureds claim from this pool, thus it is preferred that the insured risk is particular. That is, a single event does not affect a large number of assureds in the same pool at the same time.

#### *3.6.2.5 Insurable interest*

The assured must have an interest in the subject-matter of the insurance. There are two dangers without the rule of insurable interest: first, the insurance may be used as a tool for wagering; and, second, the assured may be tempted to bring about fraudulent destruction on the subject-matter insured.<sup>124</sup>

#### *3.6.2.6 Confirming to public policies*

A fundamental principle of the law of contract is that a contract must not be contrary to that which society considers to be moral. As a result, it is expected that an insurance contract will not be misused for purposes which are considered to be immoral, or which are in conflict with public policies. For example, it is not permitted to insure the benefits of a crime.

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<sup>124</sup> See, generally, Chapter 5, section 5.4 (Insurable Interest).



### **3.6.3 Functions of insurance**<sup>125</sup>

A central question of this research is, “What is the role of marine insurance in ship finance?” We may begin to answer this question by examining the primary and secondary functions of insurance.

#### *3.6.3.1 Risk transfer*

Transferring risks is the primary function of insurance: specifically, the financial consequences of risks are transferred from the assured to the insurance pool through insurance contracts. There is a range of benefits deriving from the risk transfer function, such as peace of mind, loss prevention and a source of investment. These benefits are considered in the following paragraphs.

#### *3.6.3.2 Aid to security*

Insurances provide security, so that companies can expand without retaining too many funds to meet potential financial losses. Consequently, companies are able to invest more funds into their products or services, which may increase their profitability. Therefore, the company being protected by appropriate insurance covers can reduce the risks faced by investors and add to its attractiveness for financiers.

#### *3.6.3.3 Aid to credit*

Bank loans are often secured by the borrower’s physical assets. To take an example from within the field of ship finance, the bank normally requires a first priority mortgage on the financed ship upon advancing funds to the shipowner. However, the secured assets are meaningless if they have been lost or damaged. In the light of this, insuring secured assets is essentially a protection of the lender’s investment. In such situations, the lender is more willing to provide credit.

#### *3.6.3.4 Source of investment*

The insurance industry has a large amount of money at its disposal, so it can provide companies with an additional source of finance. As institutional investors,

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<sup>125</sup> See, generally, Thoyts (n 123) 1-3.

insurance companies can either directly place funds with companies who need finance or invest in the financial market.

### *3.6.3.5 Loss prevention*

Insurance companies generally have a good knowledge of risks, and they often contribute to loss prevention through research, education and improving regulations.

### **3.6.4 The benefits and limitations of insurance**

An advantage of insurance is its ability to turn a risky situation into a financial certainty so that, to some extent, the financial position of an assured is not affected by those insured risks. In other words, purchasing insurance can minimise some unknown factors, providing the assureds and other related parties (such as the lenders and investors) with peace of mind. In the event of a total loss of a financed ship, although neither the incident can be avoided nor can the ship can be recovered by the insurance, an assured shipowner may be indemnified of its financial losses from the insurance proceeds. Accordingly, the shipowner would be restored to the same financial position in which it would have been had the ship not been lost. In addition, purchasing insurance can mitigate financial losses resulting from the insured risks, so reducing the company's capital cost as well as improving its liquidity.

However, insurance has its limitations. First, not all risks can be insured. Risks that can be insured should be pure risks, the potential assured is required to have an insurable interest in the subject-matter insured, the loss must be fortuitous, and the insurance cannot be against public policies. Apart from the insurability issue, some risks which are insurable in theory are not insurable in practice because no insurer is willing to underwrite them. Whether or not to underwrite particular risks is a business decision of the insurer, thus the insurer has to consider whether a risk is good and whether underwriting such a risk is profitable. Second, insurance can only indemnify the financial consequence of risks, but it cannot restore other damages such as reputation. Third, insurance is a contract rather than a guarantee, so it can be void or voidable in certain situations. Despite insurance contracts being subject to the general rules of contract law, they are also subject to the special rules of insurance law. Examples of these special rules

are the doctrine of utmost good faith, the rule of warranties and the principle of indemnity. Last, the assured must pay the premium as a consideration of the insurance contract, therefore insurance is not necessarily the most economical risk management technique from a business perspective.

### **3.6.5 How does marine insurance fit into ship finance?**

Marine insurance is one among a range of different insurances. In the previous sections, we argued that insurance is a risk management technique which can be used to mitigate the financial consequence of risks; we also considered how important the insurance industry is in supporting business and the economy. In this section, we are going to consider the contribution of marine insurance to the success of ship finance projects.

#### *3.6.5.1 The definition of marine insurance*

Section 1 of the Marine Insurance Act 1906 (MIA 1906) defines marine insurance as ‘...a contract whereby the insurer undertakes to indemnify the assured, in manner and to the extent thereby agreed, against marine losses, that is to say, the losses incident to marine adventure.’<sup>126</sup> That is, a marine insurance contract is a contract in respect of indemnifying the losses incident to marine adventure. Accordingly, marine policies are designed to insure against specific risks occurring to certain properties which can be categorised into the subject-matter of marine insurance. Similarly, motor insurance is designed to cover risks arising out of the usage of motor vehicles and life insurance is designed to cover risks in relation to the safety of lives. Marine insurance is different from non-marine insurance for many reasons,<sup>127</sup> but they are similar as regards their functions.

#### *3.6.5.2 The role of marine insurance in ship finance*

The cash flow and the value of ships are two crucial elements in the success of ship finance projects, but history has shown that these two elements are highly volatile. From the perspective of ship financiers, a baseline is that the financed ship shall safely exist in undamaged conditions and continuously operate to generate revenues, so that the income is sufficient to repay debts and/or pay

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<sup>126</sup> Marine Insurance Act 1906 s. 1.

<sup>127</sup> See Chapter 5, section 5.2.2 (Characteristics of marine insurance law).

## RISK MANAGEMENT IN SHIP FINANCE: THE ROLE OF MARINE INSURANCE

dividends. Moreover, the financed ship is not expected to be held to liabilities, especially those liabilities which may result in the ship being arrested and/or being attached to maritime liens. Although marine insurance cannot avoid the occurrence of loss or damage to a financed ship, or of the ship incurring liability, the financial consequences of such marine losses can be indemnified, provided that appropriate marine policies are properly in place. Given that those risks identified in section 3.5 have adverse impacts on the cash flow and the value of ships, ship financiers naturally hope to move them as far as possible away from their finance projects, and marine insurance is an efficient and effective tool for transferring certain risks to insurers who are not directly involved in the projects.

### (a) Transfer the risk

Marine insurance, as a risk transfer mechanism, plays a vital role in supporting ship finance. It can provide financial protection against, *inter alia*, loss or damage to the hull or machinery, loss of hire, pollution liability, collision liability, and wreck removal. In the light of this, the shipowner's financial position is less likely to be affected by such risks when these risks are insured. Therefore, marine insurance, to a certain extent, is a safety net for shipowners, which encourages them to engage in larger shipping adventures, since certain marine risks can be mitigated by insurance.

### (b) Reduce capital costs and improve liquidity

For shipbuilders, indemnity from marine policies provides them with sufficient funds to continue the ship's construction upon the happening of an insured event, so they are able to complete the building project rather than have to terminate the order and breach the shipbuilding contract. If there were no insurance protections available, both shipowners and shipbuilders would have to reserve more capital, much of it unused, or be prone to a wholly unacceptable risk of ruin. In other words, marine insurance can effectively reduce capital costs and improve the liquidity of shipowners and shipbuilders.

### (c) Peace of mind

For ship financiers, marine insurance provides them with peace of mind by securing the security, which is, in fact, an additional layer of protection. In the light

## RISK MANAGEMENT IN SHIP FINANCE: THE ROLE OF MARINE INSURANCE

of the role of marine insurance in securing the financier's investment, it is reasonable to suggest that the sophistication of modern marine insurance must have been a factor in making ship finance projects more attractive. In reality, marine insurance has formed an integrated part of ship finance transactions.

### (d) Research and education

The role of marine insurance in ship finance is not merely limited to risk transfer. In modern times, many marine insurers act in a role similar to that of a risk manager, from the advantageous position of possessing knowledge of all forms of marine risk. The insurers are not only motivated to prevent unnecessary losses to their clients, but also have enough funds to carry out research into – and conduct education on – topics related to marine risks.

### (e) Source of ship finance

Much of the significant premiums generated by the marine insurance industry will be invested back into financial markets. For the purposes of ensuring the safety of insurance funds, insurance companies' investment activities are strictly regulated by most of the world's governments. However, given that marine insurers have more knowledge of marine risks than most other financiers – not only knowledge of “the nature and types of risk” but also of “the way to manage risks” – is it possible to attract insurance funds into ship finance projects? Especially in the role of the institutional investor, insurance companies would be able to place funds directly with shipping companies who need finance to expand their fleets.

## 3.7 Conclusion

Risk is unavoidable, but risk is manageable. In the light of the significant and unique risks arising out of shipping investment, ship financiers have strong motives for – and interests in – managing such risks. Different financiers' approaches towards risk management vary, however, a formal risk management process normally involves four key steps. The first step is to establish the objectives, which involves setting out expectations concerning the outcome of risk management. Although the appropriate objectives will not be the same in

every situation – especially where the expectations of equity investors and debt providers are distinct – a fundamental one is minimising the cost of risks.

The second step is to analyse the risks in ship finance. Three groups of shipping risks that may affect the finance projects have been identified: risks associated with the operating cash flow, with the value of ships, and with the shipping market. These identified shipping risks will link with the discussions in chapter 4.

The third step is to implement appropriate risk management techniques. It has been argued above that marine insurance is one of an array of risk management techniques, but is definitely an important technique for ship financiers, because insurance turns a risky situation into a financial certainty and financiers are in favour of predictable risks. However, insurance has limitations, such as the fact that not all the risks can be insured, thus insurance gaps will be identified in chapter 4. Besides, insurance is a contract rather than a guarantee, which may be void or voidable; this limitation leads to the discussions in chapter 5 regarding general rules and legal risks.

The final step is a review of the risk management process. This chapter has particularly considered the role of marine insurance in ship finance, beyond traditional risk transfer. Marine insurance may reduce capital costs and improve the liquidity of shipowners and shipbuilders, and provide peace of mind for ship financiers. Moreover, marine insurers may act in a similar role to that of a risk manager, conducting research and education on topics related to marine risks, and the large amount of money generated from premiums may even be a source of ship finance.

## CHAPTER 4

# MARINE INSURANCE: INSURABLE RISKS AND COVERAGE

### 4.1 Introduction

Shipping attracts funds from a variety of sources; not only from equity but also from debt. However, the financed ship is often the most important, even the only, asset of shipping companies who raise funds. Naturally, it is the wish of both equity investors and debt providers that the financed ships are physically safe, without being held to any liability from the phases of building through to operating and scrapping.

Three groups of risk that ship financiers hope to move away from in ship finance projects have been identified in the previous chapter, namely (1) risks associated with the operating cash flow; (2) risks associated with the value of ships; and (3) risks associated with the shipping market.<sup>128</sup> Among a range of risk management techniques, marine insurance is arguably the most important one, which has been proved to be efficient and effective under most circumstances.<sup>129</sup> Although marine insurance cannot avoid the happening of the abovementioned risks, it can indemnify the financial consequences of resulting marine losses, if appropriate marine policies are properly in place. Consequently, the questions, “What types of marine policy are appropriate?” and “How to properly arrange marine insurance?” may arise.

These questions are complex. The best way to begin to examine them probably involves four steps. The first step is exploring the types of insurable risk that are available under marine insurance (in theory). The second step is examining the forms of marine policy which can be used to protect the ship financier’s financial interest in the ship (in practice). The third step is considering the general rules and special rules in relation to arranging marine insurance. The

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<sup>128</sup> See Chapter 3, section 3.5.2 (Risks associated with the operating cash flow), section 3.5.3 (Risks associated with the values of ships) and section 3.5.4 (Risks associated with the shipping market).

<sup>129</sup> See Chapter 3, especially, section 3.6.5.2 (The role of marine insurance in ship finance).

last step is analysing potential legal risks which may arise out of such arrangements. The first two steps are considered in turn in this chapter, whereas the third and fourth steps are the themes of next chapter. Section 4.2 explores the insurable risks of marine insurance, followed by section 4.3 which considers the existing marine policies that can be used to facilitate ship finance transactions. In order to examine risks covered by those policies, section 4.3 considers various forms of standard clause; its focus is not on the standard clauses' wordings,<sup>130</sup> because marine clauses are no more than standard contracts, which shall be negotiated and customised to serve each ship finance project's purpose, and this is particularly so in the event of the financier's contingency insurance such as mortgagees' interest insurance and lessors' interest insurance. To conclude this chapter, section 4.4 provides a summary of covered risks and identifies insurance gaps.

## 4.2 Insurable risks

Marine insurance is international in nature, since the main subject-matter of marine insurance is the ship which carries passengers and goods worldwide. In contrast, the subject-matter of other forms of insurance is often restricted to a distinct and limited territorial area. Given the international feature of marine insurance, risks covered by marine policies must be broad enough to protect the shipowners and other related parties against marine losses arising out of a variety of incidents, which may happen in many jurisdictions where they will be subject to different rules.

According to the Marine Insurance Act 1906 (MIA 1906), marine insurance is 'a contract whereby the insurer undertakes to indemnify the assured, in manner and to the extent thereby agreed, against marine losses, that is to say, the losses incident to marine adventure'.<sup>131</sup> Thus, a marine insurance contract insures marine adventure. Subsequently, section 3 of the MIA 1906 defines the terms "marine adventure" and "maritime perils": the former determines what may be insured under the marine insurance contract, whereas the latter decides what risks can be insured against. Marine insurance can insure a variety of subjects,

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<sup>130</sup> See NG Hudson and T Madge, *Marine Insurance Clauses* (5th edn, Informa 2012) for the comparison and detailed analysis of marine insurance clauses.

<sup>131</sup> Marine Insurance Act 1906 s. 1.



## MARINE INSURANCE: INSURABLE RISKS AND COVERAGE

provided these subjects are exposed to the risk of loss or may incur liabilities arising out of maritime perils.<sup>132</sup> Examples of such subjects include ships and oil rigs;<sup>133</sup> cargoes; earnings or acquisition of any freight, passage money, commission, profit, or other pecuniary benefit, or the security for any advances, loan, or disbursements; as well as third party liabilities.

However, the assured must make sure that the loss, damage, liability or expenditure that it suffered resulted from the insured perils, in order to be indemnified. Broadly speaking, maritime perils include (but are not limited to) perils of the sea, fire, war perils, pirates, rovers, thieves, captures, seizures, restraints and detentions of princes and peoples, jettisons and barratry.<sup>134</sup> Similar to other insurable risks, the maritime peril must be a fortuity or accident. In the light of this, marine insurers do not provide covers for inevitable losses which result from inherent vice or ordinary wear and tear, or for losses caused by the assured's willful misconduct.

In spite of the above listed maritime perils, in certain events, a marine policy may be extended to cover risks that are not "maritime perils" in a narrow sense. For example, a policy in marine form which insures against risks arising out of the course of building or launching of a ship is considered to be a marine policy (i.e. builders' risks insurance),<sup>135</sup> and an insurance contract which protects the mortgagee from the shipowner's default risk under its primary insurance is considered to be a marine insurance contract (i.e. mortgagees' interest insurance).<sup>136</sup> Although a marine policy may be extended to cover risks arising inland, the contract itself must substantially insure marine adventure. That is, the subject-matter of marine insurance (such as ships, goods or earnings) must be capable of exposure to maritime perils.

There are a variety of commercially available marine policies,<sup>137</sup> and these cover a wide range of maritime perils. It is not practicable to comment in detail in

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<sup>132</sup> Ibid s. 3(2).

<sup>133</sup> Oil rigs are generally insured under marine insurance, see: *Promet Engineering (Singapore) Pte Ltd v Sturge (The Nukila)* [1997] 2 Lloyd's Rep 146; *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582.

<sup>134</sup> Marine Insurance Act 1906 s. 3.

<sup>135</sup> Marine Insurance Act 1906 s. 2(2). See also, *Jackson v Mumford* (1902) 8 Com Cas 61, affirmed (1904) 9 Com Cas 114; *James Yachts v Thames & Mersey Marine Insurance Co* [1979] 1 Lloyd's Rep 206; *Heesens Yacht Builders BV v Cox Syndicate Management Ltd (The Red Sapphire)* [2006] Lloyd's Rep IR 476.

<sup>136</sup> See *Continental Illinois National Bank & Trust Co of Chicago v Bathurst (The Captain Panagos DP)* [1985] 1 Lloyd's Rep 625.

<sup>137</sup> See Chapter 4, section 4.3 (Marine insurance policies).

this research on all insurable risks and all forms of marine policy, thus only marine policies which are closely related to ship finance transactions are considered here.

### **4.3 Marine insurance policies**<sup>138</sup>

Given the large amount of money involved in ship finance projects and the significant risks to which ocean-going ships are exposed, ship financiers are forced to become familiar with the nuances of marine insurance and with how the insurance market works, in order to protect their security interests in their financed ships, and in order to protect themselves from potential liabilities to pollutions, passengers or third parties. If properly arranged, marine insurance can ensure that certain risks can be transferred from financiers to insurance pools, ultimately reducing the ship finance cost.

Shipowners and bareboat charterers (in the event of a finance lease) take out different forms of policy to cover shipping risks, which usually reflect the specific risks associated with the areas in which their ships navigate. Nevertheless, all ships have three basic types of cover, including hull and machinery (H&M) insurance, which mainly covers physical losses to a ship; protection and indemnity (P&I) insurance, for the risk of liability; and war risks insurance, which covers physical losses arising out of war or war-like perils that are neither covered by H&M insurance nor P&I insurance. Shipowners or their financiers normally require additional insurances, such as increased value (IV) insurance which covers the revenue loss and increased costs arising out of a total loss incident (the insured sum is normally limited to 25% of the hull insured value), and loss of hire (LOH) insurance which covers the income loss following the physical loss or damage caused by insured perils. Further insurances are available at request, for example the refund guarantee insurance which is designed to protect the buyer (i.e. the prospective shipowner) and their financiers from the risk of a default on the part of guarantors who guarantee the refund of advance payments made under a shipbuilding contract, and maritime lien insurance (MLI) which protects the buyer and their financiers from the risk of liens being enforced against a ship under the new ownership, but such liens must be unknown to the buyer at the time of purchase. Strictly speaking, refund guarantee insurance is a

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<sup>138</sup> See, generally, NG Hudson and T Madge, *Marine Insurance Clauses* (5th edn, Informa 2012) (hereafter in this chapter, '*Insurance Clauses*').

form of financial insurance, but it is considered here for its importance in newbuilding finance projects.

The shipowner's insurance (referred to as the primary insurance) form a vital part of the lender's security package. Lenders and their advisors will check the primary insurance to make sure that no gaps exist between marine risks and coverages, and that the financed ship is properly insured for her full value with creditworthy insurers. For example, additional insurances to cover the piracy risk and the terrorism risk are normally required by the lender if a ship trades in areas prone to piracy. Despite such review work, lenders generally require, in the loan agreements, that the primary insurance is fully assigned to them, and the notice of assignment must be served to brokers and insurers following such assignments. Moreover, lenders may require that a loss payable clause is included in the policy and attached to the certificate of entry, and also that letters of undertaking are obtained from brokers and insurers. In some cases, lenders may require that the primary insurance is arranged in the joint names of the owner and the lender, so that the lender is a co-assured under the primary insurance.

Turning to the newbuilding finance, it is customary that shipbuilders arrange builders' risks insurance.<sup>139</sup> This form of insurance covers the risk of physical losses or damages to a ship during the course of construction, and the risk of collision and sinking during the sea trial. Like the shipowner's insurance, builders' risks insurance also forms a vital part of the security package of a lender who provides loans for newbuilding projects. Although the buyer (i.e. the prospective shipowner) may be a co-assured of the builders' risks policy, it is not common for the lender to be included as a co-assured. In the light of this, the lender will normally take a full assignment of builders' risks insurance.

However, an insurance contract is a contract rather than a guarantee. It is not only claims under the shipowner's or shipbuilder's insurance that can be void or voidable, but also liabilities imposed by a court judgment may exceed the limits of the liability, in which case the ship financier's security interests in the financed ships will be seriously impaired. For example, a first priority mortgage on a ship is meaningless in the event of the ship becoming a total loss or being attached to maritime liens for unpaid liabilities which exceed the ship's market value. In the

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<sup>139</sup> Most standard shipbuilding contracts impose the duty to insure the ship in respect of its 'builder's risks' upon the builder, for example, Article VII.5 of the SAJ Form, Clause 31 of the NEWBUILDCON, and Article XVI of the CMAC Forms.

light of this, ship financiers will take out contingency insurance in order to better protect their financial interests, and the insurance market has responded to this need.

Yet commercially available contingency insurance mainly protects only two types of ship financier—mortgagees and lessors. There are three forms of contingency insurance for mortgagees, including mortgagees' interest insurance (MII) which covers the risk of the shipowner's default under the primary insurance; mortgagees' additional perils insurance (MAP), which covers the excess liability risk; and mortgage rights insurance (MRI) which protects the mortgagee's legitimate interest from the interference of foreign governments (i.e. the political risk). The main marine policies that are designed for lessors and innocent owners are lessors' interest insurance (LII) and innocent owners insurance (IOI). There are standard wordings for both of these types of policy on the market from both underwriters and P&I Clubs. The wording is much the same as for MII, and to date there is no authority on such policies.. Both innocent investors and lessors are referred to as the passive investor: that is, an investor without any operational interest in the ship, who is therefore not obliged to arrange or maintain insurances for the ship, for example an actual shipowner under a bareboat charter. It is customary that ship financiers arrange contingency insurance through brokers appointed by themselves, but the premium will be reimbursed by shipowners.

This section aims to present a clearer picture of the way that marine insurance contributes to ship finance projects, therefore a range of different marine policies which are useful for ship finance projects are considered in the following paragraphs. For each policy, it starts from a brief review and is followed by an analysis of insured risks. Particular attention is given to the relationship between the primary insurance and the contingency insurance.

#### **4.3.1 The insurance of shipowners**

It is the hope of a prudent shipowner that its ship is adequately insured, as is the hope of financiers who provide funds for the ship, since the shipowner's insurance forms a vital part of the financier's security package. Three forms of policy are essential to safely guard the financed ship, from the ship financier's perspective, these being H&M, P&I and war risks policies. IV and LOH policies are desirable, and these two forms of policy are generally required in loan

agreements. In specific situations, financiers may require the refund guarantee policy or MLI. These policies are considered in turn in the following paragraphs.

#### *4.3.1.1 Hull and Machinery Insurance*

H&M insurance is designed to protect the shipowner's economic interest in its ship, and the scope of this form of insurance is broader than its name suggests. It covers risks in relation to a ship's hull and her machinery, onboard equipment and spare parts, as well as bunkers and lubricating oil carried by ship, if these properties are owned by the shipowner. Depending on the particular policy's precise terms, H&M insurance may also cover physical losses or damages to a ship, shipowner's proportion of general average, salvage, sue and labour expenses, as well as third party liabilities arising out of the collision. However, war risks are usually excluded from a standard H&M policy, so the shipowner shall take out separate policies to cover them.

Both commercial insurance companies and P&I clubs provide H&M insurance, but there is not a universal scope for H&M insurance. A range of different wordings are available on the market, *inter alia*, the Nordic Marine Insurance Plan (NMIP), the English ITC Hulls clauses, and the German ADS/DTV clauses. These wordings differ not only in their terms and conditions, but also in the level of deductibles that they require.

#### *4.3.1.2 Protection and Indemnity Insurance*<sup>140</sup>

P&I insurance was created in response to an increasing demand by shipowners for third party liability insurance, and because of the insufficiency of a standard H&M policy in covering certain expenses. Accordingly, P&I insurance is a form of liability insurance which covers liabilities arising out of a wide range of incidents. Examples of such incidents include, *inter alia*, the loss of, or damage to cargoes; pollution from ships or onboard cargoes; loss of life or injury to crew members or passengers; removal of wrecks; damage to fixed or floating objects; and collision with other ships. This form of insurance also covers legal liability of the assured to third parties, but war risks are generally excluded from P&I insurance. Although there is a limit of USD 1 billion on pollution liability, there is no upper limit on the

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<sup>140</sup> See, generally, SJ Hazelwood and D Semark, *P&I Clubs Law and Practice* (4<sup>th</sup> edn, Informa 2010).

sum of third party liability cover in general.

P&I clubs operate on a mutual basis, whereby each member, upon entering the club, agrees to share risks which affect other members of the club and to contribute funds to meet potential claims during the policy year. Since the club member is not only an assured but also an insurer, P&I insurance only covers risks which are regularly and commonly encountered by a majority of the membership, and so excludes unusual risks and excessively onerous liabilities. By the same token, P&I clubs have more flexibility in terms of the manner in which they can provide covers compared with commercial insurance companies. An example of this is the “Omnibus Rule”, which permits risks to be covered at the discretion of the P&I club even where they do not expressly fall within the stipulated cover but nonetheless broadly fall within the scope of club covers, if the club considers such risks to be incidental to the insured ship’s operation.<sup>141</sup>

P&I clubs have cooperatively formed the International Group of P&I Clubs (IG), in order to provide high levels of cover to their members, as well as to share liabilities, losses, costs and expenses that exceed a certain amount.<sup>142</sup> There are now thirteen members of IG, which collectively provide liability insurance for more than 90 percent of the world’s ocean-going tonnage and more than 95 percent of the world’s ocean-going tankers.<sup>143</sup>

#### 4.3.1.3 War Risks Insurance

Liabilities arising out of war risks are normally expressly excluded from H&M and P&I insurance. For example, clause 23 of the Institute Time Clauses – Hulls (1/10/83) provides:

In no case shall this insurance cover loss damage liability or expense caused by (a) war civil war revolution rebellion insurrection or civil strife arising therefrom, or any hostile act by or against a belligerent power; (b) capture seizure arrest restraint or detainment (barratry and piracy excepted), and the consequences thereof or any attempt thereat; (c) derelict mines, torpedoes bombs or other derelict weapons of war.<sup>144</sup>

As a result, shipowners take out separate war risks insurance to cover claims

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<sup>141</sup> R Williams, *Gard Guidance to the Rules* (Gard AS 2015) 15.

<sup>142</sup> IG P&I <<http://www.igpandi.org>> accessed 30 October 2017.

<sup>143</sup> IG P&I <<http://www.igpandi.org/about>> accessed 30 October 2017.

<sup>144</sup> Institute Time Clauses – Hulls (1/10/83) cl. 23.

which have resulted from war risks, under H&M, P&I or LOH insurance. However, war risks insurance expressly excludes risks like the loss or damage caused by nuclear, chemical, biochemical and electromagnetic weapons, as well as deprivation of a ship by the act of a government or authority of the country in which the ship is registered or being managed.

A special feature of war risks insurance is that insurers are entitled to suspend or even cancel such policies under certain critical circumstances. For example, in the event of an outbreak of war between major global powers, insurers can cancel the war risks policy. In addition, war risks insurers are also entitled to give notice to define an insured ship's trading limits – for example, a particular area may be considered an excluded area or conditional area during the insurance period. These insurers' rights are highlighted in sanctions cases, where super authorities such as the UN or the EU often restrict the supply of insurance in order to achieve the effects of sanctions.<sup>145</sup>

War risks policies are mainly provided by two groups of insurers: (a) war risks mutual clubs, such as the Den Norske Krigforsikring for Skib and the Hellenic War Association; and (b) commercial war risks insurers, with insurers who operate in the Lloyd's and the London Company Markets accounting for the largest proportion of war risks insurance supplies. On a collective basis, IG takes out insurance for P&I war risks on behalf of its member shipowners.

### *4.3.1.4 Increased Value Insurance*

IV insurance is actually an extension of H&M insurance, which is designed to enable the assured, under certain circumstances, to recover on the basis of a higher valuation of the ship than the amount valued in her principal hull policy, but it only applies in total loss cases.

In the event of a total loss, the sum that may be recovered by an assured is the value fixed by a valued H&M policy; if it is an unvalued policy, then the sum that may be recovered will be the ship's market value at the commencement of the risk.<sup>146</sup> In practice, nearly all H&M policies are now valued policies. In the light of the volatility of ship prices, both shipowners and their financiers will find it a cause for concern that the sum recoverable under a valued H&M policy is not

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<sup>145</sup> See Chapter 5, section 5.11.1 (The Compliance of marine insurers with the sanctions).

<sup>146</sup> See Chapter 5, section 5.7 (Value to insure).

sufficient to fully indemnify a total loss, since the ship's market value may be higher than her insured hull value, especially during economic booms. As a result, ship financiers generally require shipowners to purchase IV insurance to minimise the economic consequences of a total loss, either an actual total loss (ATL) or a constructive total loss (CTL). This form of insurance covers not only revenue loss but also increased costs resulting from total loss incidents, which may include sue and labour, general average and excess collision liabilities. It can also be extended to cover anticipated income loss following total loss incidents, which is the only option to protect income when substituting the lost ship. The insured sum under a standard IV policy is normally limited to 20% of the ship's market value, or 25% of the insured sum of the H&M policy.

IV policies are frequently effected on the terms of the Institute Time Clauses (Hulls) (Disbursements and Increased Value) (1/10/83). Other wordings are available, such as the Institute Time Clauses (Hulls) (Disbursements and Increased Value) (1/11/95) and the International Hull Disbursements and Increase Value Clauses (1/11/03).<sup>147</sup>

#### 4.3.1.5 Loss of Hire Insurance

Benefits derived from the employment of a ship (generally referred to as freight) are insurable under marine insurance.<sup>148</sup> Freight is broadly defined in the context of marine insurance, referring not only to the traditional sense of the word, but also to charter hire and to any other forms of income that shipowners expect to derive from providing shipping services.<sup>149</sup>

LOH insurance is designed to insure shipowners against the income risk (or the cash flow risk), which covers the income loss arising out of physical damages to the ship, in a variety of situations. Examples include, *inter alia*, damages to the ship which are recoverable from its H&M cover, stranding of the ship, physical obstructions which prevent the ship from leaving the port (ice excluded), salvage or removal of damaged cargos, and events which give rise to an allowance in general average. However, this form of insurance only covers losses if a ship has

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<sup>147</sup> See *Insurance Clauses* (n 138) Part IV, Chapter 3, section B, where provides a sample of the Institute Time Clauses, Hulls: Disbursements and Increased Value (Total Loss only, including Excess Liabilities) (1/11/95).

<sup>148</sup> *Flint v Flemyng* (1830) 1 B & Ad 45 at para [48].

<sup>149</sup> J Gilman and others, *Arnould: Law of Marine Insurance and Average* (18th edn, Sweet & Maxwell 2013) para 10-15 (hereafter in this chapter, '*Arnould*').



suffered physical damage or other incidents that would give the assured rights of recovery under H&M insurance. In general, an LOH policy merely covers the loss of time arising out of partial loss incidents, as the loss of time resulting from total loss incidents are accounted into the H&M policy under the freight interest. Moreover, the loss of time arising out of events such as detention by authorities or arrest by third party claimants is not covered by LOH insurance, since these events are not physical damages. LOH policies generally contain limits and deductibles. Limits of the cover are calculated by the number of indemnity days being multiplied by the daily earnings total at the inception of the policy, and the number of indemnity days is typically 90, 120, or 180. As regards deductibles, a minimum deductible of 14 days is normally required, and it is common to require an excess point of 20 to 30 days for old ships.

Given that a ship out of operation will prejudice the financier's financial interests in the ship, ship financiers may take out LOH insurance. However, it is common market practice for shipowners to arrange this form of insurance, so that they will be able to repay outstanding debts even in cases where an incident has deprived the financed ship of income. Among those limited markets which provide LOH policies, the Norwegian market is, in general, more competitive than the London market.

#### *4.3.1.6 Refund Guarantee Insurance*

The buyer (i.e. the prospective shipowner) and their pre-delivery financiers always require refund guarantees from the shipbuilder, in order to secure their pre-delivery instalments. These guarantees are usually provided by a financial institution, typically the builder's bank or an export credit agency in the builder's jurisdiction, who guarantees, to the buyer, refund of advance payments plus an agreed interest in the event of the shipbuilder's default.<sup>150</sup> However, guarantors may fail to honour their obligations following valid claims, in which case, the buyer and their financiers may have to turn to insurance solutions against the guarantor's default risk.

As a result, refund guarantee insurance is designed to cover the risk of defaults on the part of the guarantor who guarantees the refund of advance payments made by the buyer under a shipbuilding contract. The condition for triggering a

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<sup>150</sup> Discussions on refund guarantees, see: M Davis, *Refund Guarantees* (Informa 2015).

refund guarantees policy is that the refund guarantor does not refund as required by the court or tribunal, following a cancellation of the shipbuilding contract on the part of the shipbuilder's default. Payments under refund guarantee insurance usually have to be delayed for a pre-agreed period, typically 180 days.

#### 4.3.1.7 *Maritime Lien Insurance*

Second-hand ships may be subject to maritime liens arising out of the vendor's conduct, and these liens rank ahead of mortgages in almost all jurisdictions, including that of English law. Liens attached to a ship seriously prejudice the buyer's property right, since an ownership change will not cease the claimant's arrest right if such an arrest is based on maritime liens.<sup>151</sup> By the same token, mortgagees will also have cause for concern with regards to a pre-existing maritime lien, because it will undermine their security interests in the mortgaged ship. In the Memorandum of Agreement (MOA), the seller inevitably warrants that the ship is free from maritime liens at the time of delivery,<sup>152</sup> or it is obliged to fully indemnify the buyer any financial consequence arising out of liens attached prior to the delivery. However, where the "sale of ship" company adopts a special purpose vehicle (SPV) structure (which is not uncommon in shipping), there are limited remedies available to the buyer who does not have any security to ensure the performance of post-delivery obligations by the seller.<sup>153</sup>

Maritime lien insurance (or pre-existing lien insurance) fills this gap in protection, covering the risk of liens which are unknown to the buyer at the time of purchase being enforced against the ship under new ownership.<sup>154</sup> This form of insurance covers the extra expense to the buyer in removing liens (for which the seller should have been responsible) after the delivery of the ship,<sup>155</sup> and it is especially useful where the purchase of second-hand ships is financed by the mortgagee. There is usually a fixed amount for each lien in respect of the sum insured, and the policy contains "sue and labour" clauses requiring the insured

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<sup>151</sup> I Goldrein, M Hannaford and P Turner, *Ship Sale and Purchase* (6th edn, Informa 2012) section 7.3.5.

<sup>152</sup> For example, Norwegian Saleform, Nippon Sale and Singapore Ship Sale Form 2011.

<sup>153</sup> I Goldrein, M Hannaford and P Turner, *Ship Sale and Purchase* (6th edn, Informa 2012) section 7.3.5.

<sup>154</sup> P Mellett (ed), *The Insurance Aspects of Shipping and Offshore Financing* (Bankserve 2013) 111.

<sup>155</sup> I Goldrein, M Hannaford and P Turner, *Ship Sale and Purchase* (6th edn, Informa 2012) section 7.3.5.

(i.e. the buyer) to take all reasonable actions to avoid or minimise such claims.<sup>156</sup>

#### 4.3.2 The insurance of shipbuilders

During the course of building a ship, the shipbuilder is exposed to a variety of risks, and the buyer and their pre-delivery financiers are also directly or indirectly exposed to these risks, since they are often obliged to make advance payments and to provide various items of equipment before delivery of the ship. As a result, the shipbuilder is normally contractually bound under the shipbuilding contract's terms to take out builders' risks insurance.

This form of insurance covers the risk of losses or damages to a ship during the course of construction, testing and trials. It also covers certain liabilities on the part of the shipbuilder such as collision liability during trials. It is common practice that the shipbuilder purchases this form of insurance,<sup>157</sup> but the buyer may be named as a co-assured at the latter's request. The buyer often asked to be named as a co-assured in two situations: (a) where the shipbuilding contract contractually vests the buyer's ownership in the newbuilding by progressively passing the title to the buyer as the buyer pays instalments; and (b) where the buyer makes advance payments at stages during the construction period. It is not uncommon for the buyer and their financiers to take a full assignment of builders' risks insurance, but merely incorporating a loss payable clause into the policy is not sufficient to support an effective statutory assignment. The effect of an effective statutory assignment is identical to that of co-insurance.

The insurance market has developed a variety of forms of wording, such as the Institute Clauses for Builders' Risks (1/6/88) (ICBR) and the London Marine Construction All Risks Wording 2007 (MarCAR). However, standard wordings only consider common circumstances: for example, the standard ICBR clauses exclude war, strikes, malicious acts and nuclear risks. The standard MarCAR clauses go further, excluding loss, damages, liabilities, expenses resulting from the assured's willful misconduct, as well as from insolvency, and solely from ordinary wear and tear or delay. In addition, subject to negotiations, loss,

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<sup>156</sup> Ibid.

<sup>157</sup> Most standard shipbuilding contracts impose the duty to insure the ship in respect of her 'builder's risks' upon the builder, for example, Article VII.5 of the SAJ Form, Clause 31 of the NEWBUILDCON, and Article XVI of the CMAC Forms.

damages, liabilities and expenses resulting from earthquakes or volcanic eruptions are usually expressly excluded from builders' risks insurance. As a result, care should be taken to ensure that the terms of a particular policy are broad enough to cover risks which are likely to arise out of the specific building project.

#### 4.3.3 The insurance of ship financiers

Four types of ship financiers' insurance are considered in this section: (a) mortgagees' interest insurance; (b) lessors' interest insurance; (c) mortgagees' additional perils insurance, which is divided into mortgagees' additional perils (pollution) insurance (MAPP) and mortgagees additional perils (all P&I risks) insurance; and (d) mortgage rights insurance. The analysis of each policy primarily focuses on its connection with the primary insurance and the risk covered.

It is advisable for ship financiers to take out such financier's policies through their own brokers, and the risks arising out of placing these policies through shipowners' brokers are considered in next chapter.<sup>158</sup>

##### 4.3.3.1 Mortgagees' Interest Insurance<sup>159</sup>

In the 1950s, MII was first provided by the Swedish club and was written in the Swedish wording.<sup>160</sup> Subsequently, German ship finance banks developed this wording into a particular form of policy in the early 1970s. The majority of MII policies today are underwritten in Lloyd's and the London Company Market, with either the Institute Mortgagees' Interest Clauses – Hulls (1/3/97) (the 1997 Institute Clauses) or various bespoke forms developed by insurance brokers in order to meet their clients' special requirements.<sup>161</sup> The 1997 Institute Clauses is actually an amended form of the Institute Mortgagees' Interest Clauses – Hull (30/5/86) (the 1986 Institute Clauses), because the latter did not impress its protective clients as expected. Although the 1997 Institute Clauses had

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<sup>158</sup> See Chapter 5, section 5.8.2 (Arranging contingency insurance with a separate broker).

<sup>159</sup> See, generally, *Insurance Clauses* (n 138) Part V, Chapter 4; Mellett (n 154) 105-108; *Colinvaux's Law of Insurance* (11th edn, Sweet & Maxwell 2016) paras 24-001 to 24-007 (hereafter in this chapter, '*Colinvaux*'); D Osborne, G Bowtle and C Buss, *The Law of Ship Mortgages* (2nd edn, Informa 2016) Chapter 16.

<sup>160</sup> D Smith, 'Using Insurance to Protect Lender's Interest' (1991) 6(3) JIBL 107, 111.

<sup>161</sup> Mellett (n 154) 105.

considerably improved on its previous form, there are still plenty criticisms from within the market of the wording of the 1997 Institute Clauses.<sup>162</sup> Mortgagees usually arrange MII policies through their own brokers, who subsequently become the sole assured of the MII policies. However, mortgagors are generally obliged to reimburse the premiums as agreed in the loan agreement.

(a) Significance

Mortgagees can enjoy many benefits by participating in the primary insurance as a co-assured, an assignee or a loss payee,<sup>163</sup> but they require other measures to further secure their financial interests in the ship. Broadly speaking, MII is designed to insure the mortgagee against the balance sheet risk, which is essentially supplementary to the primary insurance. Given MII is merely a supplement to the primary insurance,<sup>164</sup> the MII insurer will incur liability only insofar as the primary insurer fails to pay. By the same token, the mortgagee is obliged to warrant that the primary insurance (e.g. H&M, P&I and war risks insurance) have been arranged by the shipowner to cover an amount no less than the insured value of MII or the amount of the outstanding loan, with the mortgagee's interest being endorsed on those policies, and that the primary insurance shall be maintained throughout the MII policy period.<sup>165</sup>

(b) Nature

English legal authorities on the nature of MII are limited. In *The Captain Panagos DP*,<sup>166</sup> Mustill J held that 'I have come to the conclusion that its general tenor and shape speak more of an insurance against physical damage to (and liability of) the ship, than against a financial damage to the mortgagee's interests'.<sup>167</sup> Likewise, clause 1.1 of the 1997 Institute Clauses provides that 'MII will indemnify the assured for loss resulting from loss or damage to or liability of the mortgaged

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<sup>162</sup> *Insurance Clauses* (n 138) 304.

<sup>163</sup> See Chapter 5, section 5.5 (Utilising the primary insurance).

<sup>164</sup> See, e.g. *Schiffshypothekenbank Zu Luebeck AG v Norman Philip Compton (The Alexion Hope)* [1988] 1 Lloyd's Rep 311 (CA); *Bank of Nova Scotia v Hellenic Mutual War Risks Assn (Bermuda) Ltd (The Good Luck)* [1988] 1 Lloyd's Rep 514 at 521.

<sup>165</sup> Institute Mortgagees' Interest Clauses – Hulls (1/3/97) cl. 1 and 4.

<sup>166</sup> *Continental Illinois National Bank & Trust Co of Chicago v Bathurst (The Captain Panagos DP)* [1985] 1 Lloyd's Rep 625.

<sup>167</sup> *Ibid* at 630.

ship'.<sup>168</sup> In the light of this, MII is a form of marine insurance in nature, rather than a form of financial guarantee insurance.

(c) Measure of indemnity

Although MII is a form of marine insurance, unlike other forms of marine policy which indemnify the assured's financial loss, MII policies only indemnify the assured's net loss. The 1997 Institute Clauses define net loss as follows:

The Assured's loss under the loan agreement to the extent secured by mortgage on the Mortgaged Vessel net of any amounts recovered or recoverable under all security arrangements contained in or collateral to the loan including but not limited to all mortgages (whether on vessels assured hereunder or on other vessels), liens, any floating and fixed charges, security interests, guarantees, insurance policies and pledges.<sup>169</sup>

That is, in computing the amount payable by MII, recoveries available under other forms of security for the assured to make up the amount of the loan agreement are included. Accordingly, clause 1.2 of the 1997 Institute Clauses provides that the amount payable to the mortgagee is the lesser of either (a) the mortgagee's actual net loss plus any claim under the duty of insured clause; (b) the claim, or part of a claim, which cannot be recovered under the primary insurance; and (c) the sum insured under MII.<sup>170</sup> These provisions were designed for the purpose of moderating the mortgagee's unfavourable position, as shown in *The Captain Panagos DP*,<sup>171</sup> in which the amount payable under MII was insufficient to repay the outstanding loan since it was computed by reference to the ship's market value at the time of the loss.

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<sup>168</sup> Institute Mortgagees' Interest Clauses – Hulls (1/3/97) cl. 1.1.

<sup>169</sup> *Ibid* cl. 2.3.

<sup>170</sup> *Ibid* cl. 1.2.

<sup>171</sup> *Continental Illinois National Bank & Trust Co of Chicago v Bathurst (The Captain Panagos DP)* [1985] 1 Lloyd's Rep 625. In this case, the owners of the ship *Captain Panagos DP* entered into an H&M policy, under which, the mortgagee bank was nominated as a loss payee; the bank also insured the ship under an MII policy. Unfortunately, the ship grounded and caught fire, thereby suffering damage. The owners' claim was declined by the hull insurers, and thus the bank thought to recover its loss from the MII insurers. The MII insurers admitted liability but one of the issues to be decided was that 'whether the amount due under the MII should be computed by reference to the amount which would have been recoverable under the H&M policy'. In order to ascertain that, Mustill J briefly considered the nature of MII by interpreting the policy, and concluded MII was a type of marine insurance. His analysis will not be further discussed here, by reference to normal MII wordings, there are rarely doubts about its marine nature because it insures against marine losses.

## (d) Covered and excluded risks

MII insurers promise to indemnify the assured for losses resulting from loss or damage to – or liability of – the mortgaged ship, but such loss is recoverable under MII policies only if it is caused by insured perils which are *prima facie* covered by the primary insurance, and if the primary insurers fail to indemnify.<sup>172</sup> In other words, MII policies will not be triggered if losses are caused by perils which are not covered by the primary insurance in the first instance.

Clause 2.1 of the 1997 Institute Clauses provides a list of insured perils, including (a) breach of any warranty or condition (including warranties as to legality, seaworthiness, trading, classification or condition surveys, ownership, management or flag); (b) failure to exercise due diligence where required under the shipowners' insurances (as under the Hulls Clauses' Inchmaree clause); (c) deliberate fraud or casting away on the part of the shipowner; (d) avoidance of the policy by reason of breach of the duty of good faith; (e) the expiry of a time limitation period under the primary insurance; and (f) in the case of a total loss, failure to prove that the loss was proximately caused by an insured peril, providing that the loss fell outside any of the specific exclusions under the policy.<sup>173</sup> This provision accordingly incorporates the coverage of and exclusions from the terms of the Institute Hull Clauses 1883, 1996 or 2003, whichever set is adopted by the parties.<sup>174</sup> The ordinary rules of causation are similarly incorporated.<sup>175</sup> Meanwhile, clause 3 of the 1997 Institute Clauses provides a range of exclusions, including any loss or expense resulting from the termination or cancellation of the shipowners' policies and club entries for reasons of non-payment of premiums or calls; insolvency or financial default on the part of underwriters; the inability of any party to transmit funds; purely financial risks such as fluctuation in exchange rates; the operation of any franchise or deductible; as well as losses caused by

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<sup>172</sup> Institute Mortgagees' Interest Clauses – Hulls (1/3/97) cl. 1.1.

<sup>173</sup> *Ibid* cl. 2.1.

<sup>174</sup> The insured perils fall into two classes: (1) those recoverable independently of due diligence, most importantly perils of the seas; and (2) those in the Inchmaree clause recoverable unless the insurers can prove want of due diligence. The most important exclusion is for inherent vice. For the meaning of perils of the seas and the nature of the exclusions, see *Global Process Systems Inc v Syarikat Takful Malaysia Berhad, The Cendor Mopu* [2011] UKSC 369.

<sup>175</sup> For proof of the existence of a proximate cause, see *Rhesa Shipping v Edmunds, The Popi M* [1985] 2 All ER 712. Where the loss is caused by two or more perils working in conjunction, only one of which is insured, there is recovery if the other peril is uninsured but not if the other peril is specifically excluded: see the discussion in *Atlasnavios-Navegacao LDA v Navigators Insurance Co Ltd* [2018] UKSC 26.

nuclear and radiation risks.<sup>176</sup>

The case of perils being excluded from the primary insurance and the case of primary insurers' liabilities being void or voidable are very different, as the following two cases illustrate. In *The Kleovoulos of Rhodes*,<sup>177</sup> a yacht was seized in Greece after large quantities of cocaine had been found on board, but the primary insurance contained a provision which expressly excluded loss arising out of 'arrest...detention by reason of infringement of any customs or trading regulations'.<sup>178</sup> Given that the loss had not resulted from perils which were *prima facie* covered by the primary insurance, an MII claim on the terms of the 1997 Institute Clauses (or other similar wordings) would have failed. By contrast, an MII claim on the terms of the 1986 Institute Clauses was upheld by the Court of Appeal,<sup>179</sup> in spite of similar exclusions contained in the primary insurance. In *The Alizia Glacial*,<sup>180</sup> a ship was seized and detained by the Australian authorities on the grounds of illegal fishing. The shipowner's war risks policy contained an illegal fishing warranty and expressly excluded loss arising out of 'arrest restraint detainment confiscation expropriation under quarantine regulations or by reason of infringement of any customs or trading regulations',<sup>181</sup> but the MII claim was successful because such illegal fishing was held to be in breach of warranty rather than excluded from insured perils.<sup>182</sup>

#### (e) Duration of cover

The normal period of an MII policy runs for 12 months, but it will automatically terminate in certain events such as a change in ownership, flag, management and control, or the loss of the ship's entry in her classification society. These events must be known to the assured. The owner's policies and club entries may be maintained if the assured has given prompt notice of such changes in writing and has agreed to pay additional premiums.<sup>183</sup> In addition, clause 10 of the 1997 Institute Clauses provides that an MII will terminate automatically, or by notice, in

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<sup>176</sup> Ibid cl.3.

<sup>177</sup> [2002] EWHC 225 (Comm), affirmed [2003] EWCA Civ 12.

<sup>178</sup> *Sunport Shipping Ltd v Tryg Baltica International (UK) Ltd (The Kleovoulos of Rhodes)* [2003] EWCA Civ 12 at para [5].

<sup>179</sup> *Handelsbanken ASA v Dandridge (The Aliza Glacial)* [2002] EWCA Civ 577.

<sup>180</sup> Ibid.

<sup>181</sup> Ibid at para [8].

<sup>182</sup> Ibid at para [34].

<sup>183</sup> Institute Mortgagees' Interest Clauses – Hulls (1/3/97) cl. 5.



certain war risks related circumstances.

(f) The right to payment

In order to be indemnified, the assured is required to prove an MII claim in one of two ways, according to the 1997 Institute Clauses: (a) by demonstrating to the satisfaction of MII insurers that, by reason of the perils insured under MII, there is no reasonable prospect of the shipowner and/or mortgagee succeeding in the claim against the primary insurers; or (b) where disagreement exists between the MII insurers and the mortgagee, by referring the issue to arbitration, or on a final court judgment or arbitration award is delivered in favour of the primary insurers.<sup>184</sup> Once the claim has been proven in the abovementioned ways, and the assured's net loss has been established, the MII insurers are bound to pay the assured within three months.<sup>185</sup>

(g) Comments

From the mortgagee's perspective, the MII policies are in fact a fallback plan, thus mortgagees are not really expecting any claim under MII policies. In practice, not many cases trigger MII policies, since the majority of claims have been paid or settled by the primary insurers. Although statistics concerning MII claims are not publicly available, circumstantial evidence shows that the premiums collected from MII policies have exceeded the settlements of MII claims, even during the economic downturn. On one hand, this indicates that the primary insurance is effective and efficient, which is a comfort for both shipowners and their financiers. On the other hand, the precise meaning of MII wordings are not well-defined since these covers are rarely tested, and so neither the obligations of parties to the contract well-defined. Among the occasional instances of MII claims, a majority of them have been privately settled or arbitrated, thus the MII's evolutionary process has been slow and largely unpublished. In addition, according to the market's feedback, the standard forms of MII policy within either the 1997 Institute Clauses or its previous form (the 1986 Institute Clauses) are not as popular as other standard insurance contracts. As a result, MII policies have more forms of wording than other types of policy.

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<sup>184</sup> Ibid cl.7.

<sup>185</sup> Ibid cl. 7.2.

Experience has shown that MII claims are more frequently made in the early part of a shipping recession,<sup>186</sup> when reductions in earnings, which have tempted the shipowner into making imprudent economies, have been compounded by a drop in the ship's market value, so an extent that can wipe out the shipowner's equity. Given that the super authorities (e.g. the UN and the EU) are imposing extensive sanctions direct at the shipping industry in modern times, these may affect the shipowner's claims under the primary insurance and may therefore trigger MII claims. As a result, MII policies may be contested in the courts in the near future.

MII claims most likely appear in the event of a total loss arising out of fraud or gross negligence on the part of the shipowner, but these are difficult matters to prove. Even if it has been proved that a total loss resulted from the shipowner's fraud or gross negligence, refusals of payments by primary insurers for the reason that a total loss was caused by the shipowner's fraud or gross negligence are virtually certain to be subject to litigation. Before agreeing to pay an MII claim, MII insurers need to be satisfied that the shipowner's claims under the primary insurance are legitimately void or voidable; either a final court judgment or an arbitration award confirming the primary insurer's rejections can serve this purpose. However, such litigations may take a long time, and the long process of obtaining a final court judgment or an arbitration award may result in a situation whereby the final MII payment is insufficient to cover the amount of outstanding loans plus those interests accruing at the default rate. This situation is obviously unwelcome for mortgagee banks, especially after the introduction of the Basel Capital Adequacy Accords.<sup>187</sup> To sum up, it is probably better to have an MII policy than not to have one from the perspective of ship mortgagees, but MII is, in fact, not as effective as expected by ship mortgagees. In other words, MII has been overrated in respect of its efficacy of better securing the mortgagee's financial interests in the ship.

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<sup>186</sup> Stephenson Harwood (ed), *Shipping finance*, (3rd edn, Euromoney 2006) 523.

<sup>187</sup> Mellett (n 154) 107; The Basel Capital Adequacy Accords are three sets of recommendations for regulations in the banking industry issued by the Basel Committee on Bank Supervision, including Basel I, II and III. The Accords provide recommendations on banking regulations in managing capital risk, market risk and operational risk, ensuring financial institutions have enough capital on account to meet obligations and absorb unexpected losses. The difficulty and/or long process of obtaining MII payment will reduce liquidity and increase the operational risk of banks; this deal, in principle, is not recommended by the Accords.

#### 4.3.3.2 Lessors' Interest Insurance

Lessors' interest insurance and innocent owner's insurance are the lease equivalent of mortgagees' interest insurance. This form of insurance insures lessors or innocent investors against the risk of claims under the primary insurance (i.e. the demise charterer's insurance) being void or voidable, up to the sum insured under LII/IOI. For example, a full LII/IOI responds to the risk of non-disclosure or misrepresentation on the part of the bareboat charter, operator or any of their agents; the unseaworthiness risk; the deliberate sinking of the ship risk; the breach of warranty risk; the non-compliance with international codes risk; and the time bar risk. Moreover, where the P&I club does not respond, or where the P&I cover limits are insufficient, policies which protect the lessor from direct claims made by third parties are commercially available.<sup>188</sup>

The lessor is also the financed ship's registered owner, unlike the mortgagee who is purely a financier. Given that environmental liabilities may incur as a consequence of the collision of ships, the lessor requires a triple indemnity against the non-payment risk under the primary insurance.<sup>189</sup> The triple indemnity shall cover loss resulting from (a) total or constructive total loss; (b) collision liability; and (c) general liability and removal of wrecks.<sup>190</sup> By contrast, passive investors (such as mortgagees) who are not the responsible party of the liable ship, can safely insure against confiscation of the ship following accidental pollution to the extent of the value of their security interests in the ship.<sup>191</sup>

#### 4.3.3.3 Mortgagees' Additional Perils Insurance

If shipowners are not able to meet their liabilities, as awarded by the court against the liable ship, the ship may be detained, arrested, or be attached to maritime liens. Maritime liens rank ahead of mortgages, and this is a major cause of concern to the mortgagee. Although the primary insurance is normally sufficient to cover common types of maritime lien arising out of collision and salvage liabilities, the amount of maritime liens may exceed the insured limit of the shipowner's liability insurance. This is disastrous for the mortgagee, since it may be deprived of its security interest in the ship.

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<sup>188</sup> Ibid 108.

<sup>189</sup> Stephenson Harwood (n 186) 523.

<sup>190</sup> Ibid.

<sup>191</sup> Ibid 524.

Mortgagees' additional perils insurance was first introduced into the market following the *Exxon Valdez* oil spill incident in Alaska. In the light of the fact that the shipowner's environmental liability may exceed its liability policy's financial limits, MAP is designed to insure the mortgagee against the risk of losing its security interest in the mortgaged ship under such circumstances. The risks insured by MAP have to refer to the ship's P&I insurance, which cover either the oil pollution risk or are extended to cover other P&I risks. Two forms of MAP are considered in this section: mortgagees' additional perils (pollution) insurance which only insures the pollution risk, and mortgagees' additional perils (all P&I risks) insurance which is extended to insure other P&I risks.

(a) Mortgagees' Additional Perils (Pollution) Insurance

In the event that the amount payable by the primary insurance is not sufficient to indemnify the mortgaged ship's oil pollution liabilities, MAPP policies may be triggered. This form of insurance was first introduced into the market in early 1990. The background of such an introduction is that IG member clubs indemnify their shipowner members to the extent of all their liabilities with unlimited coverage, but the oil pollution liability is limited to US\$1 billion per incident. In *The Exxon Valdez*, the amount payable by P&I clubs was not adequate to cover the oil spill loss which had exceeded US\$3 billion, given that US tort law allowed a wide range of third parties to acquire maritime liens for unpaid damages. Moreover, these maritime liens were ranked ahead of mortgages, thus the mortgagee's interests were seriously damaged in this case. Although the shipowner at that time could purchase excess oil pollution insurance to make up the liability differences, its cost was prohibitive.<sup>192</sup>

MAPP is now required by most shipping banks when they are acting as mortgagees of crude oil tankers, particularly tankers carrying oil in US waters. This is because the US has not ratified the International Convention on Civil Liability for Oil Pollution Damage 1992 (1992 CLC), or indeed any IMO conventions which limit the shipowner's liabilities.<sup>193</sup> The terms of the LSW 489,<sup>194</sup> which was introduced by Lloyd's Underwriters in 1992, are representative

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<sup>192</sup> Stephenson Harwood (n 186) 523.

<sup>193</sup> Mellett (n 154) 109.

<sup>194</sup> Mortgagees' additional perils (pollution) wording which is numbered as LSW 489.

of many forms of MAPP. The mortgagee shall take out MAPP through its own broker, as there were cases in the US in which the courts held that, where the shipowner had taken out insurance on behalf of the mortgagee, the policy could be deemed to be the shipowner's asset, in spite of the fact that the assured stated in the policy was the mortgagee.<sup>195</sup>

#### (b) Mortgagees Additional Perils (All P&I Risks) Insurance

Mortgagees additional perils (all P&I risks) Insurance is an extension of MAPP, and covers risks which are commonly insured by ordinary P&I policies. Mortgagees of large non-passenger ships rarely take out this form of insurance, because potential protections provided for them are merely against the terrorism risk and the piracy risk.<sup>196</sup> However, if shipowners take out a fixed premium P&I policy, which provides a lower limit than those available from a mutual entry of IG member clubs, then this form of insurance may be particularly useful for the mortgagee. Under the 1997 Institute Clauses, shipowners are required to take out P&I covers to the level equivalent to the covers provided by IG member clubs. Consequently, the importance of mortgagees additional perils (all P&I risks) insurance may be diminished.

#### 4.3.3.4 Mortgage Rights Insurance

Mortgage rights insurance is designed to protect mortgagees from the political risk. Shipping is a global business, a ship may be deployed to, or chartered into, a country with political, economic, or jurisdictional uncertainties; it may also be flagged into a country with existing sovereign debt exposures. If a ship is sent to such a country, then its local legal jurisdictions may ignore the loan contracts, mortgages and other financing agreements, thereby preventing mortgagees from enforcing their legal title and right to repossess or repatriate the collateral asset (i.e. the mortgaged ship). In the light of this, the purpose of MRI is to transfer the political risk from a mortgagee to an insurer, thus protecting mortgagees in the event that they are unable to enforce a foreclosure. MRI can be amended to accommodate the demands of lessors, providing them with similar types of protection.

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<sup>195</sup> Stephenson Harwood (n 186) 524.

<sup>196</sup> Mellett (n 154) 110.

(a) Covered risks

MRI insures mortgagees against the risk of their legitimate interests being interfered by foreign governments,<sup>197</sup> and it generally covers following risks:<sup>198</sup>

- (1) Nationalisation, confiscation, expropriation, deprivation, seizure, detention or compulsory acquisition by the foreign government or by the governmental authorised body.
- (2) Refusal by the foreign government to allow the mortgagee to exercise its repossession rights in the event of default.
- (3) Refusal by the foreign government to allow the mortgagee to remove the mortgaged ship from that foreign country.
- (4) Refusal by the authorities of the flag country to allow the mortgagee to deregister the mortgaged ship, including refusal to issue a deletion certificate or a closed transcript.
- (5) Preventing the mortgagee from receiving sale proceeds following a sale or a disposal, including where the mortgagee has obtained the “benefit” of such sale proceeds but is prevented from converting and/or exporting these proceeds.
- (6) Refusal by the foreign government and/or authorities of the flag country or the UN to allow the mortgagee to exercise its rights to repossess and/or remove the mortgaged ship on the grounds of sanctions.

(b) Benefits

There is a common misconception that the shipowner’s war risks insurance is sufficient to provide the mortgagee with the required political risk coverage, but this is not always the case.<sup>199</sup> Taking out MRI separately has some merits, compared with fully relying on the shipowner’s war risks policies. Some examples of these benefits are as follows:<sup>200</sup>

- (1) The mortgagee who is the assured of MRI may be an assignee of the shipowner’s war risks insurance, but an assignee faces more risks than an

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<sup>197</sup> Ibid.

<sup>198</sup> Marsh ‘Mortgage Rights Insurance’ <<https://www.marsh.com/content/dam/marsh/Documents/PDF/UK-en/mortgage-rights-insurance.pdf>> accessed 30 October 2017.

<sup>199</sup> Mellett (n 154) 110.

<sup>200</sup> Ibid 111; Marsh (n 198).

assured in the proceeds of a claim, and such risks may be beyond the mortgagee's control.

- (2) MRI is tailored to insure the mortgagee against risks which are normally excluded from the shipowner's war risks insurance, such as the risk of confiscation or requisition by the registry country.
- (3) MRI is non-cancellable except in the event of an absence of insurable interest by the assured. By contrast, if the political situation deteriorates, then the war risk insurer can exercise its cancellation rights at any time by giving seven days' advance notice. Moreover, war risks insurance contains certain automatic termination provisions.
- (4) Unlike war risks insurance, which typically runs for twelve months, MRI can be taken out for periods of up to ten years. In the light of this, MRI can easily match the contract period of the collateral assets.

#### **4.4 Conclusion**

In the previous chapter, we identified three groups of risk which are considered to be substantial for ship finance projects.<sup>201</sup> The first group is risks associated with the operating cash flow, including the freight rate risk, the operational risk, the operating and voyage cost risk, the counterparty risk and the delay in delivery risk. The second group is risks associated with the value of ships, including the ship price risk and the pure risk. The third group is risks associated with the shipping market, including the cyclical risk, the political risk and the regulatory risk. These identified risks, without proper management, may have adverse or even disastrous effects on the overall performance of ship finance projects. Among a variety of risk management techniques, purchasing insurance to set off the financial consequences of risks is a technique preferred by ship financiers, provided that the cost is reasonable.

In this chapter, we have considered a range of insured perils of different marine policies which relate to ship finance transactions. Comparison of the insured perils of marine insurance with the risks that ship financiers are seeking ways to manage has yielded the following key points.

First, the freight rate risk cannot be covered by any form of marine policy. It is

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<sup>201</sup> See Chapter 3, section 3.5 (Analysing risks in ship finance).

## MARINE INSURANCE: INSURABLE RISKS AND COVERAGE

not a pure risk, considering that fluctuations in earnings can lead to two outcomes (gain or loss). Thus it cannot be managed by insurance. However, this type of risk may be managed by purchasing freight derivatives.

Second, the operational risk can be partly covered by marine insurance, particularly the shipowner's insurance such as H&M and LOH insurance. However, certain risks do not have an insurance solution, such as off-hire for purely business (or market) reasons or the charterer's poor reputation.

Third, the operating and voyage cost risk generally cannot be covered by marine insurance, but there are exceptions. An example of such exceptions is that where repair works have resulted from perils insured by H&M insurance, the repair cost may be indemnified by the hull insurer.

Fourth, the counterparty risk may or may not be covered by marine insurance. This is dependent upon a number of conditions, for instance the default party and reason for default. If a default is on the part of the refund guarantor, the refund guarantee insurance may respond, although it is essentially a form of financial insurance. Maritime lien insurance is an example from marine insurance, covering the risk of liens, that are unknown to the buyer at the time of purchase, being enforced against the ship under new ownership, and these pre-existing liens usually arise out of defaults on the part of the seller.

Fifth, the delay in delivery risk can be partly covered by either refund guarantee insurance or builders' risks insurance, but the effects achieved by insurance are limited. In practice, the buyer (i.e. shipowner) and their financiers mainly rely on refund guarantees issued by reputable guarantors to mitigate this type of risk.

Sixth, the ship price risk, in a general sense, cannot be covered by marine insurance, since it is not a pure risk. However, IV insurance insures the shipowner and their financiers against the risk that the amount recoverable by H&M insurance is not sufficient to fully indemnify a total loss of the ship – a situation which may occur where there is an increase in the prices of ships.

Seventh, the pure risk, in general, can be covered by marine insurance. For example, H&M insurance covers the risk of loss or damage to the ship; P&I insurance covers the liability risk arising out of a wide range of incidents (e.g. collision and pollution); and, for historical and practical reasons, the loss, damage and liability arising out of war risks are separately insured by war risks insurance.

Eighth, the cyclical risk cannot be covered by insurance.

Ninth, the political risk can be partly covered by marine insurance. For example,



war risks insurance insures against the risk of piracy.<sup>202</sup> Other marine covers such as MII/LII and MRI may protect ship financiers from being affected by the political risk,<sup>203</sup> under certain circumstances.

Tenth, the regulatory risk normally cannot be covered by marine insurance. However, where the primary insurers reject payments for reasons of non-compliance with regulations on the part of shipowners, ship financiers may be indemnified under MII or LII, subject to the specific case.

To conclude, purchasing marine insurance can efficiently shift a variety of risks in relation to ship finance projects from the financier to the insurance pool, but insurance solutions have limitations. First, not all risks can be transferred by purchasing insurance. Second, where risks can be covered by marine insurance, ship financiers and their advisors must carefully check the specific risks insured by different forms of insurance to avoid coverage gaps. Third, insurance can only indemnify the financial consequences of risks; other consequences resulting from insured risks such as reputation damage require alternative solutions. Fourth, insurance is a contract rather than a payment guarantee, thus there is no guarantee of being indemnified for any insured peril. Issues regarding the proper arrangement of marine insurance, especially the rules in relation to, and the legal risks which may arise out of such arrangements, will be discussed in the following chapter. The above discussions have touched upon some legal risks, including MII claims being triggered by sanctions directly targeted at shipping, and MAPP being deemed to be the shipowner's asset in the event that the shipowner's insurance broker takes out MAPP on behalf of the mortgagee. Since this chapter focuses on exploring what types of marine policy are appropriate, to keep the structure neat, all substantial legal risks mentioned above will be analysed in detail in next chapter. Fifth, receiving payment from insurers may be a long process, especially where the insurance claim is subject to litigation, and this may lead to a situation where an assured has gone out of business before the final insurance payment is due. Finally, there is a cost of purchasing insurance. The premium for certain marine risks can be very high, and it is not economically worthwhile to purchase such marine policies. Nevertheless, where insurance is

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<sup>202</sup> Although 'piracy' is defined as a maritime peril for the purposes of the Marine Insurance Act 1906 and the standard P&I insurance, the current market practice is for this risk to be excluded from standard H&M and P&I insurances, and for it to be covered by war risks insurance.

<sup>203</sup> See Chapter 5, section 5.11.2.3 (The position of ship financiers).

## MARINE INSURANCE: INSURABLE RISKS AND COVERAGE

commercially available, it is worth considering shifting risks away from ship finance projects by purchasing proper marine policies.

## CHAPTER 5

# MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

### 5.1 Introduction

Marine insurance is a contract which is to be governed by and construed in accordance with the law. This chapter first considers the law which applies to marine insurance contract in England and Wales (section 5.2), followed by describing the providers of marine insurance (section 5.3). Particular emphasis is placed on Protection and Indemnity (P&I) clubs which operate completely differently from commercial insurers. The concept of insurable interest (section 5.4) is important in this research because, lacking an insurable interest, the financier can neither insure the financed ship nor participate in the shipowner's and shipbuilder's marine insurance (i.e. primary insurance). The financier who has an insurable interest may participate in the primary insurance as a co-assured (section 5.5.3), as a loss-payee (section 5.5.4), or as an assignee (section 5.5.5). The advantages and disadvantages of each of these ways of participating will be considered. Marine insurance is a contract rather than a guarantee, so if something goes wrong in the ship finance package and there is a marine policy, it should not be assumed that the policy represents money in the bank. Things can go wrong under the policy, and this chapter examines a series of potential legal risks in respect of subrogation (section 5.6), ship valuation (section 5.7), broker (section 5.8), direct access to reinsurance (section 5.9), pollution liability (5.10), and economic sanctions targeted at shipping (section 5.11), with suggestions on how to manage such legal risks. It is impossible to look at every issue affecting the policy in great detail, as that would require a text on marine insurance. For example, where the financier participates in the primary insurance as an assignee, his claim against the insurer may be hindered if the assignor has willfully scuttled the ship, or the policy is illegal, or the assignor has breached the warranty. Those issues have been well discussed in established

literatures such as *Arnould*,<sup>204</sup> since the financier will find himself in a similar position as other assignees. Nevertheless, this research has identified the key issues relevant to the proper arrangement of marine policies in ship finance.

## 5.2 The law of marine insurance

Marine insurance is essentially a contract, therefore the general law of contract applies. The contracting parties are generally free to agree on terms; issues not specified by the terms are subject to legislation and rules of common law. Under English law, the Marine Insurance Act 1906 (MIA 1906) serves as the leading statutory statement for all classes of non-life insurance, including marine insurance. The MIA 1906 is a codifying act which codified common law principles that had been developed from insurance cases decided before 1906, without any attempt to change the existing law. Although the MIA 1906 collated some 200 years of judicial decisions, it is not exhaustive and some elements of the preceding common law were uncodified, therefore the preceding case law is also a part of the framework. Given that the MIA 1906 does not reflect changes in marine insurance practice since the act was passed, it is patently legitimate to refer to other cases that highlight developments of the law. Moreover, marine insurance contracts written in England are now dominated by a variety of standard form clauses. As a result, rules governing the relationship between parties to marine insurance contracts are substantially based on the statute (especially the MIA 1906), case law, and standard form contracts.

### 5.2.1 The law reform

The MIA 1906, as the basis of insurance law, is successful and highly influential.<sup>205</sup> However, it only reflects the law and the market at the time when it was drafted, and it does not have the flexibility to accommodate changes in social and economic conditions. Given that modern insurers have greater access to information, the provisions of the MIA 1906 in respect of disclosure, representations and warranties have been criticised for being unduly harsh to the

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<sup>204</sup> J Gilman and others, *Arnould: Law of Marine Insurance and Average* (18th edn, Sweet & Maxwell 2013).

<sup>205</sup> Marine Insurance Act 1906 has influenced marine insurance legislation in New Zealand, Australia, Malaysia, India, Hong Kong, Canada and Singapore.

assured. Although case law is capable of developing new precedents to keep pace with the market practice changes, the clarity of the MIA 1906 (which used to be its advantage) to some extent restricts the judges' ability to develop the law. In the light of this, reform of the present statute is necessary.

The Third Parties (Rights against Insurance) Act 2010<sup>206</sup> (2010 Act) updated its preceding the Third Parties (Rights against Insurers) Act 1930 (1930 Act), providing a simplified means for third parties to pursue direct claims against the liability insurer in the event that the assured is or is becoming insolvent. Third parties are not allowed to be in a better position than the assured, and rights being transferred to third parties are subject to any defence (for instance, breach of warranties or misrepresentation) that the insurer could use against the assured. Some modifications have been made by the 2010 Act to defeat technical defences, including the defence by "pay first" clauses (marine insurance is exempted). As a result, the "pay first" clauses in marine insurance are still valid and enforceable, excepting the case of personal injury or death.

In 2006, the Law Commission started a major review of insurance law, leading to two modern legislations—the Consumer Insurance (Disclosure and Representations) Act 2012 (CIDRA 2012) and the Insurance Act 2015 (2015 Act). The CIDRA 2012 only applies to consumer insurance contracts, and consequently, does not fall within the scope of this research. The 2015 Act reforms existing statutes, but also retains some rules of the MIA 1906. Examples of the reform are "replacing duty of disclosure<sup>207</sup> with a new duty of fair presentation",<sup>208</sup> "remedies for breach of warranty",<sup>209</sup> and "the insurer's remedies for fraudulent claims".<sup>210</sup> As a general observation, changes introduced by the 2015 Act will not significantly impact ship financiers in securing their investments by marine insurance. This research does not, therefore, examine the impacts of the 2015 Act on the issues considered in this chapter; unless otherwise specified, rules of marine insurance referred to in this research are based on principles derived from the MIA 1906 and existing case law.

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<sup>206</sup> The Third Parties (Rights against Insurance) Act 2010 gives effect, with minor modifications, to the recommendations set out in the Law Commission and the Scottish Law Commission's 2001 joint report 'Third Parties – Rights against Insurers' (Law Com No. 272; Scot Law Com No. 184) which was accepted by the Government in 2002.

<sup>207</sup> Marine Insurance Act 1906 ss. 18-20.

<sup>208</sup> Insurance Act 2015 ss. 3-6.

<sup>209</sup> *Ibid* s. 10.

<sup>210</sup> *Ibid* s. 12.

### 5.2.2 Characteristics of marine insurance law

Marine insurance is distinguished from non-marine insurance for two major reasons.<sup>211</sup> The first is that the Financial Services and Markets Act 2000 requires separate authorisation for conducting insurance business. The second reason is that marine insurance law and non-marine insurance law are different from each other.

To set the scene for this chapter, some characteristics of marine insurance law are summarised as follows:

- (1) A contract of marine insurance is enforceable only if being embodied in a formal policy.<sup>212</sup> In contrast, there is no requirement of special form for a non-marine insurance contract, even an oral contract is enforceable.
- (2) Unlike non-marine policies which cannot be assigned without the insurer's consent (with the exception of life insurance), marine policies are freely assignable.<sup>213</sup> The assured may assign the benefit of marine policies without assigning the subject-matter, and such an assignment is permitted even after the subject-matter has been lost resulting from insured perils.<sup>214</sup> This free assignment feature is very important for ship financiers, since it allows financiers participating in the primary insurance to enhance the security they hold.
- (3) In determining the amount recoverable under a marine policy, the insurable value of the subject-matter is its value at the commencement of the risk, rather than its value at the time of the loss.<sup>215</sup> However, the assured's loss under non-marine policies is determined at the date of the loss.<sup>216</sup> Considering the volatility of ship prices and ship companies' cash flow, it is for the benefits of both shipowners and their financiers that the assured's interests are valued at the commencement of the risk.
- (4) Unlike non-marine insurance, which only recognises total loss and partial loss, marine insurance also recognises the concept of constructive total loss

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<sup>211</sup> R Merkin (ed), *Marine Insurance Legislation* (5th edn, Informa 2014) 1 (hereafter in this chapter, '*Insurance Legislation*').

<sup>212</sup> Marine Insurance Act 1906 s. 22.

<sup>213</sup> *Ibid* ss. 50-51.

<sup>214</sup> Assignment is possible after loss, see: *Sparkes v Marshall* (1836) 2 Bing NC 761; *Lloyd v Fleming* (1872) LR 7 QB 299; *Aron & Co Inc. v Miall* (1928) 34 Com Cas 18.

<sup>215</sup> Marine Insurance Act 1906 s. 16.

<sup>216</sup> *Re Wilson and Scottish Insurance* [1920] 2 Ch 28.

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

(CTL).<sup>217</sup> CTL may present in two forms: (a) reasonable abandonment of the subject-matter insured for the reason of an actual total loss (ATL) appearing to be unavoidable; and (b) expenditures to avoid an ATL which exceeds the salvaged value.<sup>218</sup> Where there is a CTL, the assured is allowed to recover the amount of a total loss.

- (5) In marine insurance, the assured undertakes to do or not to do some particular things, or to fulfil some conditions, or his statements of fact bearing upon risks introduced into the policy are construed as a warranty.<sup>219</sup> Warranties in marine insurance may be express or implied by operation of law,<sup>220</sup> whereas warranties must be expressly created in non-marine policies. Thus, implied warranties are peculiar to marine insurance.<sup>221</sup> An express warranty must be included in or incorporated by reference into, the policy.<sup>222</sup> Where there is a breach of warranty, the insurer may discharge from their liabilities,<sup>223</sup> and so non-compliance of warranties by the shipowner will impose great risks on their financiers.
- (6) The insurer of voyage policies may automatically discharge liabilities in the event of an increased risk due to change of voyage, deviation or delay.<sup>224</sup> However, an increased risk does not affect the insurer's obligation under a non-marine policy, unless the policy provides otherwise.
- (7) The assured of marine insurance is required by law to prevent or mitigate the loss,<sup>225</sup> whereas there is no equivalent obligation on the assured of non-marine insurance. Meanwhile, the insurer is obliged to indemnify the assured for costs incurred in preventing or mitigating the loss.<sup>226</sup>

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<sup>217</sup> Marine Insurance Act 1906 s. 60.

<sup>218</sup> *Ibid* s. 60(1).

<sup>219</sup> *Ibid* s. 33. Insurance Act 2015 has reduced the significance of warranties.

<sup>220</sup> *Ibid* s. 33(2).

<sup>221</sup> *Ibid* ss. 39-41. See also *Euro-Diam Ltd v Bathurst* [1988] 2 All ER 23.

<sup>222</sup> *Ibid* s. 35(2).

<sup>223</sup> Insurance Act 2015 has made changes to the law relating to warranties in insurance contracts, under which, the policy will be suspended from the time of the breach of warranty until the breach has been remedied, but the insurer will be liable for subsequent losses provided a remedy is possible. Such changes apply to all insurance and reinsurance contracts that incept or are renewed on or after 12 August 2016.

<sup>224</sup> Marine Insurance Act 1906 ss. 43-49.

<sup>225</sup> *Ibid* s. 78.

<sup>226</sup> *Ibid* s. 78(3).

### 5.3 Marine insurance providers

Three classes of insurers in the London insurance market underwrite a range of marine risks: these are insurance companies, Lloyd's underwriters, and P&I clubs.

#### 5.3.1 Insurance companies and Lloyd's

Marine policies can be written by insurance companies, and many London operating insurance and reinsurance companies are represented by the International Underwriting Association of London (IUA), which is committed to promote and enhance the London Company Market.<sup>227</sup> Lloyd's of London, now the world's most prominent insurance corporation, is in fact a market where its members join together as syndicates to insure risks. Insurance brokers assist in placing insurance with Lloyd's, and will approach the proper syndicate for particular risks.

A range of different forms of marine policy are available on the market.<sup>228</sup> Marine policies written in England are dominated by various standard form clauses, and those standard form clauses which have been developed by the Institute of London Underwriters are known as the Institute Clauses. Hull insurance is usually provided on a time or voyage basis, and there are three sets of Institute Clauses for hulls, including (a) The Institute Hull Clauses (Voyage and Time) (1/10/83); (b) The Institute Hull Clauses (Voyage and Time) (1/11/95); and (c) The International Hull clauses (1/11/03). In spite of principal Institute Clauses for cargo, hull and freight, other standard wordings for shipbuilders' risks, war and strike risks, and mortgagees' interest are also provided by the Institute. In addition, the Institute also provides standard form extensions for matters such as malicious damage, increased value, and additional marine perils.

#### 5.3.2 Protection and Indemnity clubs

P&I clubs or mutual associations are established by a group of shipowners who have agreed to pay sums into a fund – this fund being used to cover their loss. Under such a structure, the members of the clubs are not only the insurers but

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<sup>227</sup> International Underwriting Association of London <<https://www.iua.co.uk>> accessed 30 October 2017.

<sup>228</sup> See, NG Hudson and T Madge, *Marine Insurance Clauses* (5th edn, Informa 2012) (hereafter in this chapter, '*Insurance Clauses*'), which provides examples for different forms of marine policy.



also the assureds.<sup>229</sup>

### 5.3.2.1 Risks covered by Protection and Indemnity clubs

P&I clubs primarily insure the shipowner's operational liabilities, by which a significant portion of operational risks can be covered. The original purpose of establishing clubs was to insure the ships, but shipowners now use clubs to cover risks and liabilities that are not covered by the ordinary marine policies.<sup>230</sup> There are three main types of cover provided by modern clubs, including:

- (1) The P&I cover for loss, damage, liability or expense incurred during the period of entry. The P&I cover is a named risk cover: that is, it only covers particular risks which are named in the club's rules. Risks normally covered include loss or damage to cargo; loss of life and injury to crew members or passengers; collisions liability; damage to fixed or floating objects; removal of wreck and pollution liability.
- (2) The defence cover for legal and other costs which are necessarily and reasonably incurred by members in pursuing or defending claims. Claims must be directly connected with the operation, insurance, acquisition or disposal of entered ships for events which occurred during the period of entry.<sup>231</sup>
- (3) The war risks cover provided by P&I clubs or War Risks clubs insures war risks which are not covered by the ordinary marine policies.<sup>232</sup>

Since policies provided by P&I clubs are in nature indemnity insurance, P&I clubs insist a principle of "no direct liability to third parties". This means that clubs indemnify their members in respect of the members' liabilities to third parties, but make no direct payments to third parties. Ship financiers, such as the mortgagees, are regarded as third parties under the clubs' rules. Thirteen principal P&I clubs all around the world form the International Group (IG), which collectively provides liability cover (protection and indemnity) for approximately 90% of world's ocean-going tonnage.<sup>233</sup> For solvency consideration, ship financiers generally require

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<sup>229</sup> See *Lion Mutual Marine Insurance Association v Tucker* (1883) 12 QBD 176.

<sup>230</sup> J Gilman and others, *Arnould: Law of Marine Insurance and Average* (18th edn, Sweet & Maxwell 2013) para 4-10 (hereafter in this chapter, 'Arnould').

<sup>231</sup> See, e.g. Gard AS, *Gard Rules 2017* (2017) rules 65-70

<[http://www.gard.no/Content/22786698/Rules\\_2017\\_web.pdf](http://www.gard.no/Content/22786698/Rules_2017_web.pdf)> accessed 30 October 2017.

<sup>232</sup> See *Empresa Cubana de Fletes v Kissavos Shipping Co SA (The Agathon)* (No. 2) [1984] 1 Lloyd's Rep 183.

<sup>233</sup> IG P&I <<http://www.igpandi.org>> accessed 30 October 2017.

the shipowner to take out P&I insurance with IG member clubs.

### 5.3.2.2 *Protection and Indemnity clubs' rules*

As a general observation, P&I clubs constitute a special feature of the marine insurance industry. Examples of their special features include: (a) entry into a club is confirmed by a certificate, which is the conclusive evidence of the matters stated on it;<sup>234</sup> (b) covers granted by a club only insure “named risks” laid down by its rule book; (c) the “pay to be paid” rule, by which a club’s members are entitled to be indemnified only after discharging their liability to third parties, unless the club has otherwise decided;<sup>235</sup> and (d) clubs operate on a basis of mutual funds, the club’s members pay calls instead of fixed premiums, any shortfall in the fund must be made up by members, and any profit will be distributed to members.<sup>236</sup> The “pay to be paid” rule is designed to resist any direct liability of clubs to the third party plaintiff, but clubs (at the discretion of managers) provide their members with funding to settle liabilities.

When a ship has been entered into a P&I club, the terms of its marine policy are written on the club’s rules. Some peculiarities of the club’s rules may be troublesome for ship financiers, especially those rules in relation to the right of assignment. P&I insurance, unlike other marine policies which are freely assignable, is usually prohibited to be assigned, mortgaged, or disposed without the club’s consent. The club’s rules also prohibit any activity by its members of conferring the benefits of insurance on third parties so as to deprive the club’s subrogation right. These special rules create problems for mortgagees and for lessors who rely on taking assignment of the shipowner’s insurance to complete their security packages. For this reason, shipping banks, upon granting shipping loans, inevitably require that the assignment of P&I insurance has been consented by the club in which the financed ship has been entered or proposed to be entered.<sup>237</sup> In addition to taking an assignment of P&I insurance, banks also

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<sup>234</sup> See *Compania Maritima San Basilio SA v The Oceanus Mutual Underwriting Association (Bermuda) Ltd (The Eurysthenes)* [1976] 2 Lloyd’s Rep 171; *Volkswagenwerk AG and Wolfsburg Transport Gesellschaft MBH v International Mutual Strike Assurance Co (Bermuda) Ltd* [1977] 2 Lloyd’s Rep 503.

<sup>235</sup> See *Firma C-Trade v Newcastle Protection and Indemnity Association (The Fantì)* [1990] 2 Lloyd’s Rep 191.

<sup>236</sup> *Insurance Legislation* (n 211) 143.

<sup>237</sup> *Hughes v Tindall* (1856) 18 CB 98; *Turnbull v Woolfe* (1861) 66 ER 336; *Alexander v Campbell* (1872) 41 LJ Ch 78.

require a letter of undertaking (LOU) from the same club. In spite of the variety of forms of LOU, by taking an assignment of P&I insurance together with the LOU issued by the club, the bank will be able to collect insurance proceeds in the event of loss. Matters in relation to the assignment of marine policies are considered later,<sup>238</sup> while the following section considers the effects of LOUs issued by P&I clubs.

### 5.3.2.3 *The effects of a club letter of undertaking*

In order to examine the effects of an undertaking issued by the P&I club, two cases are considered in following paragraphs, by which present different folds of the LOU.

In the first case, *The Good Luck*,<sup>239</sup> the mortgagee bank had succeeded in enforcing an LOU issued by the P&I club. The shipowners insured against war risks with a P&I club, and had agreed that the insured ships would not enter into the prohibited zones. Any breach of this warranty would result in the ships ceasing to be insured. As a common practice, the mortgagee bank had taken an assignment of all the shipowner's insurances, and had also purchased mortgagees' interest insurance (MII). The club undertook to inform the bank promptly if the ships should cease to be insured. However, the insured ships had breached the warranty by being chartered into a "special risks" area without notifying the club. Although the club was aware of the breach, it had failed to give notice to the bank that the ships had ceased to be insured. Unfortunately, the ship *Good Luck* was struck by an Iraqi missile in the prohibited area and became a CTL but the bank, without knowing that the club had ceased to insure the ships, advanced loans to the shipowners. Given that the P&I club's liability was automatically discharged from the date of the breach of warranty,<sup>240</sup> the mortgagee bank could not recover its loss under marine insurance from the club. Nevertheless, the House of Lords found that the club was in breach of its undertaking, and such a breach had led the mortgagee bank to provide loans which it would not have made, since these loans were inadequately secured for

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<sup>238</sup> See Chapter 5, section 5.5.5 (As an assignee).

<sup>239</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks Assn (Bermuda) Ltd (The Good Luck)* [1992] 1 AC 233.

<sup>240</sup> Marine Insurance Act 1906 s. 33(3). The automatic termination as held by *The Good Luck* comes to an end under the Insurance Act 2015, see: n 223 for changes to the law relating to warranties in insurance contracts.

the reason that the ships had ceased to be insured. As a result, the club was held to be liable to compensate the mortgagee bank for its loss.

Turning to the second case, *The Evelpidis Era*,<sup>241</sup> an undertaking issued by the P&I club had rendered an assignment of the shipowner's insurance to the ship mortgagee merely an equitable assignment. Under this particular undertaking, the club was allowed to pay claims to the shipowners and their creditors before it was informed by the mortgagee bank that the shipowners were in default.

Lessons drawn by ship financiers from the abovementioned cases include the fact that the wordings of undertakings are very important, thus the provisions of the LOU must be carefully reviewed with the assistance of professionals such as lawyers and insurance brokers, to make sure that they are consistent with the purpose of these undertakings.

#### 5.4 Insurable interest

English law requires that the assured of marine insurance has an insurable interest in the subject-matter insured. This rule, it has been suggested, derives not only from the indemnity nature of marine insurance but also from the historical statutory prohibitions on gambling.<sup>242</sup> A marine insurance contract is, in essence, a contract of indemnity.<sup>243</sup> Where an assured has no insurable interest in the subject-matter insured, it cannot possibly suffer a loss arising out of the insured perils, therefore any payment received by the assured represents a profit, which is in fact a violation of the indemnity principle. Also, it has been suggested that the rule of insurable interest was derived from the statutory prohibitions on gambling, as a means of separating valid insurance contracts from unenforceable wagers.<sup>244</sup> Some scholars doubt this proposal, however, pointing out that the first prohibition on policies by way of wager on British shipping and goods is found in the Marine Insurance Act 1745 (19 Geo. 2 c.37), which was enacted not only later than the established principle of indemnity, but also later than the requirement of insurable interest under English law.<sup>245</sup> Nevertheless, there is little doubt that the

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<sup>241</sup> [1981] 1 Lloyd's Rep 54.

<sup>242</sup> N Legh-Jones, 'The Elements of Insurable Interest in Marine Insurance Law', in DR Thomas (ed), *The Modern Law of Marine Insurance Volume 2* (Informa 2002).

<sup>243</sup> Marine Insurance Act 1906 s. 1.

<sup>244</sup> *Lonsdale & Thompson v Black Arrow* [1993] Ch 361 at 368.

<sup>245</sup> See, e.g. Legh-Jones (n 242) 136-137; *Arnould* (n 230) para 11-01.

law in relation to insurable interest developed alongside the statutory prohibitions on wagers.

The rule of insurable interest is also for public policy considerations, for two main reasons.<sup>246</sup> Firstly, without the rule of insurable interest, the assured may gamble with the insurer on the safety of the subject-matter insured. Secondly, and more importantly, the assured who has no insurable interest may take steps to bring about the insured risks, increasing the risk of fraudulent claims. The following discussion considers the law as it currently stands, with a particular focus on the interests of parties who have a role in the ship finance chain.

#### **5.4.1 The latest developments in insurance law**

According to the MIA 1906<sup>247</sup> and the Marine Insurance (Gambling Policies) Act 1909, the assured must have an insurable interest. However, the Gambling Act 2005 provides that a contract relates to gambling shall not prevent its enforcement, without prejudice to any rule of law preventing the enforcement of a contract enforcement on account of unlawfulness (other than a rule relating specifically to gambling).<sup>248</sup> In the light of this, there were doubts as to whether the Gambling Act 2005 would affect the rule of insurable interest provided in section 4 of the MIA 1906,<sup>249</sup> and this rule was indeed unlikely to be affected based on an analysis of both the legislative technique and the history of gambling contracts.<sup>250</sup>

In January 2006, the English and Scottish Law Commissions launched a reformation of insurance law. As a part of the reformation, an issues paper on the future of insurable interest was published in January 2008, and it was suggested that there was no need to require an insurable interest in non-life insurance. Nonetheless, as the final fruit of the reformation, the 2015 Act does not make any change in respect of the rule of insurable interest.<sup>251</sup> The Law Commission subsequently issued a draft Bill in 2016 which proposed reform of insurable

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<sup>246</sup> R Merkin, I Goldrein and J Mance (eds), *Insurance Disputes* (3rd edn, Informa 2011) para 3.3 (hereafter in this chapter, '*Insurance Disputes*').

<sup>247</sup> Marine Insurance Act 1906 s. 4.

<sup>248</sup> Gambling Act 2005 s. 335. The Gambling Act 2005, which repealed the Gaming Act 1845, came into force on 1 September, 2007.

<sup>249</sup> *Arnould* (n 230) para 11-11.

<sup>250</sup> *Ibid* paras 11-12 and 11-13.

<sup>251</sup> The Insurance Act 2015 received Royal Assent on 12 February 2015, which came into force in August 2016.

interest in marine insurance. However, the most recent draft Bill, in June 2018, is confined to insurable interest in life insurance, the Law Commission seemingly having taken the view that there is no real point in meddling with the law of insurable interest in the marine context. Therefore the law still stands as before, and the assured is still required to have an insurable interest.

#### **5.4.2 Who must have an insurable interest?**

The assured who enters into a marine insurance contract with the insurer must have an insurable interest. Besides the assured, where insurance is assigned after loss or at the time of the loss, the assignor must have an insurable interest at the time of assignment.<sup>252</sup> If the insurance is assigned before the loss, the assignee must have an interest at the time of the loss, or it is not eligible to claim.

#### **5.4.3 What is insurable interest?**

##### *5.4.3.1 The attitude of the English courts*

Due to the complex nature of insurable interest, there is not a universal definition. A classical definition was derived from *Lucena v Craufurd*,<sup>253</sup> in which Lawrence J described insurable interest as:

A man is interested in a thing to whom advantage may arise or prejudice happen from the circumstances which may attend it; and whom it importeth that its condition as to safety or other quality should continue. Interest does not necessarily imply a right to the whole or a part of a thing, nor necessarily and exclusively that which may be the subject of privation, but the having some relation to, or concern in, the subject of the insurance; which relation or concern, by the happening of the perils insured against may be so affected as to produce a damage, detriment or prejudice to the person insuring. And where a man is so circumstanced with respect to matters exposed to certain risks or dangers as to have a moral certainty of advantage or benefit but for those risks or dangers, he may be said to be interested in the safety of the thing. To be interested in the preservation of thing is to be so circumstanced with respect to it as to have benefit from its existence, prejudice from its destruction. The property of a thing and the interest derivable from it may be very different: of the first the price is generally the measure; but by interest in a thing, every benefit and advantage arising out of or depending on such a thing may be considered as being comprehended.<sup>254</sup>

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<sup>252</sup> Marine Insurance Act 1906 s. 51. See also *North of England Pure Oil Cake Co v Archangel Maritime Insurance Co* (1874-75) LR 10 QB 249.

<sup>253</sup> (1806) 2 Bos & PNR 269.

<sup>254</sup> *Ibid* at para [302].

The learned judge provided a broad definition. In order to have an insurable interest, the assured does not have to vest an absolute ownership in the subject-matter insured, and an insurable interest exists if the assured may benefit from the preservation of – or may be prejudiced from the destruction of – the subject-matter insured. That is, an insurable interest can be found where the assured has a factual and economic interest in the subject-matter insured.

However, not all judges are prepared to agree with such a broad definition. In the same case, Lord Eldon observed that ownership or a right to possess the subject-matter insured was essential in establishing an insurable interest.<sup>255</sup> This is a more restrictive approach compared with the test laid down by Lawrence J; many latter cases have endorsed the broader approach.<sup>256</sup>

#### 5.4.3.2 *The legal definition*

Section 5 of the MIA 1906 defines insurable interest in the following terms:

- (1) Subject to the provisions of this Act, every person has an insurable interest who is interested in a marine adventure.
- (2) In particular a person is interested in a marine adventure where he stands in any legal or equitable relation to the adventure or to any insurable property at risk therein, in consequence of which he may benefit by the safety or due arrival of insurable property, or may be prejudiced by its loss, or by damage thereto, or by the detention thereof, or may incur liability in respect thereof.<sup>257</sup>

This definition keeps a balance between the different approaches expressed by the judges. According to the MIA 1906, an insurable interest in fact represents a type of relationship between the assured and the subject-matter insured. In order to acquire an insurable interest, the assured is normally required to have a legal or equitable relation to – and an economic interest in – the subject-matter insured. The legislative definition is not exhaustive,<sup>258</sup> but three criteria can be concluded from it, as follows.<sup>259</sup>

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<sup>255</sup> Ibid at para [321].

<sup>256</sup> See *Wilson v Jones* (1866-67) LR 2 Ex 139; *Feasey v Sun Life Assurance Corporation of Canada* [2003] Lloyd's Rep IR 637.

<sup>257</sup> Marine Insurance Act 1906 s. 5.

<sup>258</sup> See, e.g. *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582; *Feasey v Sun Life Assurance Corporation of Canada* [2003] Lloyd's Rep IR 637; *O'Kane v Jones (The Martin P)* [2004] 1 Lloyd's Rep 389.

<sup>259</sup> Marine Insurance Act 1906 s. 5(2).

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

- (1) The assured may be benefited by the safety or due arrival of the subject-matter insured, or may be prejudiced by its loss, or by damage thereto, or by the detention thereof, or may incur liability in respect thereof.
- (2) The assured stands in a legal or equitable relation to the subject-matter insured.
- (3) The benefit, prejudice or liability (referred to 1) must arise as the consequence of the legal or equitable relation (referred to 2).

Given that an economic interest is a benefit or loss which can be measured by money, the assured may have no trouble proving such an interest in the subject-matter insured, but the ambit of a legal or equitable relation is not always well-defined.

### 5.4.3.3 *The test of insurable interest*

Although the above-mentioned description by Lawrence J and the legal definition provided by the MIA 1906 can be used to test the existence of an insurable interest, there is not a universal test which can be applied in all cases. It has been suggested that “the power to abandon” is a good test for insurable interest.<sup>260</sup> Abandonment means that the assured, upon being indemnified by the insurer, is divested of all interests it has in the subject-matter insured at the time of the loss. Where an assured is incapable of abandoning the subject-matter insured, it does not have an insurable interest.<sup>261</sup> This test has been applied in *Sharp v Sphere Drake Insurance*,<sup>262</sup> in which Anthony Colman QC found an insurable interest on account of the assured being capable of abandoning the insured ship in the event of a loss.<sup>263</sup>

However, the abandonment test is not always applicable. Firstly, the subject-matter insured may not be capable of being abandoned due to its nature, such as the profit, disbursement, bottomry, and respondentia, but an insurable interest may exist in these situations.<sup>264</sup> Secondly, in *O’Kane v Jones*,<sup>265</sup> Richard Siberry QC concluded that an absence of the power to abandon did not preclude the

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<sup>260</sup> *Arnould* (n 230) para 11-33.

<sup>261</sup> See the observations of *Lucena v Craufurd* (1806) 2 Bos & PNR 269 at 312. See also *Conway v Gray* (1809) 10 East 536; *O’Kane v Jones (The Martin P)* [2004] 1 Lloyd’s Rep 389.

<sup>262</sup> [1992] 2 Lloyd’s Rep 501.

<sup>263</sup> *Ibid* at 512.

<sup>264</sup> See *Lucena v Craufurd* (1806) 2 Bos & PNR 269 at paras [289-310] and [315-327].

<sup>265</sup> [2004] 1 Lloyd’s Rep 389.



existence of an insurable interest on the part of the manager of ships.<sup>266</sup> In conclusion, it may be a mission impossible to apply one test for the insurable interest to all cases. The modern courts tend to find an insurable interest where possible, especially in the event of the insurable interest being used by the insurer and their lawyers as a technical defence.

#### 5.4.4 When must insurable interest attach?

The principle that an insurable interest must attach at the time of the loss is provided in section 6 of the MIA 1906, as follows:

- (1) The assured must be interested in the subject-matter insured at the time of the loss though he need not be interested when the insurance is effected: Provided that where the subject-matter is insured "lost or not lost", the assured may recover although he may not have acquired his interest until after the loss, unless at the time of effecting the contract of insurance the assured was aware of the loss and the insurer was not.
- (2) Where the assured has no interest at the time of the loss, he cannot acquire interest by any act or election after he is aware of the loss.<sup>267</sup>

Accordingly, the assured must have an insurable interest at the time of the loss, but is no longer required to have an insurable interest when the insurance is effected.<sup>268</sup> However, if the assured has lost its insurable interest at the time when the loss take place, it is not entitled to claim from the insurer.<sup>269</sup>

#### 5.4.5 Particular interests

Ship financiers have economic interests in their investments. They may also incur liabilities for investing in ships, such as the environmental liability arising from shipping pollution. This section mainly considers whether a particular participant in the ship finance chain has an insurable interest in the financed ship. It is important to address this question for two reasons: firstly, a person without an insurable interest in a ship cannot insure the ship under marine insurance; and, secondly, a person must have an insurable interest in the ship in order to benefit from its marine insurance. The participants referred to in this section include the

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<sup>266</sup> Ibid at para [155].

<sup>267</sup> Marine Insurance Act 1906 s. 6.

<sup>268</sup> *Lucena v Craufurd* (1806) 2 Bos& PNR 269 at para [295]. See also *Marsh v Robinson* (1802) 4 Esp 98.

<sup>269</sup> *Cepheus Shipping Corp v Guardian Royal Exchange Assurance Plc (The Capricorn)* [1995] 1 Lloyd's Rep 622.

shipbuilder, shipowner, bareboat charterer (who is often the borrower under finance lease), lessor, mortgagee, creditor and shareholder. In addition, two circumstances that may result in changes to insurable interest are also considered here, including the sale and purchase of a second-hand ship and the purchase of a new ship.

#### 5.4.5.1 Owner

The owner of a chattel has an insurable interest in the chattel, up to its full value. In the light of this, the shipowner, shipbuilder or ship lessor has an insurable interest in the ship on account of their ownership, and they can insure the full value of the ship.

##### (a) Shipowner

An owner who legally owns a ship has an insurable interest in the ship. The shipowner's insurable interest will not cease to exist in the following instances: the ship is held in trust, a mortgage or a lien is attached to the ship, the ship is chartered (bareboat charter included), the ship is sold with a reservation of rights and liabilities, and the ship is seized for a forfeiture incurred before the voyage described in the policy.<sup>270</sup> However, if a ship has been pledged by bottomry or respondentia bond for her full value, the shipowner may cease to have an insurable interest.<sup>271</sup> In addition, several persons may have separate insurable interests in the same ship, such as the co-owners of a ship.<sup>272</sup>

##### (b) Seller and buyer

At the moment of passing the ship's title to the buyer, the seller ceases to have an insurable interest in the ship, whilst the buyer acquires an insurable interest in the ship. Such a change will occur at the time of transferring the ship's title, rather than at the time of agreeing on the sale and purchase contract.<sup>273</sup>

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<sup>270</sup> *Arnould* (n 230) para 11-35. See also the recent Canadian decision in *Broadgrain Commodities Inc v Continental Casualty Co* [2017] ONSC 4721, recognising that the holder of a possessory security interest has insurable interest in the subject matter.

<sup>271</sup> *Ibid.*

<sup>272</sup> *Castellain v Preston* (1883) 11 QBD 380 at 398.

<sup>273</sup> For the importance of the passing of risk to insurable interest, see: *Tephens v Australasian Insurance Co* (1872) L.R. 8 C.P. 18; *Allison v Bristol Marine Insurance Co* (1876) L.R. 1 App. Cas. 209; *Inglis v Stock* (1885) L.R. 10 App. Cas. 263; *Wunsche Handelsgesellschaft International mbH v Tai Ping Insurance Co* [1998] 2 Lloyd's Rep. 8.

The seller has an insurable interest in the ship not only as an owner, but also as a risk taker. In *Reed v Cole*,<sup>274</sup> given that the seller had agreed in the sale and purchase contract to pay the buyer £500 in the event that the ship was lost within three months, the court decided that the seller still had an interest in the ship's safety, and was therefore eligible to recover from the mutual insurer. By the same token, the buyer can acquire an insurable interest in a ship by being an owner, or for the reason that the ship is at its risk.

(c) Shipbuilder

As long as a ship remains at the builder's risk, the shipbuilder has an insurable interest in the ship. Usually, the risk of loss or damage to a newbuilding remains with the builder until the delivery and acceptance of the ship, even when the title of the ship has been passed to the buyer before the delivery. According to the Shipbuilders' Association of Japan (SAJ) form, a widely used standard shipbuilding contract, the builder assumes the risk of loss (excepting risks of war, earthquakes and tidal waves) until the delivery and acceptance of the ship. The rationale for this practice is that the loss or damage to a newbuilding is more likely to be caused by the acts and omissions of the builder's employees, since a ship under construction normally stays at the builder's premises.<sup>275</sup> In the light of this, the builder is customarily obliged to insure the ship (including materials and engines) during the period of construction, and such an obligation shall cease and terminate forthwith upon delivery thereof and acceptance by the buyer.<sup>276</sup> The buyer may take out insurance separately for materials supplied by the buyer.

A ship will be faced with significant risks of loss or damage throughout the course of her construction, outfitting and trials. Thus not only the builder but also the buyer (and their financiers) have to be satisfied that the ship is adequately insured. However, it is not clear whether the buyer of a new ship has an insurable interest before acquiring the title of the ship. In a Canadian case,<sup>277</sup> the court found that the buyer had an insurable interest in a ship which was burnt during the course of construction, on account of the advance payments by the buyer. No similar cases have been found under English law, therefore the position of

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<sup>274</sup> (1764) 3 Burr 1512.

<sup>275</sup> S Curtis, *The Law of Shipbuilding Contracts* (4th edn, Informa 2012) 143.

<sup>276</sup> *Ibid.*

<sup>277</sup> *Clark v Scottish Imperial Insurance Co* (1879) 4 SCR 192.

English law on the abovementioned issue is not clear. Such uncertainty will not cause huge problems in reality, since the pre-delivery instalments paid by the buyer can be secured by the refund guarantees provided by the builder's bank.

(d) Lessor

A lessor is interested in a ship as the legal owner of the ship, thereby the lessor may insure the ship on its own behalf up to the full value of the ship.<sup>278</sup> Under a finance lease structure, the lessor normally participates in the lessee's (i.e. bareboat charterer) insurance as an assignee or as a co-assured, rather than insuring the ship by itself. By contrast, under an operating lease structure,<sup>279</sup> the lessor may insure the ship on its own behalf or on behalf of itself and the lessee.

5.4.5.2 Mortgagee

Section 14(1) of the MIA 1906 provides 'Where the subject matter insured is mortgaged, the mortgagor has an insurable interest in the full value thereof, and the mortgagee has an insurable interest in respect of any sum due or to become due under the mortgage.'<sup>280</sup> Accordingly, the mortgagee has an insurable interest in the mortgaged ship. In addition, section 14(2) of the MIA 1906 provides 'A mortgagee, consignee, or other person having an interest in the subject-matter insured may insure on behalf and for the benefit of other persons interested as well as for his own benefit.'<sup>281</sup> In the light of this, the mortgagee and the shipowner may insure the ship not only on their own behalf, but also for the benefit of each other.

The mortgagee may insure the mortgaged ship for the full extent of its financial interest, no matter if it is a statutory mortgage or an equitable mortgage.<sup>282</sup> Where the mortgagee's financial interest exceeds the ship's market value, it may insure the ship up to a sum equalling the full amount of the mortgage.<sup>283</sup> If the mortgagee's financial interest is less than the market value of the ship, it may insure the full value of the ship for its own benefit. Unless the mortgagee has

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<sup>278</sup> *Darrell v Tibbitts* (1880) 5 QBD 560 (CA) (fire insurance).

<sup>279</sup> The operating lease structure is typically used for financing container ships.

<sup>280</sup> Marine Insurance Act 1906 s. 14(1).

<sup>281</sup> *Ibid* s. 14(2).

<sup>282</sup> *Ibid* s. 5. See also *P Samuel and Company v Dumas* [1924] AC 431.

<sup>283</sup> See, e.g. *Glafki Shipping Co SA v Pinios Shipping Co (No. 1) (The Maira) (No. 2)* [1986] 2 Lloyd's Rep 12.

intended to cover both its own interest and the mortgagor's interest at the time of effecting the policy,<sup>284</sup> in the event that the mortgagee insures a ship for its own benefit alone it can only recover the amount of the mortgage debt owing to it at the time of the loss.<sup>285</sup> Even where the mortgagee has recovered the full amount of the policy's value, the insurer can claim back from the surplus retained by the mortgagee.<sup>286</sup>

The shipowner (i.e. mortgagor) is normally obliged to insure the mortgaged ship. The mortgagee will not only participate in the shipowner's insurance as an assignee or a co-assured, but also take out MII separately in order to insure against the risk of non-payment by the hull insurers. The cost of MII will normally be reimbursed by the mortgagor. Where the shipowner casts away the ship without the privity of the mortgagee, or where the warranty of the hull policy is breached, the mortgagee may be indemnified under MII.<sup>287</sup>

#### 5.4.5.3 Creditor

A secured creditor or an *in rem* creditor has an insurable interest, and may insure the ship up to a sum equalling the full amount of the secured debt.<sup>288</sup> By contrast, an unsecured creditor is merely interested in the debtor's solvency, and normally has no legal or equitable relation to the debtor's asset. In the light of this, an unsecured creditor is not interested in the debtor's asset.<sup>289</sup> In *Macaura v Northern Assurance Co (The Macaura)*,<sup>290</sup> the claimant was both a shareholder (the sole shareholder) and a creditor of a company who owns the timber, and the claimant had insured the timber. The timber was subsequently destroyed by fire, so the claimant had suffered losses. However, the insurer refused to indemnify

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<sup>284</sup> See *Irving v Richardson* (1831) 2 B & Ad 193.

<sup>285</sup> *Ebsworth v Alliance Marine Insurance* (1872-73) LR 8 CP 596; *Castellain v Preston* (1883) 11 QBD 380 at 398 (Bowen LJ).

<sup>286</sup> See *Irving v Richardson* (1831) 2 B & Ad 193.

<sup>287</sup> See, e.g. *P Samuel and Company v Dumas* [1924] AC 431; *Continental Illinois National Bank & Trust Co of Chicago v Bathurst (The Captain Panagos DP)* [1985] 1 Lloyd's Rep 625; *Schiffshypothekenbank Zu Luebeck AG v Norman Philip Compton (The Alexion Hope)* [1987] 1 Lloyd's Rep 60, affirmed [1988] 1 Lloyd's Rep 311 (CA); *Svenska Handelsbanken AB v Dandridge (The Aliza Glacial)* [2002] 2 Lloyd's Rep 421.

<sup>288</sup> See, e.g. *Moran Galloway & Co v Uzielli* [1905] 2 KB 555, in which Walton J held that a creditor's right to claim *in rem* against a ship conferred on it an insurable interest in the ship. See also *O'Kane v Jones (The Martin P)* [2004] 1 Lloyd's Rep 389.

<sup>289</sup> See *Moran Galloway & Co v Uzielli* [1905] 2 KB 555; *Macaura v Northern Assurance Co (The Macaura)* [1925] AC 619; *Sharp v Sphere Drake Insurance (The Moonacre)* [1992] 2 Lloyd's Rep 501.

<sup>290</sup> [1925] AC 619.

the assured claimant on account of the assured having no insurable interest in the timber. The insurer's argument was supported by Lord Buckmaster (with whom Lord Atkinson agreed) 'He stood in no "legal or equitable relation" to the timber at all. He had no "concern in" the subject insured. His relation was to the company, not to its goods...'.<sup>291</sup>

The principle in *The Macaura* is still good law in England and Wales, but it has been continually criticised for lacking flexibility in meeting the need of modern commerce and the convenience of composite and joint insurance.<sup>292</sup> As an alternative solution, the unsecured creditor may insure against the debtor's solvency risk.

#### 5.4.5.4 Shareholder

The shareholder of a company has no insurable interest in the company's properties.<sup>293</sup> The position of English law in respect of the shareholder's insurable interest was provided in *The Macaura*,<sup>294</sup> in which the court held that the shareholder was not interested in the property owned by the company. This principle still stands today. Similar to the unsecured creditor, the shareholder has no legal or equitable relation to the company's property, because its interest is in the company rather than in the property of the company.<sup>295</sup>

Later, in *Sharp v Sphere Drake Insurance (The Moonacre)*,<sup>296</sup> the court held that the sole shareholder of the company who owned the yacht had no insurable interest in the yacht. However, Anthony Colman QC (later Colman J) held that if the assured claimant had incurred liabilities for destroying the company's property, it could have an insurable interest in the property.<sup>297</sup> That is, a person who only holds shares in a company has no insurable interest in the company's property, whereas a shareholder who has any legal or equitable relation to the

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<sup>291</sup> Ibid at 630.

<sup>292</sup> See *Feasey v Sun Life Alliance Co of Canada* [2003] EWCA Civ 885 at para [146], where Ward LJ's commented 'Insurance business is no longer conducted in the coffee shop. It is now a massive market and, for contracts between commercial men to be respected, the law should march with the times'. See Also *Insurance Disputes* (n 246) para. 3.15.

<sup>293</sup> See *Wilson v Jones* (1866-67) LR 2 Ex 139; *Macaura v Northern Assurance Co (The Macaura)* [1925] AC 619.

<sup>294</sup> *Macaura v Northern Assurance Co (The Macaura)* [1925] AC 619.

<sup>295</sup> Ibid at 630 (Lord Sumner).

<sup>296</sup> [1992] 2 Lloyd's Rep 501.

<sup>297</sup> Ibid at 511.

property of the company in which it holds shares may have an insurable interest in the property.

#### 5.4.5.5 Bareboat charterer

In the event of a bareboat charter, the risk of the chartered ship's safety will be passed from her legal owner to the charterer, thus the charterer may suffer losses and/or incur liabilities arising out of marine perils. In the light of this, the bareboat charterer has an insurable interest in the chartered ship, and may insure the ship up to her full value.<sup>298</sup>

### 5.5 Utilising the primary insurance<sup>299</sup>

In practice, the shipowner and shipbuilder are generally obliged to insure the ship (or the ship under construction) and insure against a variety of risks in respect of the ship.<sup>300</sup> In the event that the ship is the primary asset (or even the only asset) of the shipowner and/or shipbuilder, the financier's security on the ship are meaningless, unless she has been properly insured and the financier can benefit from her insurance. For this reason, ship financiers (in particular mortgagees and lessors) normally require the shipowner's and shipbuilder's marine insurance to be extended to protect their interests. The ship financier may benefit from the shipowner's and shipbuilder's insurance through various approaches, and these are considered in turn in this section.

The term "ship financier" is broadly defined in this research, including both the debt provider (secured creditor and unsecured creditor) and the equity investor. Nevertheless, it is necessary to narrow the scope of ship financier in this section: here, the term "ship financier" only refers to the ship mortgagee, unless otherwise

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<sup>298</sup> *Linelevel Ltd v Powszechny Zaklad Ubezpieczen SA (The Nore Challenge)* [2005] EWHC 421 (Comm).

<sup>299</sup> See, generally: PM Eggers and A Marriott, 'Ship Mortgages and Insurance Issues' (1998) 8 JIML 251; PM Eggers, 'Mortgagees' Interest Insurance' in B Soyer and AM Tettenborn (eds), *Ship Building, Sale, and Finance* (Informa 2016) (hereafter in this chapter, 'Eggers'); G Bowtle and KP McGuinness, *The Law of Ship Mortgages* (Informa 2001) Chapter 5; D Osborne, G Bowtle and C Buss, *The Law of Ship Mortgages* (2nd edn, Informa 2016) Chapter 16 (hereafter in this chapter, 'Ship Mortgages'). See also Stephenson Harwood (ed), *Shipping finance*, (3rd edn, Euromoney 2006); P Mellett (ed), *The Insurance Aspects of Shipping and Offshore Financing* (Bankserve 2013); *Arnould* (n 230) Chapter 8; R Merkin, *Colinvaux's Law of Insurance* (11th edn, Sweet & Maxwell 2016) Chapter 15 (hereafter in this chapter, 'Colinvaux').

<sup>300</sup> See Chapter 2, section 2.6.3.2 (Insurance issues), 2.6.4.3 (Insurance issues), 2.7.1 (Who insures the ship?).

specified. There are three main reasons for narrowly interpreting the term. First, although all types of ship financier can directly or indirectly benefit from the shipowner's and shipbuilder's marine insurance (i.e. primary insurance),<sup>301</sup> some ship financiers (such as shareholders) are not interested in the financed ship.<sup>302</sup> Among a variety of ship financiers, only the mortgagee and lessor are able to directly participate in the primary insurance. Second, the mortgage-backed bank loan is – and will continue to be – the primary ship financing method.<sup>303</sup> For this reason, the mortgagee is a party to the majority of insurance cases which involve ship finance transactions. Third, the lessor stands in a similar position to the mortgagee in respect of utilising the primary insurance. In the light of this, it is meaningless to repeat the position of the lessor, except to comment on the differences.

### 5.5.1 Duty to insure

Under English law, the shipowner has no duty to insure a ship either for the benefit of itself, or for the benefit of its financiers. However, the shipowner is generally obliged by the shipping loan agreement to insure the ship and to keep the ship insured throughout the entire loan period.<sup>304</sup> If a mortgaged ship has been sent to sea without insurance covers, the mortgagee is entitled to take possession of the ship,<sup>305</sup> although an uninsured ocean-going ship cannot, in reality, operate or trade. A number of international regulations have been made to enforce compulsory insurances through flag states and port states,<sup>306</sup> in particular, P&I insurance to cover third party liabilities.

As regards the mortgagee, it may insure a ship up to the full extent of its financial interests in the ship, on behalf of itself and/or the shipowner.<sup>307</sup> Unless the mortgagee has expressly agreed to do so, it has no duty to insure the

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<sup>301</sup> See Chapter 3, section 3.6.5.2 (The role of marine insurance in ship finance).

<sup>302</sup> See Chapter 5, section 5.4.5.4 (shareholder).

<sup>303</sup> See Chapter 2, section 2.9 (Trends in ship finance).

<sup>304</sup> See Chapter 2, section 2.6.3.2 (Insurance issues).

<sup>305</sup> See, e.g. *Laming & Co v White Seater and Others* (1889) 16 R 828 (Sess); *Law Guarantee and Trust Soc v Russian Bank for Foreign Trade* [1905] 1 KB 815 (CA) at 825 (Lord Alverstone CJ); *The Manor* [1907] P 339 (CA) at 359 (Lord Alverstone CJ).

<sup>306</sup> For example: the 1992 International Convention on Civil Liability for Oil Pollution Damage; the 2001 International Convention on Civil Liability for Bunker Oil Pollution Damage; the 2007 Nairobi International Convention on the Removal of Wrecks; UK has ratified these conventions.

<sup>307</sup> See Chapter 2, section 2.6.3.2 (Insurance issues).



mortgaged ship, or to ensure that the ship is insured for her full value.<sup>308</sup> In the event that the mortgagee insures a ship, the shipowner is not obliged to reimburse the premium and/or the cost incurred for the insurance of the ship, unless the parties have expressly agreed otherwise. In practice, if the mortgagor fails to insure a mortgaged ship, the deed of covenant generally entitles the mortgagee to insure the ship at the cost of the mortgagor. However, once the mortgagee has taken possession of a ship, its duty in respect of the insurance changes. In the first place, the mortgagee shall give notice of such a possession to the insurers and P&I clubs of the ship, to make sure that the ship's current insurances can be continued. In the second place, the mortgagee shall insure the ship from the date of the possession.

### **5.5.2 The legal risks faced by ship mortgagees<sup>309</sup>**

Sufficient insurance protections are important for the success of a ship mortgage project.<sup>310</sup> As previously mentioned,<sup>311</sup> the shipowner is generally obliged to insure a mortgaged ship and to keep the ship insured through the entire loan period. The mortgagee, unless taking out contingency insurance such as MII and MAP, will not insure the ship separately under normal circumstances. However, insurance is a contract rather than a guarantee. In the light of this, the claims under the primary insurance may be not payable or be paid with reductions in the event of one or a combination of the following reasons:

- (1) The losses were not caused by the insured perils;
- (2) The insurance cover has been ceased upon the automatic termination provision being triggered, such as in the event of a loss of class or a change of flag;
- (3) The insurance is void for the reason of non-disclosure or misrepresentation;
- (4) The insurance cover has been ceased due to breach of conditions or warranties;

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<sup>308</sup> See *National Bank of Greece SA v Pinios Shipping Co No. 1 (The Maira) (No. 3)* [1989] 3 WLR 185 (CA).

<sup>309</sup> See, generally: Mellett (n 299) 101; *Ship Mortgages* (n 299) 436-438.

<sup>310</sup> See Chapter 2, section 2.6.3.2 (Insurance issues).

<sup>311</sup> *Ibid.*

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

- (5) The claim is legitimately declined because the shipowner has made a fraudulent claim;<sup>312</sup>
- (6) The insurance is void by initial illegality or is frustrated through supervening illegality;
- (7) The claim is legitimately declined because the assured has deliberately destroyed the subject-matter insured, by means such as scuttling;
- (8) The insurance cover has been cancelled because of a non-payment of premiums or a failure of renewal;
- (9) The insurance proceeds are paid with a reduction by deducting or setting off the amount owed to the broker and/or insurer, especially the amount owed in respect of other ships in the shipowner's fleet which are not mortgaged to the mortgagee;
- (10) The insurance proceeds have been paid, but are being retained by the liquidator or other insolvency officials of the shipowner;
- (11) The shipowner has assigned its interest in the policy to a third party, and the third party ranks ahead of the mortgagee because it has served the notice of assignment earlier than the mortgagee;<sup>313</sup>
- (12) The claim is not payable because the insurer becomes insolvent.

The above-listed risks are not exhaustive, but they demonstrate the degree of danger for the mortgagee who solely relies on the primary insurance. In order to resist these risks, the mortgagee may seek to utilise the primary insurance in one or a combination of three ways: as a co-assured, as a loss-payee, or as an assignee. In brief, as a composite co-assured, the mortgagee's financial interest in the ship is actually insured separately and independently from the interest of the owner. As a result, if the owner is prevented from recovery under the policy due to its misconduct, the co-assured mortgagee's rights under the policy will not be affected unless the latter is implicated in the misconduct. Moreover, the mortgagee may be named as a loss payee on the shipowner's hull policies and/or P&I entries. According to the Contracts (Rights of Third Parties) Act 1999 (1999 Act), a loss payee can require the insurer to pay the insurance proceeds directly to it, rather than to the assured.<sup>314</sup> However, the loss payee has no better rights

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<sup>312</sup> See, e.g. *Versloot Dredging BV v HDI Gerling Industrie Versicherung AG (The DC Merwestone)* [2016] UKSC 45.

<sup>313</sup> *Dearle v Hall* (1828) 3 Russ 1.

<sup>314</sup> Contracts (Rights of Third Parties) Act 1999 s. 1.

than the original assured, since its rights are derived from the original assured, and the insurer is entitled to make any defence that it would have been entitled to make against the original assured. Turning to the assignee, the rights of the assignee are also derived from the assignor. In the light of this, where the assignor assured is guilty of willful misconduct in relation to the ship, or is in breach of the duty of fair presentation, or submits a fraudulent claim, or is in breach of the warranty, the mortgagee assignee will not be indemnified by the insurer.

In addition, in order to participate in the primary insurance, the ship mortgagee may use other methods to secure their financial interests. These include (but not limited to) reviewing the terms of marine policies, taking undertakings from the shipowner, as well as taking undertakings from the insurers, clubs and brokers.

- (1) Reviewing the terms of marine policies may address risks of the scope of insured perils, automatic termination of insurance, non-disclosure, misrepresentation and breaching conditions or warranties.
- (2) Taking undertakings from the shipowner may protect the mortgagee from risks of the scope of insured perils, automatic termination of insurance, non-renewal or non-payment of premiums, non-disclosure, misrepresentation, breaching conditions or warranties, fraudulent claims, legality, set-off and competing assignees. There is no guarantee that the shipowner will comply with these undertakings, but the mortgagee has remedies if the shipowner chooses not to do so.
- (3) Taking undertakings from the insurers, clubs and brokers in favour of the mortgagees may address risks of the automatic termination of insurance, non-renewal or non-payment of premiums. In a typical LOU issued by the insurer, the insurer guarantees to pay the insurance proceeds directly to the mortgagee, and to inform the mortgagee in the event that the insurance should cease to be in place. The effects of LOUs provided by the clubs have previously been considered<sup>315</sup> and, in this section, we will further examine issues in respect of taking undertakings from the insurers, clubs and brokers.

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<sup>315</sup> See Chapter 5, section 5.3.2.3 (The effects of a club of undertaking).

### 5.5.3 As a co-assured

In this section, we will consider the rights and obligations of the mortgagee who is a co-assured under the primary insurance. Given that builders' risks insurance may be extended to insure the buyer (i.e. the prospective shipowner) but not the mortgagee, it is not a subject of this section.

Since the interests of the shipowner and mortgagee in a ship are severable and distinct, a policy which includes them as the co-assureds is deemed as a composite policy.<sup>316</sup> Unlike the joint policy (e.g. the co-owners of a ship under the same policy), which is essentially a single policy with two or more assureds who all have the same rights and obligations, the composite policy is in fact a bundle of contracts (between the insurer and every single assured), and the rights and obligations of each assured under the composite policy are distinct.<sup>317</sup> As a result, the mortgagee and shipowner who are co-assureds under the primary insurance have separate contracts with the insurer which subscribe to relevant risks, and the mortgagee's rights under the policy are independent and distinct from those of the shipowner.

#### 5.5.3.1 How to become a co-assured?

The mortgagee and the owner may become the co-assureds in two ways. The easier way is that both of them apply to the insurer for insuring their interests separately,<sup>318</sup> in which case, the scopes of each applicant's insurance cover are a matter of construction.

An alternative way is that the shipowner insures on behalf of itself and the mortgagee, which is more common in practice. Merely supported by a provision which states that the named or identifiable co-assured's interests are covered by the policy, the co-assured is neither entitled to enforce the policy nor to rely upon the policy's terms (e.g. to enjoy the benefit of the subrogation waiver clause).<sup>319</sup> In the event that the owner is required by the contract – or is authorised by the mortgagee – to insure on behalf of both of them, the mortgagee may acquire the contractual rights if it can be identified by name or class, or as an undisclosed

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<sup>316</sup> See, *P Samuel and Company v Dumas* [1924] AC 431; *Woolcott v Sun Alliance* [1978] 1 Lloyd's Rep 629; *Eide UK Ltd v Lowndes Lambert Group Ltd* [1998] 1 Lloyd's Rep 389.

<sup>317</sup> *Arnould* (n 230) para 8-13.

<sup>318</sup> *Colinvaux* (n 299) para 15-008.

<sup>319</sup> *Haberdashers' Aske's Federation Trust Ltd v Lakehouse Contracts Ltd* [2018] EWHC 558 (TCC).

principal if it is not so identifiable.<sup>320</sup> Where the mortgagee is named as a co-assured, which is essentially a matter of construction, identifying the co-assured is effortless. However, identifying the co-assured is more complex where the undisclosed principal doctrine applies; the mortgagee will be treated as a co-assured only if it has satisfied three conditions:

- (1) the shipowner has authorisation to enter into the policy on behalf of the mortgagee when taking out the policy,<sup>321</sup> or at least has ratified the unauthorised act of the shipowner;<sup>322</sup>
- (2) the shipowner has intended to cover the mortgagee's interests when take out the policy,<sup>323</sup>
- (3) the policy itself does not preclude extending the benefit of the policy to the mortgagee.<sup>324</sup>

#### 5.5.3.2 Why to be a co-assured?

Each composite assured has a separate contract with the insurer. Therefore, the co-assured mortgagee has a distinct claim from the shipowner, and such a claim will not be affected by any breach of duty on the part of the shipowner. In the light of this, the mortgagee may enjoy a range of benefits as a co-assured.

First, where the shipowner is in breach of the duty of utmost good faith,<sup>325</sup> the mortgagee may sustain its own claim.<sup>326</sup> The insurer is entitled to avoid an

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<sup>320</sup> *Arnould* (n 230) paras 8-03, 8-04.

<sup>321</sup> Authority can be express, implied or ostensible. It is uncertain whether the doctrine of undisclosed principal can apply to insurance. It was assumed to be possible in *Siu Yin Kwan v Eastern Insurance Ltd* [1994] 1 All ER 213, but it may be that the case turned upon the fact that the insurers were aware that the named assured was in fact an agent and that in other cases failure to disclose the agency relationship could be a breach of the duty of fair presentation: *Talbot Underwriting v Nausch Hogan & Murray, The Jascon 5* [2006] Lloyd's Rep IR 531.

<sup>322</sup> An undisclosed principal, insofar as the concept is recognised in insurance law, cannot ratify a contract made without authority: *Keighley, Maxsted & Co v Durant* [1901] AC 240.

<sup>323</sup> If the named assured has no authority to insure on behalf of another, then it is regarded as the assured did not intend to insure another person: *Colonia Versicherung AG v Amoco Oil Co* [1995] 1 Lloyd's Rep 570 affirmed [1997] 1 Lloyd's Rep 261; *Hopewell Project Management Ltd v Ewbank Preece Ltd* [1998] 1 Lloyd's Rep 448. The court in *Haberdashers' Aske's Federation Trust Ltd v Lakehouse Contracts Ltd* [2018] EWHC 558 (TCC) left open the question whether the test of intention is objective or subjective.

<sup>324</sup> See: *Humble v Hunter* (1848) 12 QB 310; *Said v Butt* [1920] 3 KB 497; *Dyster v Randall & Sons* [1926] Ch 932.

<sup>325</sup> The Insurance Act 2015 has made changes in respect of the duty of utmost good faith, this duty still exists in section 17, but non-disclosure and misrepresentation have been reclassified as 'unfair presentation'. Such changes may affect the mortgagee's position but will not be discussed here.

<sup>326</sup> See *Woolcott v Sun Alliance and London Insurance Ltd* [1978] 1 Lloyd's Rep. 629; *First National Commercial Bank Plc v Barnet Devanney (Harrow) Ltd* [1999] Lloyd's Rep IR 43, reversed on other grounds [1999] Lloyd's Rep IR 459; *Arab Bank Plc v Zurich Insurance Co* [1999]

insurance contract if the shipowner has failed to disclose or misrepresented any material fact or matter,<sup>327</sup> in which case, the insurer can legitimately reject any claim made by the shipowner. However, the insurer is still liable to indemnify the mortgagee who is a co-assured under the primary insurance, unless the insurance policies provide otherwise.

Second, the shipowner's willful misconduct will not preclude the mortgagee from recovering its loss, unless such conduct can be legitimately attributed to the mortgagee, or unless the loss was not caused by insured perils.<sup>328</sup>

Third, the mortgagee's claim will not be affected if a breach of warranty by the shipowner does not amount to a breach by the mortgagee.<sup>329</sup> That is, if the shipowner commits a breach of an implied or an express warranty, the insurer will be discharged from liability to the shipowner as from the date of the breach,<sup>330</sup> but the insurer is still liable to indemnify the co-assured mortgagee unless the mortgagee was complicit in the breach of warranty.<sup>331</sup> By contrast, a condition of the policy must be fulfilled not only by the shipowner but also by the mortgagee, excepting where some forms of agency have presented.<sup>332</sup> The 2015 Act has changed the remedies for breach of warranty,<sup>333</sup> issues may arise out of such a change will not be addressed here.

Fourth, if the shipowner has made a fraudulent claim, the mortgagee is not precluded from recovery<sup>334</sup> unless it has been implicated in the fraud.<sup>335</sup> However, an innocent mortgagee can only recover, in respect of its own loss, to the extent of its financial interest in the mortgaged ship. By contrast, an innocent lessor is entitled to recover the whole loss, even it intends – or is required by – the contract to hand over a part or all of the insurance proceeds to the shipowner.<sup>336</sup>

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1 Lloyd's Rep 262; *Parker v National Farmers Union Mutual Insurance Society Ltd* [2012] EWHC 2156 (Comm).

<sup>327</sup> Marine Insurance Act 1906 ss. 18, 20.

<sup>328</sup> See, *P Samuel and Company v Dumas* [1924] AC 431.

<sup>329</sup> *New India Assurance Co Ltd v Dewi Estates Ltd* [2009] HKCFI 845.

<sup>330</sup> Marine Insurance Act 1906 s. 33(3).

<sup>331</sup> See, *P Samuel and Company v Dumas* [1924] AC 431; *New Hampshire Insurance Co v MGN Ltd* [1997] LRLR 24.

<sup>332</sup> *King v Brandywine Reinsurance Co (UK) Ltd* [2004] Lloyd's Rep IR 554 affirmed on other grounds [2005] Lloyd's Rep IR 509.

<sup>333</sup> See (n 223) for these changes.

<sup>334</sup> See *New Hampshire Insurance Co v MGN Ltd* [1997] LRLR 24.

<sup>335</sup> See *Direct Line v Khan* [2002] Lloyd's Rep IR 364, in which case, the Court of Appeal implied an agency relationship so that the innocent co-assured was fixed with the consequences of the co-assured at fault.

<sup>336</sup> *Netherlands v Youell* [1997] 2 Lloyd's Rep 440.

Fifth, making payments to either the mortgagee or the shipowner can give the insurer a good discharge from its liability, but the insurer must ensure that both the mortgagee and the shipowner respectively have been satisfied to the extent of their interests.<sup>337</sup> In the event of the insurance proceeds being paid to the broker, any lien or right of setting off that the broker may have over the insurance proceeds is exercisable against the person who owes the premium only, and not against other composite co-assureds.<sup>338</sup> In particular, the broker is not entitled to set off the premium owed by other ships, which are in the shipowner's fleet but not being mortgaged to the mortgagee, against the mortgagee's insurance proceeds.

To sum up, being a composite co-assured may protect the mortgagee from the termination of insurance risk, the non-disclosure risk, the misrepresentation risk, the breach of warranty risk, the fraudulent claim risk and the set-off risk. This is especially so if the policy has clearly stated that the mortgagee will not be affected by the applicable act or omission of the shipowner (for example, by including a mortgagee's protection clause or a non-invalidation clause in the policy).<sup>339</sup> However, the mortgagee shall not solely rely on a composite interest in the shipowner's marine policies, because some risks faced by the mortgagee cannot be transferred in this way. For example, in *P Samuel and Company v Dumas*,<sup>340</sup> where a ship was lost because of the shipowner's deliberate scuttling the mortgagee, who had a composite interest in the shipowner's marine policies, was held to have no right to recover for a total loss by reason of that scuttling not being a "peril of the sea"<sup>341</sup>.

#### 5.5.3.3 *The co-insurance approach: limitations*

Although there are a range of benefits for the mortgagee in taking a composite interest in the shipowner's marine policies, in reality, ship mortgagees are reluctant to secure their interests in this way. First, the effectiveness of the co-assured approach has often been questioned by the court,<sup>342</sup> by the academic<sup>343</sup>

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<sup>337</sup> *General Accident Fire and Life Assurance Corp Ltd v Midland Bank Ltd* [1940] 2 KB 388.

<sup>338</sup> See *Eide UK Ltd v Lowndes Lambert Group Ltd* [1998] 1 Lloyd's Rep 389.

<sup>339</sup> *Arab Bank plc v Zurich Insurance Co* [1999] 1 Lloyd's Rep 262 at 272.

<sup>340</sup> [1924] AC 431.

<sup>341</sup> See Chapter 4, section 4.2 (Insurable risks), in which explains the relation between 'perils of the sea' and 'subject matter'.

<sup>342</sup> See *HLB Kidsons v Lloyd's Underwriters* [2007] EWHC 1951 (Comm) at para [93] (Gloster J).

<sup>343</sup> B Harris, 'Insurance policies for multiple assureds: the effect of a composite approach to

and by the market. Second, the co-assured approach has to be used in combination with other measures (for example, taking undertakings and/or purchasing contingency insurances), or the mortgagee is still exposed to significant risks. Third, the co-assured mortgagee may be held liable for the premium. Fourth, there may be problems if the insurer has a subrogated action against the co-assureds. In the light of this, it is advisable for the mortgagee to include a waiver of subrogation clause in the policy. The issue in relation to subrogation will be considered later.<sup>344</sup>

#### 5.5.4 As a loss-payee

In order to be nominated as a loss payee, the mortgagee generally requires the shipowner to incorporate a loss payable clause into its hull policies and P&I entries.<sup>345</sup> The scope and effects of the loss payable clause are considered in the following paragraphs.

A loss payable clause is essentially an agreement between the insurer and the assured shipowner, by which the insurer agrees to pay the insurance proceeds directly to the loss payee instead of the shipowner, if the shipowner has a recoverable claim. Prior to the 1999 Act, the loss payee could not directly enforce a loss payable clause. Accordingly, if the mortgagee was not a contractual party to the shipowner's marine policies, it could not require a direct payment by the insurer merely by means of a loss payable clause.<sup>346</sup> However, the 1999 Act entitles the loss payee to directly enforce a loss payable clause. As a result, upon satisfying three conditions, the mortgagee who is not a party to the shipowner's insurance policies may enforce a direct payment by the insurer. The three conditions are: (a) the loss payable clause purports to confer a benefit on the mortgagee; (b) the mortgagee must be expressly identified in the policy by name, or as a member of a class, or as answering a particular description; and (c) on a proper construction of the policy, the parties did not intend the loss payable clause to be unenforceable by the mortgagee.<sup>347</sup>

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construction' (2011) 3 LMCLQ 393, 394.

<sup>344</sup> See Chapter 5, section 5.6 (Subrogation).

<sup>345</sup> See, e.g. *American Airlines Inc v Hope* [1973] 1 Lloyd's Rep 233 (aviation insurance); *Amalgamated General Finance Co v Golding & Co* [1964] 2 Lloyd's Rep 163 (marine insurance).

<sup>346</sup> *Iraqi Ministry of Defence v Arcepey Shipping Co SA (The Angel Bell)* [1979] 2 Lloyd's Rep 491.

<sup>347</sup> Contracts (Rights of Third Parties) Act 1999 s. 1.



## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

The loss payee's right of direct action is subject to the terms of the policy, which will be effective if only the policy so allows.<sup>348</sup> As a loss payee, the mortgagee has no better rights than the shipowner and may only be paid losses if the shipowner would have been entitled to the payment. For example, if the shipowner is entitled to be indemnified but is subject to a relevant exclusion provision of the policy, this provision will be equally effective for use against the mortgagee; if the insurer is entitled to avoid an insurance contract by reason of a breach of warranty by the shipowner, the mortgagee will have no right to enforce the contractual benefits.

Where the 1999 Act is excluded from the policy,<sup>349</sup> the loss payee cannot require a direct payment by the insurer merely by means of a loss payable clause, although the clause may not be without its value. In *The Angel Bell*,<sup>350</sup> Donaldson J provided:

A loss payable clause gives no rights to the loss payee unless it also constitutes or evidences an assignment of the assured's rights under the policy or evidences the fact that the designated person is an original assured. But it may not be without its value, for it authorises and requires underwriters to pay losses to the loss payee on behalf of the assured and, in the circumstances of a transaction such as this, this authority is probably irrevocable by the shipowner.<sup>351</sup>

It is possible that a loss payable clause will constitute or evidence that the loss payee is a co-assured or is the beneficiary of a trust under the policy, in which case the insurer is entitled to make direct payments to the loss payee notwithstanding objections of the assured. In certain cases, the loss payee may be regarded as an equitable assignee,<sup>352</sup> thus it is entitled to sue the insurer by joining the assignor in the proceedings. In spite of this, the loss payee may be regarded as a co-assured, a beneficiary, or an equitable assignee; a loss payee who has no right to sue the insurer at all may be entitled to intervene in any proceedings brought by the assured under the policy.

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<sup>348</sup> Ibid s. 1(4).

<sup>349</sup> See, e.g. International Hull Clauses (01/11/03) cl. 36. This clause excludes the Contracts (Rights of Third Parties) Act 1999, but preserves it where a right is expressly conferred on a third party.

<sup>350</sup> *Iraqi Ministry of Defence v Arcepey Shipping Co SA (The Angel Bell)* [1979] 2 Lloyd's Rep 491.

<sup>351</sup> Ibid at 497.

<sup>352</sup> For example, the assured may nominate a loss payee under a hull policy, and such a nomination is deemed as a notice of assignment, see: *Colonial Mutual General Insurance Co Ltd v ANZ Banking Group (New Zealand) Ltd* [1995] 2 Lloyd's Rep 433.

In practice, there are not many problems in respect of the loss payable clause of the marine insurance contract. The loss payable clause will usually be served on the broker or club manager together with the notice of assignment. Under normal circumstances, the insurer will settle claims with the broker, and it is the obligation of the broker to ensure that the payment is made to the right person. In the event of a policy containing a loss payable clause, it is a common market practice that the broker will make payments to the loss payee. As regards serving a loss payable clause to the club manager, the club will generally require the loss payable clause to be worded in its form, stating that the club is entitled to make payments to the owner until being notified by the loss payee to make direct payments to the loss payee.

### 5.5.5 As an assignee

A mortgagee who has no original interest in the policy may obtain a derivative interest by way of assignment. If a mortgagee is required to become an assignee, the relevant assignment requirements will normally be contained in the deed of covenant or other collateral documents.<sup>353</sup> Upon assignment, the shipowner or the shipbuilder transfers its own rights, under relevant insurance policies, to the mortgagee. Accordingly, the mortgagee acquires rights to enforce claims under the policies, and it may enforce claims directly against the insurer. As an assignee, the mortgagee is subject to any defence that the insurer would have been entitled to make if the claim had been brought in the name of the assignor (i.e. original assured).<sup>354</sup> For this reason, the assignee is vulnerable to the risks of, *inter alia*, uninsured perils, cancellation of insurance, and breach of warranty.<sup>355</sup> If the claim is brought in the name of the assignor, the assignee is also exposed to the fraudulent claim risk.<sup>356</sup> However, by way of assignment, the mortgagee may resist the assignor's solvency risk<sup>357</sup> as well as the attachment risk.<sup>358</sup>

An assignment of marine insurance (as a chose in action) under common law

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<sup>353</sup> See Chapter 2, section 2.6.3.2 (Insurance issues).

<sup>354</sup> Marine Insurance Act s. 50(2). See also, *Pickersgill v London and Provincial Marine Insurance Co* [1912] 3 KB 614; *Graham Joint Stock Shipping Co Ltd v Merchants' Marine Insurance Co Ltd* [1924] AC 294; *Colonia Versicherung AG v Amoco Oil Co* [1995] 1 Lloyd's Rep 570, affirmed [1997] 1 Lloyd's Rep 261.

<sup>355</sup> See Chapter 5, section 5.5.2 (The legal risks faced by ship mortgagees).

<sup>356</sup> *Black King Shipping Corp v Massie (The Litsion Pride)* [1985] 1 Lloyd's Rep 437.

<sup>357</sup> See Chapter 5, section 5.5.2 (The legal risks faced by ship mortgagees), point 12.

<sup>358</sup> *Ibid*, point 10.

was generally ineffective, with the exception of the limited efficacy provided by the rules of equity. However, the common law position in respect of assigning marine insurance has been subsequently modified by statutes, thus it may now be assigned as a legal assignment or as an equitable assignment.<sup>359</sup> If it is a legal assignment, then only the entirety of a current interest can be assigned, in which case the assignor shall cease to have any direct right against the insurer.<sup>360</sup> By contrast, if it is an equitable assignment, a partial or a future interest can be assigned, and the assignor retains the right to sue the insurer for the benefit of the assignee.<sup>361</sup> In this section, we will consider the various requirements of assignment in three respects: (a) under section 50 of the Marine Insurance Act 1906; (b) under section 136 of the Law of Property Act 1925; and (c) in equity.<sup>362</sup>

#### 5.5.5.1 Assignment under the Marine Insurance Act 1906

Section 50 of the MIA 1906 provides:

- (1) A marine policy is assignable unless it contains terms expressly prohibiting assignment. It may be assigned either before or after loss.
- (2) Where a marine policy has been assigned so as to pass the beneficial interest in such policy, the assignee of the policy is entitled to sue thereon in his own name; and the defendant is entitled to make any defence arising out of the contract which he would have been entitled to make if the action had been brought in the name of the person by or on behalf of whom the policy was effected.
- (3) A marine policy may be assigned by indorsement thereon or in other customary manner.<sup>363</sup>

#### (a) Contractual restrictions

According to section 50(1) of the MIA 1906, a marine policy is freely assignable, provided that it does not expressly prohibit assignment. For example, an H&M policy may contain provisions state that the policy shall be cancelled in the event

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<sup>359</sup> Noting the mortgagee's interest on the policy may constitute an equitable assignment, see: *Colonial Mutual General Insurance Co Ltd v ANZ Banking Group (New Zealand) Ltd* [1995] 2 Lloyd's Rep 433.

<sup>360</sup> *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597; *Cape Distribution Ltd v Cape Intermediate Holdings Plc* [2016] EWHC 1119 (QB).

<sup>361</sup> *First National Bank of Chicago v West of England Shipowners Mutual P&I Association (Luxembourg) (The EVELPIDIS ERA)* [1981] 1 Lloyd's Rep 54; *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597 at paras [70-71], [75], [80].

<sup>362</sup> *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597.

<sup>363</sup> Marine Insurance Act 1906 s. 50.

that the insured ship is sold or transferred to new management. In general, modern marine policies do not prohibit assignment, but requiring the original assured and any subsequent assignors to follow certain procedures before an assignment will be binding on – or recognised by – the insurer (i.e. a formality requirement). For example, clause 23 of the International Hull Clauses (01/11/03) provides:

No assignment of or interest in this insurance or in any moneys which may be or become payable under this insurance is to be binding on or recognised by the Underwriters unless a dated notice of such assignment or interest signed by the Assured, and by the assignor in the case of subsequent assignment, is endorsed on the policy and the policy with such endorsement is produced before payment of any claim or return of premium under this insurance.<sup>364</sup>

However, the rule book of a P&I club or a war risks association generally contains restrictions on assignment.<sup>365</sup> Where this is the case, the mortgagee shall require the shipowner to obtain consent from the club manager to the assignment of P&I covers. Failing to do so will render the P&I entries invalid.<sup>366</sup> Even an undertaking provided by the club has waived the “cesser of cover” rule<sup>367</sup>, and it is not evidence of consent to the assignment of P&I covers.<sup>368</sup> Where a policy is assigned under section 50 of the MIA 1906, it is recommended (though not required) to serve a notice of assignment to the insurer.<sup>369</sup> The effects of such a notice of assignment will be considered later.<sup>370</sup>

#### (b) Requirements

A marine policy may be assigned before or after loss.<sup>371</sup> However, an assignment under the MIA 1906 must satisfy the following requirements to be effective.

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<sup>364</sup> International Hull Clauses (01/11/03) cl. 23.

<sup>365</sup> See *Laurie v West Hartlepool Steam Ship Thirds Indemnity Association and David* (1899) 43 Com Cas 322; *Bank of Nova Scotia v Hellenic Mutual War Risks Assn (Bermuda) Ltd (The Good Luck)* [1988] 1 Lloyd’s Rep 514, reversed [1990] 1 QB 818 (CA), reversed [1992] 1 AC 233 (HL) (the effect of the assignment was not an issue in the House of Lords).

<sup>366</sup> *Turnbull v Woolfe* (1861) 66 ER 336; *North-Eastern 100A Steamship Insurance Association v Red ‘S’ Steamship Company* (1905) 10 Com Cas 245 (KB), (1906) 12 Com Cas 26 (CA).

<sup>367</sup> Cesser of cover rule provides for the automatic termination of insurance coverage upon the happening of listed events.

<sup>368</sup> *Ship Mortgages* (n 299) para 16.7.1.

<sup>369</sup> *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001]

1 Lloyd’s Rep 597 at para [62] (Mance LJ).

<sup>370</sup> See Chapter 5, section 5.5.5.4 (The effect of a notice of assignment).

<sup>371</sup> Marine Insurance Act 1906 s. 50(1).

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

First, the terms of a marine policy do not prohibit assignment.<sup>372</sup>

Second, in the event that a policy is assigned before loss, the assignor must have an insurable interest in the subject-matter of the policy at the time of the assignment;<sup>373</sup> and the assignee is required to have an insurable interest in the subject-matter insured at the time of the loss, or the assignee is not entitled to claim. In the event of a policy being assigned after loss, the assignor must have an insurable interest in the subject-matter of the policy at the time of the loss.

Third, an effective assignment is required to pass the entire beneficial interest in a policy.<sup>374</sup> Assigning a marine policy to the mortgagee before loss generally fails to meet this requirement, which will not be an effective statutory assignment under section 50 of the MIA 1906. The issue of “passing the entire beneficial interest in a policy” has been considered in a number of cases.

Where the shipowner assigns its benefits under the primary insurance to the mortgagee, it is common that the loss payable provisions are constructed to retain an interest in recoveries to the shipowner, which will render the assignment an assignment in equity. In *The Evelpidis Era*,<sup>375</sup> Mocatta J held that an assignment of P&I insurance fell outside the scope of section 50 of the MIA 1906, and that it was an equitable assignment rather than a statutory assignment. This finding was based on the evidence that the LOU provided by the club had contained terms as follows:

The Vessel's Certificate of Entry will be endorsed with the following clauses: It is noted that First National Bank of Chicago are interested as First Mortgagees in the subject matter of this Insurance up to the amount of their mortgage interest. Claims hereunder for all losses shall be paid direct to the shipowners unless and until the Mortgagees shall have given notice in writing that the shipowners are in default under the First Mortgage on the vessel whereafter such claims shall be payable to the Mortgagees up to the amount of their Mortgage interest...<sup>376</sup>

Under these terms, the mortgagee had not acquired the entire beneficial interest in the policy, because the club was entitled to pay the insurance proceeds directly

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<sup>372</sup> Ibid s. 50(1).

<sup>373</sup> Ibid s. 51. See also *North of England Pure Oil Cake Co v Archangel Maritime Insurance Co* (1874-75) LR 10 QB 249.

<sup>374</sup> *Williams v Atlantic Assurance* [1933] 1 KB 81; *First National Bank of Chicago v West of England Shipowners Mutual P&I Association (Luxembourg) (The Evelpidis Era)* [1981] 1 Lloyd's Rep 54; *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597.

<sup>375</sup> [1981] 1 Lloyd's Rep 54.

<sup>376</sup> Ibid at 59.

to the shipowners until being notified by the mortgagee bank that the shipowners were in default.

Similarly, in *The Mount I*,<sup>377</sup> the Court of Appeal held that the beneficial interest assigned under a hull liability policy did not satisfy the requirement of section 50(2) of the MIA 1906. When the shipowner assigned its benefits under the liability policy to the mortgagee bank, the relevant terms intended to – and did continue to – protect the shipowner’s interests in respect of losses and liabilities incurred to the mortgagor or the ship operator.<sup>378</sup> Moreover, different types of cover, H&M cover and collision liability cover (i.e. P&I cover), were included in the same policy that insured the ship *Mount I*. However, H&M cover was assigned while the collision liability cover was not assigned, and any of the covers that failed to pass the entire beneficial interest would be fatal to the passing of the entire beneficial interest in the policy. That is, in the event of assigning a marine policy before loss, section 50 of the MIA 1906 is inapplicable if the shipowner purports to retain an interest in the policy and/or the ship. In addition, a loss payable clause in this case allowed the insurer to continue to pay some claims to the shipowners in spite of the assignment. To explain why this clause had prevented the application of section 50 in this case, Mance LJ followed the reasoning provided by Mocatta J in *The Evelpidis Era*<sup>379</sup> and gave a further reason: namely that no loss payable clause was actually endorsed upon or attached to the present insurance, and this fact alone would prevent the application of section 50 of the MIA 1906.<sup>380</sup>

Fourth, a marine policy may be assigned by indorsement thereon or in another customary manner.<sup>381</sup> However, assigning marine policies by endorsing paper copies of the full policy has been replaced by the new market practice of electronic commerce. In the light of this, the Law Commissions proposed ‘amending section 50(3) to say that a marine insurance contract may be assigned in any customary manner or as agreed between the parties to the transfer’.<sup>382</sup>

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<sup>377</sup> [2001] 1 Lloyd’s Rep 597.

<sup>378</sup> *Ibid* at para [69].

<sup>379</sup> [1981] 1 Lloyd’s Rep 54.

<sup>380</sup> *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd’s Rep 597 at para [73] (Mance LJ).

<sup>381</sup> Marine Insurance Act 1906 s. 50(3).

<sup>382</sup> Law Commission, *Insurance Contract Law: Post Contract Duties and other Issues* (Law Com No 201, 2011) para 16.41.

## (c) Effects

Upon assignment, the assignee succeeds to the rights and liabilities of the original assured,<sup>383</sup> thus the assignee is entitled to sue the insurer in its own name,<sup>384</sup> and is equally obliged to pay the premium and act in good faith towards the insurer. By contrast, the assignor ceases to have any direct right against the insurer, who then becomes a third party.<sup>385</sup> Given that the rights of the assignee are derived from the assignor, the assignee has no better right than the assignor, thus the insurer is entitled to make any defence concerning the policy which it would have been entitled to make had the claim being made by the original assured (i.e. the assignor). For example, in the event that the ship is willfully scuttled by the owner,<sup>386</sup> or that the policy is illegal,<sup>387</sup> or that there has been a breach of warranty by the assignor,<sup>388</sup> then the insurer may have a successful defence against the innocent assignee.

## 5.5.5.2 Assignment under the Law of Property Act 1925

Section 136(1) of the Law of Property Act 1925 (1925 Act) provides:

Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action, of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action, is effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice – (a) the legal right to such debt or thing in action; (b) all legal and other remedies for the same; and (c) the power to give a good discharge for the same without the concurrence of the assignor...<sup>389</sup>

An effective assignment under section 136(1) of the 1925 Act shall comply with the following requirements: (a) the assignment of a debt or other legal thing in action must be absolute;<sup>390</sup> (b) the assignment must be in writing; and (c) the

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<sup>383</sup> *Arnould* (n 230) para 8-42.

<sup>384</sup> Marine Insurance Act 1906 s. 50(2).

<sup>385</sup> *Davitt v Titcumb* [1990] Ch 110.

<sup>386</sup> *P Samuel and Company v Dumas* [1924] AC 431; *Graham Joint Stock Shipping Co Ltd v Merchants Marine Insurance Co Ltd (The Ioanna)* (No. 1) [1924] AC 294.

<sup>387</sup> The assignor had become an enemy alien at the time of assignment, see: *Bank of New South Wales v South British Insurance Co Ltd* (1920) 4 Ll L Rep 384.

<sup>388</sup> See *Outhwaite (Richard Henry) v Commercial Bank of Greece SA (The Sea Breeze)* [1987] 1 Lloyd's Rep 37.

<sup>389</sup> Law of Property Act 1925 s. 136(1).

<sup>390</sup> *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597 at paras [74-75] (Mance LJ).

assignment must be expressly noticed in writing to the debtor, trustee or other person from whom the assignor would have been entitled to claim such a debt or a thing in action.<sup>391</sup> In addition, an assignment under section 136 of the 1925 Act must pass the entirety of current interest in the policy: passing a partial or a future interest renders the assignment ineffective. In *The Mount I*,<sup>392</sup> the Court of Appeal decided that there was not an effective assignment under the 1925 Act, on account of the following three reasons: (a) given that the shipowner had retained its interests in and liabilities under the policy, the entire beneficial interest in the policy had not been passed to the assignee; (b) the assigned rights by the shipowner had included the rights to be paid amounts which might become payable in the future, but an assignment under the 1925 Act could not apply to future claims; and (c) the assignment was not absolute due to the wording of the loss payable clause.

An assignment under section 50 of the MIA 1906 is not required to be notified to the insurer, while an assignment under section 136 of the 1925 Act has to be perfected by serving a notice of assignment to the insurer. Following a valid legal assignment, the assignee is entitled to sue the insurer in its own name which gives a good charge of the insurer's liabilities,<sup>393</sup> while the insurer is entitled to make any defence concerning the policy which it would have been entitled to make had the claim being made by the assignor.

#### 5.5.5.3 Assignment in equity

An assignment which is recognised in common law may be valid in equity. Unlike a legal assignment which must pass the entirety of current interest in a policy, an equitable assignment may assign a partial or a future interest. If an assignment does not pass the entire beneficial interest in a policy to the mortgagee, such an assignment would, in any event, be recognised in equity.<sup>394</sup> For there to be an effective equitable assignment, all that appears to be required is evidence of an absolute intention to assign the contractual rights. Accordingly, an equitable

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<sup>391</sup> *Williams v Atlantic Assurance* [1933] 1 KB 81 at 105-106.

<sup>392</sup> *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597.

<sup>393</sup> Law of Property Act 1925 s. 136(1). See also *Williams v Atlantic Assurance* [1933] 1 KB 81.

<sup>394</sup> *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597.



assignment may take effect by delivering either a policy<sup>395</sup> or an agreement to assign,<sup>396</sup> if made for valuable consideration.<sup>397</sup> It is not required – but it is recommended – to serve a notice of assignment to the insurer, because such a notice can help the equitable assignee to secure a priority position in the case of competing assignments.<sup>398</sup> Where the assignee requires its interest to be noted in the policy, such as to be nominated as a loss payee on the policy, such a request is deemed as a notice to the insurer.<sup>399</sup>

In theory, an equitable assignee has to join the assignor as a party to bring proceedings against the insurer. In practice, an equitable assignee may sue the insurer in its own name, provided that there is no risk that the assignor will bring a separate claim against the insurer.<sup>400</sup> In the event of an equitable assignment, the insurer is entitled to make any defence concerning the policy which it would have been entitled to make had the claim being made by the assignor.

#### 5.5.5.4 *The effect of a notice of assignment*

In the event of a mortgage-backed finance, assigning marine insurance to the mortgagee before loss is unlikely to qualify as a statutory assignment under either section 50 of the MIA 1906 or section 136 of the 1925 Act. This is because the shipowner will invariably retain an interest in the mortgaged ship and the marine policy in respect of the ship.<sup>401</sup> In the light of this, most of the assignments are, in essence, equitable assignments.

As previously discussed, it is required that a notice of assignment is served to the insurer in order to create a legal assignment under the 1925 Act,<sup>402</sup> while such a notice is not essential to create a legal assignment under the MIA 1906 or

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<sup>395</sup> *Exp Kensington* (1813) 2 V & B 79; *Gurnell v Gardner* (1863) 66 ER 857; *Green v Ingham* (1866-67) LR 2 CP 525; *Shaw v Foster* (1871-72) LR 5 HL 321.

<sup>396</sup> See *Crossley v City of Glasgow* (1876) 4 Ch D 421, where an intention to assign did not constitute an agreement.

<sup>397</sup> *Ashley v Ashley* (1829) 3 Sim 149; *Vavas seur v Vavas seur* (1909) 25 TLR 250.

<sup>398</sup> *Dearle v Hall* (1828) 3 Russ 1.

<sup>399</sup> *Colonial Mutual General Insurance Co Ltd v ANZ Banking Group (New Zealand) Ltd* [1995] 2 Lloyd's Rep 433.

<sup>400</sup> *Central Insurance Co Ltd v Seacalf Shipping Corporation (The Aiolos)* [1983] 2 Lloyd's Rep 25 at 33-34; *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597.

<sup>401</sup> *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC (The Mount I)* [2001] 1 Lloyd's Rep 597.

<sup>402</sup> See Chapter 5, section 5.5.5.2 (Assignment under the Law of Property Act 1925).

an equitable assignment.<sup>403</sup> However, where there is an equitable assignment in favour of the mortgagee, it is strongly advisable for the mortgagee to serve a notice of assignment to the insurer for two main reasons. The first is that serving a notice of assignment (e.g. by incorporating a loss payable clause into the policy) may impose an obligation on the insurer to make direct payments to the mortgagee. The second reason is that a notice of assignment may help the mortgagee to secure a priority position in the case of competing assignments. In *Dearle v Hall*,<sup>404</sup> the court held that the priority of competing assignments ranked in the order in which the notice of assignment was given to the debtor. As a result, if an equitable assignee fails to serve a notice of assignment to the insurer, its rights may be overridden by a subsequent assignee who has served such a notice.

An alternative function of a notice of assignment is to cut off the set-off rights which are not related to the assigned policy.<sup>405</sup> However, serving a notice of assignment cannot cut off the set-off rights in respect of the unpaid premium, because these rights are closely related to the assigned policy. Either a legal assignee or an equitable assignee stands in the shoes of the original assured (i.e. the assignor), thereby succeeding to both the rights and the liabilities of the original assured. Accordingly, the assignee is liable for the unpaid premium for which the original assured would have been liable, and such an obligation will not be discharged by serving a notice of assignment. By virtue of mercantile customs, in the case of a broker placing marine policies on behalf of an assured, it is the broker who is liable to pay the premium to the insurer. Section 53(1) of the MIA 1906 provides:

Unless otherwise agreed, where a marine policy is effected on behalf of the assured by a broker, the broker is directly responsible to the insurer for the premium, and the insurer is directly responsible to the assured for the amount which may be payable in respect of losses, or in respect of returnable premium.<sup>406</sup>

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<sup>403</sup> See Chapter 5, section 5.5.5.1 (Assignment under the Marine Insurance Act 1906) and section 5.5.5.3 (Assignment in equity).

<sup>404</sup> (1828) 3 Russ 1.

<sup>405</sup> See, e.g. *Newfoundland v Newfoundland Railway Co* (1888) 13 App Cas 199 (PC); *Christie v Taunton Delmard Lane & Co* [1893] 2 Ch 175; *Hanak v Green* [1958] 2 QB 9 (CA); *Muscat v Smith* [2003] EWCA Civ 962 (CA).

<sup>406</sup> Marine Insurance Act 1906 s. 53(1).

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

This rule applies to any marine policy placed in the London market, in spite of the applicable law of the policy.<sup>407</sup> Equally, the assured is responsible to the broker for the amount covering the premium and commission, so the broker is entitled to impose a lien on the policy for the broking service provided. Section 53(2) of the MIA 1906 provides:

Unless otherwise agreed, the broker has, as against the assured, a lien upon the policy for the amount of the premium and his charges in respect of effecting the policy; and, where he has dealt with the person who employs him as a principal, he has also a lien on the policy in respect of any balance on any insurance account which may be due to him from such person, unless when the debt was incurred he had reason to believe that such person was only an agent.<sup>408</sup>

That is, the broker has the right to impose two separate liens on a policy. One is a specific lien in relation to the effecting policy on the particular transaction; the other is a general lien in respect of any balance on any insurance account which may be due from the original assured (so is from the succeeding assignee). Accordingly, if a ship is insured under a fleet policy which includes other ships that are not mortgaged to the mortgagee, the mortgagee assignee may be trapped by the broker's liens for any relevant unpaid premiums in respect of not only the mortgaged ship but also other ships in the fleet. To avoid the insurance proceeds in respect of the mortgaged ship being deducted for the unpaid premiums attributable to either the mortgaged ship or other ships in the fleet, the mortgagee shall obtain an enforceable contract consideration (e.g. a letter of undertaking) provided by the broker which waives the broker's right of fleet lien. Ideally, the mortgagee shall also obtain a waiver from the insurer which waives the insurer's set-off rights in respect of the unpaid premium of the whole fleet.<sup>409</sup> However, the mortgagee is unlikely to obtain such a waiver from the insurer in reality, because the broker, rather than the assured (or the mortgagee assignee), is personally responsible to the insurer for the premium. By all accounts, the mortgagee assignee will be cautious when dealing with matters in relation to the premium, especially when the shipowner is experiencing financial difficulties, and the mortgagee must ensure that the premium in respect of a mortgaged ship is paid adequately and in good time, both before and after taking out the mortgage.

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<sup>407</sup> *Heath Lambert Ltd v Sociedad de Corretaje de Seguros* [2004] 1 Lloyd's Rep 495.

<sup>408</sup> Marine Insurance Act 1906 s. 53(2).

<sup>409</sup> *Ship Mortgages* (n 299) para 16.6.2.

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

In the London market practice, a notice of assignment is served on the broker who will subsequently arrange for the notice to be signed by the insurer. In the case of P&I clubs, a notice of assignment is directly served on the clubs. A typical notice of assignment is written in the following form:

(the ship)

We [name of owner] the owners of the Ship, hereby give you notice that by a deed of covenant dated [...] between us and [name of mortgagee] ('the Mortgagee') collateral to a first priority mortgage on the Ship granted by us to the Mortgagee, we have assigned to the Mortgagee our right, title and interest in the insurances on the Ship, including the insurance written in the policy on which this notice is endorsed and all amounts payable under the policy in respect of claims, return of premiums or otherwise.<sup>410</sup>

Given that the broker is essentially an agent of the assured rather than the insurer, a notice of assignment served on the broker is not taking effect as a notice to the insurer,<sup>411</sup> and such a notice is effective upon transmitting from the broker to the insurer. As a consequence of this, other competing assignees may serve a notice of assignment ahead of the mortgagee assignee, who will therefore rank ahead of the mortgagee assignee. If a marine policy is placed in the London market on the terms of the Institute Time Clauses – Hulls (1/11/95) (ITH-95), this marine policy is freely assignable, provided that the shipowner has complied with clause 21 of the ITH-95, in which stated:

No assignment of or interest in this insurance or in any moneys which may be or become payable thereunder is to be binding on or recognised by the Underwriters unless a dated notice of such assignment or interest signed by the Assured, and by the assignor in the case of subsequent assignment, is endorsed on the Policy and the Policy with such endorsement is produced before payment of any claim or return of premium thereunder.<sup>412</sup>

In simple words, a notice of assignment must be signed by the assured (and also by the assignor in the case of subsequent assignment) and must be endorsed on the policy. Compared with section 136 of the 1925 Act, which does not require a signature of the assured, the requirement in the ITH-95 is stricter. Given that no similar requirements are found under section 50 of the MIA 1906 or section 136 of the 1925 Act, the legal effect of clause 21 in respect of frustrating a statutory

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<sup>410</sup> G Bowtle and KP McGuinness, *The Law of Ship Mortgages* (Informa 2001) para 5.21.

<sup>411</sup> *Amalgamated General Finance Co Ltd v C E Golding & Co Ltd* [1964] 2 Lloyd's Rep 163.

<sup>412</sup> Institute Time Clauses – Hulls (1/11/95) cl. 21.

assignment is open to doubt. However, clause 21 may be deemed to constitute the terms of a marine policy which prohibit assignments, thus rendering a statutory assignment ineffective and creating legal risks for the assignee.

Accordingly, if a ship is insured on the terms of the ITH-95, the mortgagee assignee must make sure that clause 21 has been fully complied with, and this may be achieved by taking an LOU from the broker. The standard form of a London broker's LOU states that the broker undertakes 'to have endorsed on each and every Contract or Policy as and when the same is issued a copy of the said Notice of Assignment'.<sup>413</sup> It also contains confirmation that 'the Notice of assignment in the form of Appendix C attached has been acknowledged by Underwriters in accordance with Market practice'.<sup>414</sup> The broker's LOU is unclear as regards which market practice applies, or whether such market practice is able to reach the standard of clause 21 of the ITH-95. In *The Angel Bell*,<sup>415</sup> Donaldson J held that endorsement of notice of assignment on the leading policies was sufficient also as regards satellite policies, for the purpose of satisfying the requirements of the predecessor equivalent to clause 21 of the ITH-95. In the light of this, the abovementioned market practice stated in the broker's LOU has been thought to refer to acknowledgement by lead underwriters.

To conclude, a notice of assignment served on the broker and/or the insurer provides additional layers of protection, in terms of protecting the assignee from risks arising out of full reliance on the assignor's LOUs. If a mortgagee refinances a ship which has already been owned by the mortgagor, the mortgagee shall ensure that a notice of assignment is served to the insurer under all the previous insurances, for the purpose of reducing the risk of unpaid claims.<sup>416</sup>

### 5.5.6 Letter of undertaking

As a part of a majority of ship finance arrangements, the LOU becomes a ubiquitous feature of ship finance, and the mortgage (or the lessor) seeks a variety of LOUs from a range of parties. First, the mortgagee seeks an undertaking in respect of H&M insurance from the broker, or from the insurer in

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<sup>413</sup> See the current standard form of a London broker's letter of undertaking (published in 2008 by the London Market Insurance Brokers' Committee). A sample of the broker's letter of undertaking, see: Mellett (n 299) 83.

<sup>414</sup> Ibid.

<sup>415</sup> [1979] 2 Lloyd's Rep 491.

<sup>416</sup> *Ship Mortgages* (n 299) para 16.6.8.

the absence of a broker. Second, if a mortgaged ship has been entered into a mutual association and/or a P&I club for war and/or P&I risks, the mortgagee will seek an undertaking from the relevant mutual association and/or P&I club.

A mortgagee has no contractual relation with the insurers, clubs, or brokers, unless the mortgagee is a co-assured under the primary insurance. An LOU is essentially a contract between the issuer and the mortgagee, in which the issuer (e.g. an insurer, broker or club) undertakes to hold the relevant marine policy or insurance proceeds to the order of the mortgagee. If the issuer fails to comply with its undertaking, the mortgagee is entitled to sue for breach of contract and to claim damages for losses resulting from such a breach.

Among those identified risks,<sup>417</sup> taking LOUs in favour of the mortgagee from the insurers or clubs may protect the mortgagee from the automatic termination of insurances risk, the non-renewal risk, the non-payment of premiums risk, the set-off risk, as well as the broker risk (the broker's solvency risk excluded). In addition, taking an LOU provided by the broker may address the fleet lien risk, although insuring each ship under a separate insurance contract (which is not common in reality) is more effective in respect of limiting the fleet lien risk.

#### *5.5.6.1 Purpose*

The purpose of taking LOUs is to create separate primary contractual duties, owed by the issuer to the mortgagee. Taking LOUs from insurers and brokers is helpful in ensuring that the insurance proceeds are being directly paid to the mortgagee in accordance with relevant loss payable clauses. In addition, taking LOUs from brokers has further functions, including (but not limited to) providing insurance information to the mortgagee, serving the notice of assignment to the insurer, and arranging endorsement of loss payable clauses. As regards LOUs provided by P&I clubs, the clubs generally undertake certain things in respect of the "cesser of cover" rule and the loss payable clause.

#### *5.5.6.2 Consideration*

Given that an LOU is in nature a contract, it is not a binding contract if the promisee (i.e. the mortgagee in this case) fails to provide considerations. In

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<sup>417</sup> See Chapter 5, section 5.5.2 (The legal risks faced by ship mortgagees).

*Amalgamated General Finance Co v CE Golding & Co Ltd*,<sup>418</sup> Diplock LJ held that the LOU provided by the brokers, in which they undertook to pay an insurance claim to the nominated party, was incapable of constituting a contract, because there was no consideration. As referred to in the standard forms of broker's and club's undertaking, the approval of appointing the broker or the approval of the club entry by the mortgagee is deemed to be consideration. To constitute good consideration, the mortgagee must actually have the approval specifically in those documents signed with the shipowner, and such an approval is conditional on the broker or the club issuing a satisfactory LOU.<sup>419</sup>

#### 5.5.6.3 Standard form

It has taken decades to develop standard forms of LOU to be used in the marine insurance industry. A standard form of LOU of the broker was published in 2008 by the London Market Insurance Brokers' Committee (LMBC), whose previous functions are now performed by the London and International Insurance Brokers' Association (LIIBA). However, some brokers, particularly brokers outside of the London market, still insist on using their own "standard" LOUs, which differ in certain respects from the primary London market standard LOU. Turning to LOUs provided by the clubs, they are diverse in respect of their forms,<sup>420</sup> reflecting the different types of cover to which those LOUs relate. By contrast, LOUs provided by the mutual war risks association are similar in respect of their forms.<sup>421</sup>

The following broker's LOU recommended by the LMBC illustrates what a broker generally undertakes in respect of H&M insurance:

We confirm that:

- (1) we have effected insurances for the account of the above Owners as set out in Appendix "A" attached,
- (2) the said insurances include the Loss Payable Clause(s) set out in Appendix "B" attached, and
- (3) the Notice of Assignment in the form of Appendix "C" attached has been acknowledged by Underwriters in accordance with Market practice.

Pursuant to instructions received from the above Owners and/or their authorised Manager or Agents and in consideration of your approving us as the appointed

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<sup>418</sup> [1964] 2 Lloyd's Rep 163.

<sup>419</sup> *Ship Mortgages* (n 299) para 16.9.2.

<sup>420</sup> A sample form of an undertaking, see: Mellett (n 299) 86-87.

<sup>421</sup> A sample form of an undertaking, see: *Bank of Nova Scotia v Hellenic Mutual War Risks Assn (Bermuda) Ltd (The Good Luck)* [1992] 1 AC 233 (HL) 252.

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

Brokers in connection with the insurance covered by this letter, we hereby undertake:

1. to hold the Insurance Slips or Contracts, the Policies if and when issued, any renewals of such Contracts or Policies or any Contracts or Policies substituted therefor with your consent as may be arranged through ourselves until the time of the issue of any new or replacement Letter of Undertaking, the benefit of the insurances thereunder to your order in accordance with the terms of the said Loss Payable Clause(s); and
2. to arrange for the said Loss Payable Clause(s) to be included on the Contracts or Policies if and when issued; and
3. to have endorsed on each and every Contract or Policy as and when the same is issued a copy of the said Notice of Assignment; and
4. to advise you promptly if we cease to be the Broker for the Assured or in the event of any material changes which we are aware have been made to the said insurances; and
5. following a written application received from you not later than one month before expiry of these insurances to notify you within fourteen days of the receipt of such application in the event of our not having received notice of renewal instructions to renew to advise you promptly of the details hereof; and
6. to forward to you promptly any notices of cancellation that we receive from Underwriters; and following a written application from you to advise you promptly of the premium payment situation where such premium is paid or payable through our intermediary.<sup>422</sup>

### 5.5.6.4 A recent trend

Along with the evolution of the standard forms of LOU, there has been a tendency for both the broker and the club to aim to reduce their exposure to the mortgagee by tightening the terms of LOUs. As previously discussed,<sup>423</sup> properly arranging LOUs is very important for the mortgagee. This importance has also been demonstrated by two cases, namely *The Good Luck*<sup>424</sup> and *The Evelpidis Era*.<sup>425</sup> The wordings in respect of ceasing to insure, as adopted in *The Good Luck*, are not common in current standard forms of club's LOU. Modern P&I clubs have obviously drawn lessons from the case of *The Good Luck*, seeking to avoid the kind of liability held by that club, and clubs consequently draft LOUs in such a way as to minimise the burden of their duties. It seems clubs have reached their target since no case similar to *The Good Luck* reported after such changes of wordings. The broker's and club's intentions to reduce their exposure to claims

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<sup>422</sup> Mellett (n 299) 83-85.

<sup>423</sup> See Chapter 5, section 5.3.2.2 (Protection and Indemnity clubs' rules).

<sup>424</sup> *Bank of Nova Scotia v Hellenic Mutual War Risks Assn (Bermuda) Ltd (The Good Luck)* [1988] 1 Lloyd's Rep 514 reversed [1990] 1 QB 818 (CA), reversed [1992] 1 AC 233 (HL).

<sup>425</sup> *First National Bank of Chicago v West of England Shipowners Mutual P&I Association (Luxembourg) (The Evelpidis Era)* [1981] 1 Lloyd's Rep 54.



brought by the mortgagee are also reflected in many other ways. Examples include, *inter alia*, the deletion of the application requirement in respect of non-renewal in the standard London broker's letter of undertaking 1977, changes as regards notice of non-payment of premiums since 1977, and the abolition of the broker's obligation to notify the mortgagee of any material change to the terms of the insurance.<sup>426</sup>

## 5.6 Subrogation

Broadly speaking, subrogation is the right of the insurer to 'take advantage of any means available to the assured to extinguish or diminish the loss for which the insurer has indemnified the assured'.<sup>427</sup> That is, where an assured has a claim against a third party in relation to the loss insured, upon indemnifying the assured the insurer is entitled to stand in the shoes of the assured to recover the loss paid out from the third party who is ultimately liable for the loss. However, the insurer's subrogation right may be excluded or modified by the terms of the policy,<sup>428</sup> such as the incorporation of a waiver of subrogation clause into the policy.<sup>429</sup>

### 5.6.1 The general rule

In the context of marine insurance, the doctrine of subrogation has statutory recognition in section 79 of the MIA 1906, as follows:

- (1) Where the insurer pays for a total loss either of the whole, or in the case of goods of any apportionable part, of the subject matter insured, he thereupon becomes entitled to take over the interest of the assured in whatever may remain of the subject matter so paid for, and he is thereby subrogated to all the rights and remedies of the assured in and in respect of that subject matter as from the time of the casualty causing the loss.
- (2) Subject to the foregoing provisions, where the insurer pays for a partial loss, he acquires no title to the subject matter insured, or such part of it as may remain, but he is thereupon subrogated to all rights and remedies of the assured in and in respect of the subject matter insured as from the time of the casualty causing the loss, in so far as the assured has been indemnified, according to this Act, by such payment for the loss.<sup>430</sup>

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<sup>426</sup> These change, see: *Ship Mortgages* (n 299) para 16.9.7.

<sup>427</sup> J Birds, S Milnes and B Lynch, *MacGillivray on Insurance Law* (13th edn, Sweet & Maxwell 2015) para 24-001 (hereafter in this chapter, '*MacGillivray*').

<sup>428</sup> See, e.g. *Thomas & Co v Brown* (1899) 4 Com Cas 186; *Lucas (L) v Export Credits Guarantee Department* [1973] 1 WLR 914 at 922 (Megaw LJ), reversed [1974] 1 WLR 909 (HL).

<sup>429</sup> See *The Marine Sulphur Queen* [1973] 1 Lloyd's Rep 88 (US).

<sup>430</sup> Marine Insurance Act 1906 s. 79.

The marine insurance contract is, in nature, an indemnity contract. Therefore the doctrine of subrogation applies to marine insurance.<sup>431</sup> Moreover, an underlying principle of indemnity contract is that the parties to the contract are not entitled to be indemnified more than their losses. In the light of this, the doctrine of subrogation serves two principal functions: (a) to prevent the assured who has been paid by the insurer from being over indemnified by any recoveries from third parties; and (b) to permit the insurer to diminish or extinguish the loss it has paid to the assured, at the expense of the party who is ultimately liable for causing the loss.

The doctrine of subrogation is closely related to the doctrine of abandonment, although it is important to make a distinction. They are distinguished by two main characteristics: (a) the rules of abandonment only apply to total loss and probably only apply to contracts of marine insurance, whereas the rules of subrogation apply to any indemnity contract and apply not only to total loss but also to partial loss; (b) the insurer becomes the owner of the lost thing through abandonment, while the subrogated insurer is entitled to the benefit of claims and other remedies that may be available for the assured rather than the title of the lost thing.<sup>432</sup>

To sum up, a subrogated insurer is entitled to the benefit of the rights of the assured against third parties, or is interested in the proceeds of recovery made by the assured. Although the operation of subrogation does not vest the assured's rights in the insurer, the insurer is entitled to compel the assured to exercise those subrogated rights.<sup>433</sup> However, the subrogated insurer can neither sue a third party in its own name,<sup>434</sup> nor acquire better rights than those of the assured.

### **5.6.2 Subrogated actions against co-assured<sup>435</sup>**

The basic principle of subrogation is quite clear. However, in the case of co-

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<sup>431</sup> Subrogation does not apply to any insurance contract which is not a contract of indemnity (e.g. life insurance), see: *Meacock v Bryant & Co* [1942] 2 All ER 661.

<sup>432</sup> See *Simpson v Thomson* (1877) 3 App Cas 279 (HL) at 292 (Blackburn LJ); *Dornoch Ltd v Westminster International BV (The WD Fairway)* [2009] 2 Lloyd's Rep 191.

<sup>433</sup> See *King v Victoria Insurance Co Ltd* [1896] AC 250 at 256; *John Edwards & Co v Motor Union Insurance Co Ltd* [1922] 2 KB 249 at 254; *Yorkshire Insurance Co Ltd v Nisbet Shipping Co Ltd* [1962] 2 QB 330 at 341; *Morris v Ford Motor Co Ltd* [1973] QB 792 at 801.

<sup>434</sup> *Central Insurance Co Ltd v Seacalf Shipping Corporation (The Aiolos)* [1983] 2 Lloyd's Rep 25.

<sup>435</sup> See, generally, *Arnould* (n 230) paras 31-18 to 31-26; *Colinvaux* (n 299) paras 12-045 to 12-048; *Eggers* (n 299) 183-185.

insurance, the position of English law on whether an insurer is entitled to exercise its subrogation rights to pursue a claim in the name of one co-assured against another is subject to debate. Legal uncertainties regarding such subrogated claims introduce risks to ship financiers, since it is not uncommon for ship financiers (i.e. mortgagees or lessors) to have composite interests in the shipowner's insurance.<sup>436</sup> Where an assured shipowner is ultimately liable for an insured loss, it is difficult to decide whether an insurer is entitled to bring a subrogation claim against the shipowner at fault, after indemnifying a co-assured financier. If such subrogated claims were permitted, the shipowner would have to pay the insurer an amount approximately equivalent to that which the insurer had paid out. It is, in fact, diminishing or eliminating the security held by ship financiers.

By way of background, co-insurance can be divided into two categories, namely joint insurance and composite insurance.<sup>437</sup> A policy is only joint if the co-assureds' insurable interests are indivisible, for example, a policy taken out by the co-owners of a ship is joint. By contrast, if the co-assureds of a policy have severable and distinct insurable interests in the subject-matter insured (e.g. the ship), the policy is composite. Examples of composite co-assureds include the owner and mortgagee of a ship,<sup>438</sup> the owner and repairer of a ship, the owner and charterer of ship,<sup>439</sup> as well as companies in the same group.<sup>440</sup> A majority of ship financiers and shipowners are composite co-assureds, and in such cases each of them, in essence, has a separate contract with the insurer subscribing to the relevant risks. Thus the ship financier's rights under the policy are independent and distinct from those rights of the shipowner. The abovementioned subrogated claims are more likely to arise under the composite insurance, whereas an action by way of subrogation is not normally available in the name of one joint co-assured against another.<sup>441</sup>

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<sup>436</sup> See Chapter 5, section 5.5.3 (As a co-assured).

<sup>437</sup> The distinction between joint insurance and composite insurance, see: Chapter 5, section 5.5.3 (As a co-assured).

<sup>438</sup> *P Samuel and Company v Dumas* [1924] AC 431; *Woolcott v Sun Alliance and London Insurance Ltd* [1978] 1 Lloyd's Rep. 629; *Eide UK Ltd v Lowndes Lambert Group Ltd* [1998] 1 Lloyd's Rep 389; *First National Commercial Bank Plc v Barnet Devanney (Harrow) Ltd* [1999] Lloyd's Rep IR 459.

<sup>439</sup> *Newcastle P&I Association v Ships (USA) Inc* [1996] 2 Lloyd's Rep 515.

<sup>440</sup> *New Hampshire Insurance Co v MGN Ltd* [1997] LRLR 24.

<sup>441</sup> See *Commonwealth Construction Co Ltd v Imperial Oil Ltd* [1978] 1 SCR 317 at 318, where the Supreme Court of Canada held 'In the case of true joint insurance the interests of the joint insured are so inseparably connected that the several insureds are to be considered as one with

Generally, the insurer is not allowed to exercise subrogation rights to pursue a claim in the name of one co-assured against another.<sup>442</sup> If such subrogated claims were permitted, in most cases the insurer would recover a loss from one person for which the insurer had agreed to indemnify this person.<sup>443</sup> However, the rule that insurers cannot pursue subrogated claims against a co-assured is not absolute under English law. Although it is well established that where the parties have agreed in a contract that the insurance shall insure for both of their benefits (typically in the circumstance of co-insurance) they cannot claim against each other in respect of insured losses,<sup>444</sup> the precise ambit and juridical basis of this rule are less clear.<sup>445</sup> When we summarise authoritative judgments: three theories have been put forward in respect of such subrogated claims, and these are considered in turn in the following paragraphs.

#### 5.6.2.1 *The first theory: rules of circuity*

The earliest decisions provided that although there was no principle of law preventing the insurer from bringing subrogation actions in the name of one co-assured against another, such subrogated claims nonetheless were prevented, in order to avoid circuity of actions.<sup>446</sup> However, the circuity theory did not find much support in court,<sup>447</sup> and it was clearly rejected in *Co-operative Retail Services Ltd v Taylor Young Partnership*.<sup>448</sup>

#### 5.6.2.2 *The second theory: an implied term in the insurance contract*

An alternative theory concerning an insurer's ability to sue by way of subrogation against a co-assured on the basis of the latter's negligence or default is the theory

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the obvious result that subrogation is impossible'. However, this decision does not form part of English law.

<sup>442</sup> See, generally, *MacGillivray* (n 427) Chapter 24, section 6 (Claims against assured).

<sup>443</sup> See *Simpson v Thomson* (1877) 3 App Cas 279 (HL).

<sup>444</sup> *Petrofina (UK) Ltd v Magnaload Ltd* [1984] QB 127.

<sup>445</sup> See *The Yasin* [1979] 2 Lloyd's Rep 45; *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582; *Co-operative Retail Services Ltd v Taylor Young Partnership Ltd* (2001) 3 TCLR 4 (CA), affirmed [2002] 1 WLR 1419 (HL); *Tyco Fire & Integrated Solutions (UK) Ltd (formerly Wormald Ansul (UK) Ltd) v Rolls Royce Motor Cars Ltd (formerly Hireus Ltd)* [2008] EWCA Civ 286; *Rathbone Brothers Plc v Novae Corporate Underwriting Ltd* [2013] EWHC 3457 (Comm), reversed in part [2014] EWCA Civ 1464; *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)* [2013] EWHC 2199 (Comm), reversed [2015] EWCA Civ 16, affirmed [2017] UKSC 35.

<sup>446</sup> See *The Yasin* [1979] 2 Lloyd's Rep 45; *Petrofina (UK) Ltd v Magnaload Ltd* [1984] QB 127.

<sup>447</sup> See *Aktieselskabet Ocean v B Harding and Sons Ltd* [1928] 2 KB 371.

<sup>448</sup> (2001) 3 TCLR 4 (CA) (Brooke LJ), affirmed [2002] 1 WLR 1419 (HL) (Lord Hope).

of an implied term in the insurance contract. This theory suggests that the insurance contract contains an implied term that the co-assured will not be pursued by the insurer. For this reason, the insurer is precluded from bringing a subrogated action against the co-assured. Such an approach was adopted in *National Oilwell (UK) Ltd v Davy Offshore Ltd*,<sup>449</sup> in which Colman J provided:

The explanation for the insurers' inability to cause one co-assured to sue another co-assured is that in as much as the policy on goods covers all the assureds on an all risks basis for loss and damage, even if caused by their own negligence, any attempt by an insurer after paying the claim of one assured to exercise rights of subrogation against another would in effect involve the insurer seeking to reimburse a loss caused by a peril (loss or damage even if caused by the assured's negligence) against which he had insured for the benefit of the very party against whom he now sought to exercise rights of subrogation. That party could stand in the same position as the principal assured as regards a loss caused by his own breach of contract or negligence. For the insurers who had paid the principal assured to assert that they were now free to exercise rights of subrogation and thereby sue the party at fault would be to subject the co-assured to a liability for loss and damage caused by a peril insured for his benefit... it is necessary to imply a term into the policy of insurance to avoid this unsatisfactory possibility. The implication of such a term is needed to give effect to what must have been the mutual intention (on this hypothesis) of the principal assured and the insurers, as to the risks covered by the policy. On this basis the purported exercise by insurers of rights of subrogation against the co-assured would be in breach of such a term and would accordingly provide the co-assured with a defence to the subrogated claim ....<sup>450</sup>

### 5.6.2.3 *The third theory: an implied term in the underlying contract*

The third theory, which has now generally been favoured by the courts, suggests that subrogation immunity generally rests upon the true construction of the underlying contract between the co-assureds. A range of examples<sup>451</sup> from the most recent debates under English law in respect of the insurer's subrogated claims in the context of co-insurance are considered in this sub-section, among which the most recent, the Supreme Court's judgement in *The Ocean Victory*,<sup>452</sup> has obviously attracted the most attention.

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<sup>449</sup> [1993] 2 Lloyd's Rep 582.

<sup>450</sup> *Ibid* at 613-614.

<sup>451</sup> See, e.g. *Tyco Fire & Integrated Solutions (UK) Ltd (formerly Wormald Ansul (UK) Ltd) v Rolls Royce Motor Cars Ltd (formerly Hireus Ltd)* [2008] EWCA Civ 286; *Rathbone Brothers Plc v Novae Corporate Underwriting Ltd* [2013] EWHC 3457 (Comm), reversed in part [2014] EWCA Civ 1464; *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)* [2013] EWHC 2199 (Comm), reversed [2015] EWCA Civ 16, affirmed [2017] UKSC 35.

<sup>452</sup> [2017] UKSC 35.

(a) *Tyco Fire & Integrated Solutions (UK) Ltd v Rolls Royce Motor Cars Ltd*

In *The Tyco Fire*,<sup>453</sup> Rix LJ provided:

It appears ... that the following doctrines have at times been put forward to explain the impermissibility for an insurer to sue by way of subrogation to recoup himself from another co-assured on the basis of the latter's negligence or default: the doctrine of circuitry of action and the doctrine of an implied term in the insurance contract. It also appears that the doctrine of circuitry of action is no longer favoured (see Brooke L.J. at para 69 and Lord Hope at para 64), and that the doctrine of an implied term in the insurance contract has now been replaced by a doctrine of the true construction of the underlying contract for the provision of joint names insurance (Brooke L.J. at para 73 and Lord Hope at para 65); and that this last doctrine may operate with the assistance of an implied term to the effect that co-assureds cannot sue one another in respect of damage in respect of which they are jointly insured (Lord Hope at para 65).<sup>454</sup>

That is, if the underlying contract between co-assureds contains terms exempting the defendant co-assured from liabilities towards the indemnified co-assured, there is a subrogation immunity. In the light of this, an insurer will not be precluded from bringing a subrogation action against a co-assured unless the insurance contract contains a waiver of subrogation clause, or unless the underlying contract between co-assureds by its terms confers immunity (in clear words) upon the defendant co-assured.

(b) *Rathbone Brothers Plc v Novae Corporate Underwriting Ltd*

It has generally been accepted that subrogation immunity can be conferred by the terms of the underlying contract between co-assureds. However, the question as to whether an insurer, after paying the claim of one co-assured, can exercise rights of subrogation against another, continues to trouble the courts. The observations of Rix LJ in *The Tyco Fire*<sup>455</sup> were considered in two more recent Court of Appeal decisions—*Rathbone Brothers Plc v Novae Corporate Underwriting Ltd*<sup>456</sup> and *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)*.<sup>457</sup>

The case of *The Rathbone Brothers*<sup>458</sup> concerns a claim regarding an excess

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<sup>453</sup> [2008] EWCA Civ 286.

<sup>454</sup> *Ibid* at para [75].

<sup>455</sup> [2008] EWCA Civ 286.

<sup>456</sup> [2013] EWHC 3457 (Comm), reversed in part [2014] EWCA Civ 1464.

<sup>457</sup> [2013] EWHC 2199 (Comm), reversed [2015] EWCA Civ 16, affirmed [2017] UKSC 35.

<sup>458</sup> [2013] EWHC 3457 (Comm), reversed in part [2014] EWCA Civ 1464.

layer professional indemnity policy. One such personal trustee (PEV) of a Jersey trust, who was also an employee of – and later a consultant for – a Jersey trust company (Rathbone Trustees), was sued by the beneficiaries of the Jersey trust, alleging breach of professional and fiduciary duties. PEV had two options to meet his liabilities. The first option was made available by Rathbone Trustees and its parent company (Rathbone plc) having granted PEV a contractual indemnity which could indemnify him up to a limit of £40 million with respect to certain liabilities arising from the performance of his duties (fraud and willful misconduct excluded), and the contractual indemnity expressly included his acting as a trustee. Turning to the second option, as a person employed in the performance of professional services, PEV was able to claim on a professional indemnity policy taken out by Rathbone plc for itself and its subsidiaries (Rathbone Trustees included). It was a claim made policy with a primary layer of £5 million with AIG, and an excess layer of £45 million with Novae. The excess clause of the policy stated that ‘Insurance provided by this policy applies excess over insurance and indemnification available from any other source’.<sup>459</sup> In addition, the policy included a subrogation clause, in the following terms ‘The insurer shall be subrogated to all assureds’ rights of recovery, contribution and indemnity before or after any payment under this policy...The insurer shall no exercise its rights of subrogation against an assured person in connection with a claim’.<sup>460</sup> PEV, Rathbone Trustees and Rathbone plc sought cover under the professional indemnity policy; whilst AIG had accepted that the claim was covered, Novae and other excess layer insurers had not. The claimants, therefore, sued excess layer insurers for establishing their liabilities under the excess layer professional indemnity policy. The insurers contended that: (a) PEV was not covered by the policy; (b) even if it were the case that he was covered, the insurers would only have been liable after the contractual indemnity had been exhausted for the reason of the excess clause; and (c) if the insurers would be liable to indemnify PEV, the insurers claimed to be entitled to be subrogated to PEV's claim against Rathbone plc and Rathbone Trustees under the contractual indemnity.

At first instance,<sup>461</sup> Burton J held that PEV was covered by the policy: although

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<sup>459</sup> *Rathbone Brothers Plc v Novae Corporate Underwriting Ltd* [2014] EWCA Civ 1464 at para [49].

<sup>460</sup> *Ibid* at para [70].

<sup>461</sup> *Rathbone Brothers Plc v Novae Corporate Underwriting Ltd* [2013] EWHC 3457 (Comm).

Novae was not entitled to rely on the excess clause, it had a subrogation claim against Rathbone upon the paying out of the policy amount. Each of them appealed – Novae on the coverage and excess clause issues; Rathbone on the subrogation issue.

The Court of Appeal dismissed the appeal by Novae and upheld the appeal by Rathbone.<sup>462</sup> On the subrogation issue, the Court held that there was no claim to be subrogated under the contractual indemnity. The majority judges (Beatson LJ dissenting) were prepared to imply a waiver of subrogation clause into the policy in exceptional circumstances, and that this would have precluded insurers from exercising rights of subrogation against Rathbone plc. However, such an implied waiver cannot be presumed to apply in other cases. The Court unanimously agreed that the terms of the contractual indemnity had precluded insurers from exercising rights of subrogation against Rathbone. The contractual indemnity contained an implied term that it would provide supplemental protection only in the event that the claim against the insurance company had been exhausted.<sup>463</sup> Accordingly, the professional indemnity policy was the primary source of indemnification, and the contractual indemnity was merely the secondary source, and these were not coextensive. In the light of this, any payment made by the insurer would have discharged the obligation Rathbone plc might otherwise have had under the contractual indemnity, unless the insurance cover had failed to meet the full liability in which case recourse would only then be had to the contractual indemnity (to the extent that the liability was discharged by the insurance monies). Elias LLJ held that the policy being treated as the primary source of indemnification was not based merely on the fact that Rathbone plc had paid the premium. Rather, it was justified by the combined facts that persons who had promised to provide contractual indemnity had no fault and that the subrogated rights in relation to an indemnity were providing the same protection as the insurance.<sup>464</sup> Therefore, even if there were a subrogation right in principle which was not waived by the implied terms of the policy, there would still have been no rights to which the insurers could have been subrogated in the present case.<sup>465</sup>

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<sup>462</sup> *Rathbone Brothers Plc v Novae Corporate Underwriting Ltd* [2014] EWCA Civ 1464.

<sup>463</sup> *Ibid* at paras [102-104].

<sup>464</sup> *Ibid* at para [106].

<sup>465</sup> *Ibid* at para [107].



(c) *Gard Marine & Energy Ltd v China National Chartering Co Ltd*

In *The Ocean Victory*,<sup>466</sup> a ship was chartered by her owners to demise charterers on the Barecon 89 form.<sup>467</sup> The demise charterers subsequently time chartered the ship, and time charterers then sub-chartered the ship for a time charter trip. As a result, there was a charterparty chain, and each charterparty contained the same undertaking to trade the ship between safe ports. The demise charterparty provided that the demise charterers were obliged to procure insurance for the ship, at their own expense, against marine, war, protection and indemnity risks, for the joint interest of themselves and the owners.<sup>468</sup> Clause 13 would have been applied in place of clause 12 if the parties had so chosen. Both clause 12 and clause 13 were standard clauses of the Barecon 89 form, and they both contained the same scheme, which was designed to provide an insurance funded result in the event that loss or damage to the ship resulted from marine risks. However, clause 12 differed from clause 13 in certain aspects. Clause 12 required the demise charterers to take out marine and war risks insurance as well as P&I insurance, while clause 13 imposed on the owners the obligation of maintaining marine and war risks insurance. Similar to clause 12, clause 13 also required marine and war risks insurance to be arranged “in the joint names of the Owners and the Charterers as their interests may appear” but, unlike clause 12, it expressly excluded the owners’ and/or insurers’ rights of recovery or subrogation against the demise charterers in respect of the liabilities covered by the insurance.

At the time of the casualty, the ship *Ocean Victory* sought to leave the port because a considerable swell had affected berth of ships, but she allided with the northern end of the South Breakwater and grounded. Salvors were engaged, but *Ocean Victory* eventually became a total loss. The hull insurers, in their capacity as assignees of the rights of the owners and demise charterers in respect of the grounding and total loss of the ship, sought to exercise their rights of subrogation against the time charterers on account of there being a breach of the safe port undertaking. The time charterers sought to pass any liability down the chain to the sub-charterers.

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<sup>466</sup> *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)* [2013] EWHC 2199 (Comm), reversed [2015] EWCA Civ 16, affirmed [2017] UKSC 35.

<sup>467</sup> Barecon 89 form is a standard bareboat charter drafted by BIMCO.

<sup>468</sup> Barecon 89 form cl. 12.

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

The High Court held that there was a breach of the safe port undertaking and awarded the hull insurers substantial damages.<sup>469</sup> However, the Court of Appeal found that the condition which had affected the port was an “abnormal occurrence” and that there was therefore no breach of the safe port undertaking on the part of the charterers.<sup>470</sup> Thus the High Court decision was overturned.

Given the conclusion that there was no breach of the safe port undertaking, it was not necessary for the Court of Appeal to decide on the recoverability issue, but the Court went on to consider this issue on the grounds of its potential importance; the issue being, if there had in fact been a breach of the safe port undertaking, whether the insurers would have been able to rely upon a breach of that undertaking to exercise their rights of subrogation against the time charterers. The Court reversed the finding of Teare J (at the first instance) on the recoverability issue, holding that the owners were not entitled to claim against the demise charterers in respect of an insured loss, for the reason of joint insurance provision being contained in the underlying demise charterparty, or therefore by the latter down the charterparty chain. The Court had confirmed that the subrogation immunity was not based on an implied term in the insurance contract. Instead, it was based on the construction of the agreement between the parties. In addition, the Court had rejected Rix LJ's suggestion in *The Tyco Fire*<sup>471</sup> that clear words of exclusion of liability were necessary to give rise to immunity, and the Court had preferred a less restrictive approach in *GD Construction (St Albans) Ltd v Scottish & New Castle*.<sup>472</sup> Longmore LJ stated:

The *prima facie* position where a contract requires a party to that contract to insure should be that the parties have agreed to look to the insurers for indemnification rather than to each other. That will be all the more so if it is agreed that the insurance is to be in joint names for the parties' joint interest or if there are other relevant circumstances.<sup>473</sup>

That is to say that where there are co-insurance arrangements, the presumption is that any losses will be discharged by reference to the insurance alone and

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<sup>469</sup> *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)* [2013] EWHC 2199 (Comm).

<sup>470</sup> *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)* [2015] EWCA Civ 16.

<sup>471</sup> [2008] EWCA Civ 286.

<sup>472</sup> [2003] EWCA Civ 16 at paras [39] and [59].

<sup>473</sup> *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)* [2015] EWCA Civ 16 at para [83].

rights of subrogation are not available against co-assured. The recoverability issue in *The Ocean Victory*<sup>474</sup> was appealed to the Supreme Court.

#### 5.6.2.4 *The Supreme Court's approach in the Ocean Victory*

The Supreme Court handed down its judgment in *The Ocean Victory*<sup>475</sup> very recently. The recoverability issue was considered along with other two issues, namely the “safe port undertakings” issue and the “limitation of liability” issue. The limitation of liability issue was not considered by the Court of Appeal because it had accepted that it was bound by the Court of Appeal decision in *The CMA Djakarta*.<sup>476</sup> The appeal was dismissed by the Supreme Court unanimously, on the grounds that there was no breach of the safe port undertaking in the present case. If there had been a breach of the safe port undertaking, all the justices agreed that the sub-charterers would not have been entitled to limit their liability under the Convention on Limitation of Liability for Maritime Claims 1976, in respect of any claim from the subrogated insurers. The reasons were essentially the same as those given by the Court of Appeal in *The CMA Djakarta*.

On the recoverability issue, however, the Supreme Court was not unanimous. The Supreme Court agreed with the Court of Appeal by a 3:2 majority that the joint insurance provision contained in the demise charterparty precluded any claim by the owners against the demise charterer in respect of that part of the loss which represented the ship's value, or therefore by the latter down the charterparty chain. Lord Toulson, supported by Lord Mance and Lord Hodge, gave the majority decision. Lord Sumption and Lord Clark, as the dissenting minority, agreed with the judge.

All the lords agreed that, where there was a co-insurance arrangement, the co-assureds could not claim against each other in respect of an insured loss. Thus the insurer who had indemnified an innocent co-assured could not seek recovery from other co-assureds. However, their opinions were split in respect of the reasoning.

The majority judges agreed that it was the provisions of clause 12 of the demise charterparty, which provided for joint insurance and a distribution of

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<sup>474</sup> [2015] EWCA Civ 16.

<sup>475</sup> [2017] UKSC 35.

<sup>476</sup> [2004] 1 Lloyd's Rep 460.

insurance proceeds that had precluded such a claim. It was a clear intention of clause 12 to be a comprehensive scheme for providing an insurance funded result in the event of loss or damage to the ship resulting from marine risks,<sup>477</sup> and the safe port undertaking did not alter the way in which clause 12 was to operate.<sup>478</sup> Such a joint insurance arrangement not only provided a fund but also avoided commercially unnecessary and undesirable disputes between the co-assureds. In other words, even if there was a breach of the safe port undertaking, the head owners were obliged to look exclusively to the insurance proceeds to recover the loss of the ship due to the co-insurance arrangement in the demise charterparty (clause 12). In the light of this, the demise charterers had no liability to pass on to the sub-charterers as damages for a breach of the safe port undertaking, and the insurers who were assignees could be in no better position than assignors. In addition, Lord Mance expressed his view that clause 12 and 13 were merely mirror images of each other, and the reason that no express exclusion of subrogation appeared in clause 12 was that such subrogated claims were impossible in the context of insurances arranged by charterers on behalf of themselves and owners.<sup>479</sup>

The minority judges disagreed that clause 12 was a "complete code" for all insured losses as a matter of construction; rather, it provided a mechanism for discharging liability via insurance proceeds. In the present case, the owners could not claim an insured loss from the demise charterers because any loss between them had been made good by the insurers.<sup>480</sup> In other words, the demise charterers' liability to pay damages was not excluded by the terms of the contract but was satisfied by the payments of the insurers, therefore the demise charterers had suffered a loss capable of being passed on down the charterparty chain. There were reasons for the terms of clause 13 expressly granting an exclusion of owners and/or insurers' subrogation right, while this was not so provided in clause 12: it was the draftsman's intention to deal with the overlap between the liability of the insurers and of the demise charterers with the express exclusion contained in clause 13.<sup>481</sup> Given that the parties in the present case had selected clause 12,

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<sup>477</sup> *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)* [2017] UKSC 35 at para [114].

<sup>478</sup> *Ibid* at para [118].

<sup>479</sup> *Ibid* at paras [116-117].

<sup>480</sup> *Ibid* at paras [100-105].

<sup>481</sup> *Ibid* at para [105].

the charterers were liable for breaching the demise charterparty.

It is worth noting that the judges had indicated that the demise charterer or their subrogated insurers might have sought to claim damages from the time charterers on alternative bases, such as bailment or “transferred loss”.<sup>482</sup> The Supreme Court did not express any further views regarding this matter, since no argument had appeared. If the subrogated insurers had claimed as the bailees of the ship (by virtue of the demise charterer's right of possession and/or by virtue of a contractual right), they might have bypassed the joint insurance provisions and might have succeeded in claiming damages from the time charterers.

By way of background, *The Ocean Victory* was complex and unique because the wrongdoers were third parties rather than parties to the contract which included the co-insurance agreement. It seemed, from the Court of Appeal's decision, as though the sub-charterers could obtain a free ride on the demise charterers' subrogation immunity. However, the Supreme Court lordships' opinions differed regarding whether the demise charterers had suffered a loss capable of being passed on down the charterparty chain. That is, the insurers' case was based on whether the demise charterers were liable to the owners under the safe port undertaking.

In summary, if parties to a contract have agreed in the contract that their interests will be insured under the same policy, it is presumed that any loss between them will be discharged by reference to the insurance, even where the co-assureds are in fact liable for the loss. In addition, a party to an insurance contract can be granted immunity from subrogation not only by an express exclusion of the parties' liability in the underlying contract, for a proof of the existence of co-insurance could also serve the purpose. Where the financier participates in the primary insurance as a co-assured, it is a norm that the loan or lease agreement includes a co-insurance clause providing that the financier and the shipowner could not claim against each other in respect of an insured loss, that clause would be deemed as an express exclusion. In the light of this, where the question arises as to whether the insurer is entitled to bring subrogated actions against the shipowner at fault after indemnifying the co-assured financier (who has a composite interest in the shipowner's insurances), the answer is negative provided a co-insurance agreement is in place and is properly

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<sup>482</sup> Ibid at para [94].

constructed. There are lots of interesting discussions arise from *The Ocean Victory*,<sup>483</sup> the author intends to explore this case further in a separate article. This section aims to consider the issue of subrogated actions against co-assured in the context of ship finance, and the above summary has achieved that goal. Another original analysis relevant to the subrogation issue in ship finance context will be provided in below section 5.6.4 (Mortgagees' interest insurance).

An alternative way to exclude the insurer's subrogation rights against co-assured is to incorporate a waiver of subrogation clause into the policy. It seems that such a waiver is no longer essential if a properly constructed co-insurance agreement has already been in place. In spite of the fact that, in reality, insurers are generally reluctant to waive their subrogation rights, the ambit and effects of a waiver of subrogation clause are considered in the following section.

### 5.6.3 Waiver of subrogation clauses

As a general observation, subrogation can be much more complicated than a substitution of one person in the place of another with reference to a lawful claim. This is particularly so if multiple parties are involved in a contractual chain, as in the case of *The Ocean Victory*.<sup>484</sup> Nevertheless, the insurer's subrogation rights may be excluded or modified by the terms of the policy,<sup>485</sup> and a possible way to preclude the insurer's subrogated actions against co-assured is to incorporate a waiver of subrogation clause into the policy.<sup>486</sup> Such a waiver may be either express or implied,<sup>487</sup> although an express waiver is preferred.

The insurer may expressly waive its subrogation rights against co-assured by incorporating a waiver of subrogation clause into the policy. It is, indeed, quite common for insurance contracts in relating to offshore, construction and aerospace projects to contain such a waiver clause.<sup>488</sup> As regards the ambit and

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<sup>483</sup> See, e.g. E Blackburn and A Dinsmore, 'Joint Insurance Issues in *The Ocean Victory*: The Roads Not Taken' (2018) 1 LMCLQ 50; this paper analyses the *obiter* decision on the joint insurance issues in *The Ocean Victory*, with a particular focus on the terms to be implied into the co-assureds' underlying contract, and concludes that insurers should advance their claim on the basis of the subrogated actions that arise as a result of the demise charterers' possessory title.

<sup>484</sup> *Gard Marine & Energy Ltd v China National Chartering Co Ltd (The Ocean Victory)* [2013] EWHC 2199 (Comm), reversed [2015] EWCA Civ 16, affirmed [2017] UKSC 35.

<sup>485</sup> See, e.g. *Thomas & Co v Brown* (1899) 4 Com Cas 186; *Lucas (L) v Export Credits Guarantee Department* [1973] 1 WLR 914 at 922 (Megaw LJ), reversed [1974] 1 WLR 909 (HL).

<sup>486</sup> See *The Marine Sulphur Queen* [1973] 1 Lloyd's Rep 88 (US).

<sup>487</sup> *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582.

<sup>488</sup> See, e.g. International Hull Clauses (1/11/03); American Institute Hull Clauses (2/6/77); American Institute Tug Form (8/1/76).

effects of a waiver clause, it is essentially a matter of construction which is to be considered in combination with other terms and circumstances of the policy. An express waiver is not required to relate to the person who will be actually indemnified under the policy.<sup>489</sup> However, unless clearly worded, an express waiver clause in favour of the co-assureds may be construed as indicating that the clause's protection is co-extensive with each co-assured's cover under the policy.<sup>490</sup> That is, in the absence of clear words, the insurer's subrogation rights cease only in the event that a loss is one for which the co-assured itself could claim against the insurer. If the loss is not covered by the policy,<sup>491</sup> or if the co-assured will be prevented from claiming against the insurer for certain reasons (e.g. the loss resulted from the co-assured's willful misconduct),<sup>492</sup> the co-assured cannot rely on a waiver of subrogation clause to defend subrogated actions brought by the insurer.

#### 5.6.4 Mortgagees' interest insurance

Mortgagees' interest insurance is designed to provide balance sheet protection for mortgagees, which may be triggered in the event that, *inter alia*, the shipowner's insurers decline to pay for reasons such as mid-term cancellation of the policy following non-payment of the premium, non-compliance with international codes (e.g. International Safety Management Code), unseaworthiness, and scuttling. Under MII, the assured can only be a mortgagee, and difficulties may arise in two circumstances: (a) the MII insurer brings subrogated actions against the shipowner at fault; and (b) the MII insurer requires the assured mortgagee to abandon an insured ship after paying the amount of a total loss. These two circumstances are considered in turn in the following paragraphs.

As regards the subrogation issue, an MII insurer is entitled to bring subrogated actions against a third party at fault upon indemnifying the assured mortgagee, and this third party is often the shipowner. The MII insurer's subrogation rights are stated in section 8 of the Institute Mortgagee's Interest Clauses-Hulls

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<sup>489</sup> *The Surf City* [1995] 2 Lloyd's Rep 242.

<sup>490</sup> *National Oilwell (UK) Ltd v Davy Offshore Ltd* [1993] 2 Lloyd's Rep 582 at 603-604.

<sup>491</sup> *Ibid.*

<sup>492</sup> *Ibid* at 582-616.

(1/3/97),<sup>493</sup> as follows:

- (1) Upon payment to the Assured of a claim hereunder, the Underwriters shall be subrogated to all the rights and remedies of the Assured in respect of such payment;
- (2) It is a condition of this insurance that any payments by the Underwriters shall not be applied by the Assured in or towards discharge or satisfaction of the amount of the outstanding indebtedness.<sup>494</sup>

The purpose of section 8(2) is to prevent the mortgagee from paying over to the mortgagor (i.e. shipowner) any part of recoveries that it makes under MII. It is beyond doubt that MII insurers are entitled to rights of subrogation. However, assuming that the mortgagee and mortgagor have made a loan agreement in which the mortgagee is required to take out MII, the question arises as to whether this provision implies that the mortgagor is not liable for any loss which is covered by MII. If the answer is positive, will the mortgagor be allowed to use this provision to defend subrogated actions brought by the MII insurer? There is not a straightforward answer for these questions; such a provision must be considered in specific contexts. Nevertheless, it is possible that such a provision contained in a loan agreement becomes an obstacle to the MII insurer exercising its subrogation rights.

The second circumstance is essentially a salvage issue: that is, whether an MII insurer is entitled to salvage upon paying for a total loss. The doctrine of abandonment is closely related to that of subrogation;<sup>495</sup> in spite of the heading (Rights of Subrogation) of section 79(1) of the MIA 1906, this clause actually deals with matters of abandonment.<sup>496</sup> Although there are some overlaps between section 63(1) and section 79(1) of the MIA 1906,<sup>497</sup> the latter applies to events where insurers have made payments. Accordingly, section 79(1) of the MIA 1906 applies to the discussion here, which provides:

Where the insurer pays for a total loss either of the whole, or in the case of goods of any apportionable part, of the subject matter insured, he thereupon becomes entitled to take over the interest of the assured in whatever may remain of the subject matter so paid for, and he is thereby subrogated to all the rights and

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<sup>493</sup> A standard insurance contract designed to protect interests of the mortgagees.

<sup>494</sup> Institute Mortgagee's Interest Clauses – Hulls (1/3/97) s. 8.

<sup>495</sup> See Chapter 5, section (5.6.1 The general rule).

<sup>496</sup> *Arnould* (n 230) para 31-01.

<sup>497</sup> The relationship between ss. 63 and 79 of the Marine Insurance Act 1906: see *Dornoch Ltd v Westminster International BV* [2009] 2 Lloyd's Rep 191 (Tomlinson J).



## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

remedies of the assured in and in respect of that subject matter as from the time of the casualty causing the loss.<sup>498</sup>

For example, upon paying for a total loss, the hull insurer can acquire the legal title of the insured ship (if it is a CTL, the insurer is entitled to the title of the ship by exercising its election to take over the ship) as well as obtain the shipowner's personal rights and obligations associated with the ship. Assuming that an MII policy is triggered following a total loss claim being declined by the hull insurer, the question arises as to whether the MII insurer can acquire similar abandonment rights as those which are accorded to the hull insurer upon paying for a total loss. The answer is affirmative for two main reasons. First, the general shape of MII is more like a policy which covers risks of physical loss or damage to the ship, rather than a policy which covers risks of financial damage to the mortgagee.<sup>499</sup> Second, while the mortgagee's ownership is distinguished from an absolute ownership in the register,<sup>500</sup> the assured who has less than an absolute interest in the subject-matter insured is entitled to abandonment.<sup>501</sup> Thus it is possible for the assured mortgagee to abandon its interest in the ship to the MII insurer, and an acceptance of such an abandonment will vest that interest in the MII insurer.

### 5.7 Value to insure

It is not always easy for shipowners and their financiers to decide the right amount for which to insure the ship, since the sum insured is closely related to the measure of indemnity. The measure of indemnity is the sum which the assured can recover in respect of a loss on a policy by which it is insured. If such a sum is not enough to cover the actual loss, shipowners and their financiers will have to suffer a shortfall. For the purposes of demonstration, in this section we will assume that the ship is financed under the mortgage-backed bank loan structure (the most common structure for financing ships), thus the "ship financier" will be referred as the "bank" in the following discussions. When banks calculate the sum for which to insure, they mainly examine the amount of loan and the financed

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<sup>498</sup> Marine Insurance Act 1906 s. 79(1).

<sup>499</sup> *Continental Illinois National Bank & Trust Co of Chicago v Bathurst (The Captain Panagos DP)* [1985] 1 Lloyd's Rep. 625 at 626.

<sup>500</sup> Merchant Shipping (Registration of British Ships) Regulations 1993 (SI 1993/3138).

<sup>501</sup> *Arnould* (n 230) para 30-10.

ship's market value, and a basic rule is that a CTL of the ship can be covered by insurance at any time during the entire period of the loan. Under most circumstances, banks will not provide loans up to the full value of the ship. However, loans provided by banks may be close to – or even exceed – the ship's market value under some circumstances (especially when loans are restructured),<sup>502</sup> which increases the difficulty in calculating the amount for which to insure.

### 5.7.1 Valued and unvalued policies

For the purposes of quantifying indemnities, the MIA 1906 categories marine policies into two groups: namely the valued policies and the unvalued policies.<sup>503</sup> A valued policy is defined in section 27(2) of the MIA 1906 as 'a policy which specifies the agreed value of the subject-matter insured'.<sup>504</sup> By contrast, an unvalued policy is defined in section 28 the MIA 1906 as 'a policy which does not specify the value of the subject-matter insured, but, subject to the limit of the sum insured, leaves the insurable value to be subsequently ascertained, in the manner specified in the Act'.<sup>505</sup> Whether a policy is valued or unvalued is a matter of construction,<sup>506</sup> merely referring to an "insured amount" does not make the policy a valued policy, but the sum insured may be regarded as an upper limit on recovery or a basis for the calculation of premiums.<sup>507</sup> A valued policy may be indicated by the inclusion of the words "valued at" or "agreed insured value", but there is no specific requirement for such words.<sup>508</sup>

One of the main differences between valued and unvalued policies is the difference between their effects. Where there is a loss, the assured of a valued

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<sup>502</sup> Christian Roed Christensen (Danske Bank) stated 'In the restructuring deal, we had several vessels which had loans exceeding their values by 70-100%, in which the lift up in the hull interest and the freight interest cannot fill the gap.' in seminar 'Handling Insurance On Vessels' (London, June 2016).

<sup>503</sup> Marine Insurance Act s. 27(1).

<sup>504</sup> Ibid s. 27(2).

<sup>505</sup> Ibid s. 28.

<sup>506</sup> *Wilson v Nelson* (1864) 5 B & S 354. See also *Asfar v Blundell* [1895] 2 QB 196; *Loders & Nucoline v Bank of New Zealand* (1929) 33 LI L Rep 70; *Kyzuna Investments Ltd v Ocean Marine Mutual* [2000] 1 Lloyd's Rep 505 at 508.

<sup>507</sup> See *Continental Illinois National Bank & Trust Co of Chicago v Bathurst (The Captain Panagos DP)* [1985] 1 Lloyd's Rep 625 at 630; *Kyzuna Investments Ltd v Ocean Marine Mutual Ins Assn (Europe)* [2000] 1 Lloyd's Rep 505 at 509; *Quorum AS v Schramm* [2002] 1 Lloyd's Rep 249 at 260; *Thor Navigation v Ingosstrakh Insurance* [2005] 1 Lloyd's Rep 547 at 552-553.

<sup>508</sup> *Kyzuna Investments Ltd v Ocean Marine Mutual Ins Assn (Europe)* [2000] 1 Lloyd's Rep 505; *Thor Navigation Inc v Ingosstrakh Insurance* [2005] 1 Lloyd's Rep 547.

policy is not obliged to prove the actual value of the subject-matter insured, because this value is fixed in the policy (either by means of a fixed sum or by reference to some other criterion such as the invoice value) and is generally conclusive against parties to the policy. By contrast, the assured of an unvalued policy is obliged to prove the sound market value of the subject-matter insured.<sup>509</sup> In practice, nearly all H&M policies are now valued policies.<sup>510</sup> In the light of this, only the situation of a ship being insured under a valued policy is considered in the following discussions.

### 5.7.2 The measure of indemnity

The measure of indemnity is defined in section 67(1) of the MIA 1906 as 'the sum which the assured can recover in respect of a loss on a policy by which he is insured'.<sup>511</sup> In the case of a valued policy, the measure of indemnity is calculated by reference to the agreed value contained in the terms of the insurance contract.<sup>512</sup> As a general principle, the agreed value fixed in the policy is conclusive against both the insurer and the assured, no matter whether it is a total loss or partial loss.<sup>513</sup> Accordingly, the sum recoverable by the assured under a valued policy is fixed at the commencement of the risk, by the parties beforehand agreeing an estimated value for the subject-matter insured, even though this estimated value may not in fact reflect its true value. Consequently, under a valued policy, the sum which the assured can recover in respect of a loss will not be affected by any subsequent increase or decrease in the ship's market value.

By way of background, the ships' market values are extremely volatile, thus it is not uncommon to find a significant difference between a ship's value at the commencement of the risk and at the time of the loss. Ship financiers are faced with significant risks arising out of such changes, and these risks are considered in the following paragraphs.

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<sup>509</sup> See Marine Insurance Act 1906 ss. 27, 28. See also *Barker v Janson* (1867-68) LR 3 CP 303; *Thames & Mersey Marine Insurance Co Ltd v Gunford Ship Co Ltd* [1911] AC 529 (HL).

<sup>510</sup> The reasons of the majority of marine policies written in the London market are now valued policies, see: *Arnould* (n 230) para 2-20 and para 12-03.

<sup>511</sup> Marine Insurance Act 1906 s. 67 (1).

<sup>512</sup> *Ibid.*

<sup>513</sup> *Ibid* s. 27(3). See also *Lewis v Rucker* (1761) 2 Burr 1167; *Shawe v Felton* (1801) 2 East 109; *Irving v Manning* (1847) 1 HL Cas 287; *Barker v Janson* (1867-68) LR 3 CP 303; *Shawe v Felton* (1801) 2 East 109; *Woodside v Globe Marine Insurance Co Ltd* [1896] 1 QB 105.

### 5.7.2.1 Total loss

The agreed value in the policy has always been held as the conclusive measure of indemnity in the case of total loss.<sup>514</sup> A special case is provided by section 27(4) of the MIA 1906, which states ‘Unless the policy otherwise provides, the value fixed by the policy is not conclusive for the purpose of determining whether there has been a constructive total loss’.<sup>515</sup> That is, provided that there is no contrary expression in the policy, whether there has been a CTL is dependent on “whether the cost of repairs has exceeded the ship’s market value at the time of repairing”, rather than on “whether the cost of repairs has exceeded the value fixed by the policy”.<sup>516</sup> However, the application of section 27(4) is invariably excluded from most marine policies, thereby in practice the value fixed by the policy is conclusive for the purpose of determining whether there has been a CTL.<sup>517</sup> In ascertaining whether there has been a CTL, 80 percent of the insured value is to be taken as the repaired value under the International Hull Clauses 2003,<sup>518</sup> whereas the whole insured value is deemed to be the repaired value under earlier versions of the International Hull Clauses,<sup>519</sup> nothing in respect of the damaged or break-up value of the ship or wreck shall be taken into account.

However, how to compute repair costs to ascertain a CTL has often troubled the court. The test to assess the cost of repair is that of a prudent uninsured shipowner.<sup>520</sup> Specifically, the cost of repair is to be assessed by asking what a prudent uninsured shipowner, in the position of the assured, would have done in respect of carrying out the repair, and financial constraints of the assured shall not be taken into account. Under English law, it is established that the cost of repair includes costs incurred both before and after the notice of abandonment,<sup>521</sup> and actual or estimated repair and refloating costs at the place of the casualty

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<sup>514</sup> Marine Insurance Act 1906 s. 68 (1). See also *Shawe v Felton* (1801) 2 East 109; *Irving v Manning* (1847) 1 HL Cas 287.

<sup>515</sup> *Ibid* s. 27(4).

<sup>516</sup> *Arnould* (n 230) para 29-40.

<sup>517</sup> See Institute Time Clauses (Hulls) and Voyage Clauses (Hulls) (1/10/83) cl.19.1 and 17.1 respectively.

<sup>518</sup> International Hull Clauses (01/11/03) cl. 21.

<sup>519</sup> See Institute Time Clauses (Hulls) and Voyage Clauses (Hulls) (1/10/83) cl.19.1 and 17.1 respectively.

<sup>520</sup> *Venetico Marine SA v International General Insurance Company Ltd* [2013] EWHC 3644 (Comm); *Suez Fortune Investments Ltd v Talbot Underwriting Ltd* [2015] EWHC 42 (Comm).

<sup>521</sup> *Connect Shipping Inc v Sveriges Anfgartygs Assurans Forening (The Swedish Club)* [2016] EWHC 1580 (Comm).

are to be taken into account.<sup>522</sup> However, any payable amount by third parties is to be excluded, in respect of the loss,<sup>523</sup> the ship's left value (i.e. unrepaired wreck),<sup>524</sup> or the excess repair cost following the casualty because of the advanced age of the ship.<sup>525</sup>

In *Connect Shipping Inc v Sveriges Anfgartygs Assurans Forening*,<sup>526</sup> a ship was insured for US\$12 million under an H&M policy in which the Institute Time Clauses – Hulls (1/10/83) was incorporated; it was also insured for US\$3 million under an increased value policy. Under both policies, there were sets of clauses provided 'No claim for constructive total loss based upon the cost of recovery and/or repair of the Vessel shall be recoverable hereunder unless such cost would exceed the insured value...'<sup>527</sup> On 23 August 2012, the ship suffered significant damages following a fire breaking out in her engine room, and a dispute arose in relation to the measure of indemnity. The assureds contended that they were entitled to be indemnified on a CTL basis, whereas the insurers asserted that there was a partial loss only; the amount recoverable on different bases were significantly different. In the present case, whether there had been a CTL was dependent on whether the cost of repairs had exceeded the insured value of the ship.<sup>528</sup> The learned judge held that there had been a CTL. Knowles J included salvage costs incurred between the casualty and the service of the notice of abandonment (i.e. pre-notice of abandonment salvage costs) in the CTL calculation.<sup>529</sup> The case of *Hall v Hayman*<sup>530</sup> and *Helmville Ltd v Yorkshire Insurance Company Ltd*<sup>531</sup> were not followed, in each of which costs incurred prior to the notice of abandonment had not been granted.<sup>532</sup> In determining the post-notice of abandonment repair costs, a contingency of 10 percent was included for many matters that could not be determined with precision in

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<sup>522</sup> *Young v Turing* (1841) 2 Man & G 593.

<sup>523</sup> Marine Insurance Act 1906 s. 60(2)(ii).

<sup>524</sup> *Hall v Hayman* [1912] 2 KB 5.

<sup>525</sup> *Phillips v Nairne* (1847) 4 CB 343.

<sup>526</sup> [2016] EWHC 1580 (Comm).

<sup>527</sup> *Ibid* at para [30].

<sup>528</sup> Marine Insurance Act 1906 s. 60, as modified by Institute Time Clauses – Hulls (1/10/83) cl. 19.

<sup>529</sup> *Connect Shipping Inc v Sveriges Anfgartygs Assurans Forening (The Swedish Club)* [2016] EWHC 1580 (Comm) at paras [31] and [35].

<sup>530</sup> [1912] 2 KB 5.

<sup>531</sup> [1965] 1 Lloyd's Rep 361.

<sup>532</sup> *Connect Shipping Inc v Sveriges Anfgartygs Assurans Forening (The Swedish Club)* [2016] EWHC 1580 (Comm) at paras [31-32] and [38-46].

advance.<sup>533</sup> In addition, the learned judge held that insurers were liable to indemnify reasonable costs incurred for the purposes of averting or minimising a loss which would have been recoverable under the suing and labouring clause of the H&M policy (for example, costs incurred for employing tugs, agents, surveyors, consultants, and for preserving the machinery).<sup>534</sup>

The issue of suing and labouring expenses also arose in *Atlasnavios Navegacao Lda v Navigators Insurance Co Ltd (The B Atlantic)*,<sup>535</sup> but under different circumstances. This case provides guidance as to when the right to recover suing and labouring expenses comes to an end. The ship *B Atlantic* was insured against war risks by the defendant insurers, and the policy incorporated the terms of the Institute War and Strikes Clauses (1/10/83) (with additional perils). The policy provided cover for “malicious damage”, “malicious mischief” and “loss of the Vessel...caused by...any person acting maliciously”. Furthermore, the policy stated that if the assured had lost the free use and disposal of the ship for a continuous period of six months, the ship would be deemed to be a CTL. The policy also contained a suing and labouring clause. In 2007, the ship was detained in a port in Venezuela for contravening the Venezuelan Anti-Drug Law 2005, because a quantity of cocaine had been discovered strapped to her hull. On 18 June 2008, a notice of abandonment was served but this was rejected by the leading underwriter. However, the parties entered into a “writ agreement” on that day whereby the rejection of the abandonment notice was to be treated as if proceedings had commenced. The ship remained in detention until two officers were convicted and the court ordered the final confiscation of the ship in 2010. The shipowner claimed a CTL against the insurers under the war risks policy, and sought to recover both the ship’s insured value as well as the suing and laboring costs incurred. The insurers agreed that there had been a CTL but denied their liability by reference to the policy exclusions. Regarding the sue and labour claim, the insurers referred to the decision in *Kuwait Airways Corp v Kuwait Insurance*<sup>536</sup> and argued that any duty to sue and labour came to an end once the parties’

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<sup>533</sup> Ibid at para [92].

<sup>534</sup> Ibid at para [94].

<sup>535</sup> [2014] EWHC 4133 (Comm), reversed in part [2016] EWCA Civ 808, affirmed [2018] UKSC 26.

<sup>536</sup> [1996] 1 Lloyd’s Rep 664 at 696-697. This is an aviation case rather than a marine case, thus the issue of crystallisation did not arise.

rights had crystallised, therefore the entitlement to claim for expenditure had ceased by their so doing. This suggestion was clearly rejected by Flaux J in *The B Atlantic*,<sup>537</sup> and the learned judge held that in many cases a ship would still be “in the grip of the insured peril” at the time of the writ agreement, thus she would still be in the interest of both parties and suing and laboring expenses incurred continuously.<sup>538</sup> In the light of this, the right to recover suing and labouring expenses would not end at the time of tendering the abandonment notice or at the time of the abandonment notice being declined with a writ clause. This right would instead come to an end at the earliest date on which the legal proceeding was actually issued. Accordingly, suing and labouring expenses were recoverable in the present case.

As a consequence, where a ship has a total loss (either an ATL or a CTL), the hull insurer normally indemnifies the assured or the relevant parties (e.g. the assignee) the sum fixed by the policy,<sup>539</sup> subject to any excess or financial ceiling in the policy. That is, the ship’s actual value is not relevant, and the assured may make a profit or suffer a shortfall from the indemnity of a total loss.<sup>540</sup> In addition, if there is a sue and labour clause, the insurers are obliged to indemnify reasonable suing and labouring expenses incurred, even after the tendering of the abandonment notice or even after the abandonment notice being declined with a writ clause, but only before the date of the legal proceeding actually being issued. However, where a ship has a total loss, the sum recoverable under H&M policies may not be sufficient to provide the shipowner with a complete indemnity, especially if the ship’s market value has increased. The possibility that the shipowner will suffer a shortfall from the total loss indemnity also brings significant risks for ship financiers, thus the shipowner is generally required in accordance with the loan agreement to take out additional insurances to cover these risks. Increased value (IV) insurance<sup>541</sup> provides additional coverage in the event that a ship has a total loss, enabling the shipowner in certain circumstances to recover on the basis of a higher valuation of the ship than that contained in the H&M policy.

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<sup>537</sup> [2014] EWHC 4133 (Comm).

<sup>538</sup> *Ibid* at para [343].

<sup>539</sup> Marine Insurance Act 1906 s. 68(1); *Lidgett v Secretan (No. 2)* (1870-71) LR 6 CP 616.

<sup>540</sup> *Barker v Janson* (1867-68) LR 3 CP 303; *Steamship Balmoral Co v Marten* [1902] AC 511 (HL).

<sup>541</sup> See Chapter 4, section 4.3.1.4 (Increased Value Insurance).

### 5.7.2.2 *Partial loss*

Under a valued policy, where a ship has a partial loss, the measure of indemnity is computed by reference to the fixed value in the policy. The computation is based on three situations that are set out in section 69 of the MIA 1906: (a) the ship has been completely repaired; (b) the ship has been partially repaired; and (c) the ship has not been repaired.<sup>542</sup> Under all three circumstances, in respect of any one casualty, the maximum amount recoverable by the assured is the fixed value in the policy, and the measure of indemnity is as follows:

- (1) Where a ship has been completely repaired, the indemnity recoverable by the assured is the reasonable cost of repairs, subject to customary deductions.<sup>543</sup>
- (2) Where a ship has been partially repaired, the indemnity recoverable by the assured is the reasonable cost of repairs plus the reasonable depreciation arising out of the unrepaired damage – provided that the aggregate amount does not exceed the reasonable cost of full repairs as calculated in sub (1).<sup>544</sup>
- (3) Where the ship has not been repaired, and has not been sold in her damaged state during the risk, the indemnity recoverable by the assured is the reasonable depreciation arising out of the unrepaired damage, provided that the aggregate amount does not exceed the reasonable cost of full repairs has the repair been carried out, as calculated in sub (1).<sup>545</sup>

However, the MIA 1906 does not indicate a precise way to calculate the depreciation. On the merits of existing authority, the depreciation of a ship is defined as the difference between the ship's unrepaired market value (or damaged value) and the ship's sound market value (or true value) at the termination of the risk (not exceeding the fixed value by the policy).<sup>546</sup> The shipowner and its financiers may face the risk that the recoverable indemnity is not sufficient to cover the ship's repair cost in the event of partial loss, and the financier is naturally averse to this risk.

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<sup>542</sup> Marine Insurance Act 1906 s. 69.

<sup>543</sup> *Ibid* s. 69(1).

<sup>544</sup> *Ibid* s. 69(2).

<sup>545</sup> *Ibid* s. 69(3).

<sup>546</sup> *Arnould* (n 230) para 12-16.



### 5.7.3 Ship valuation

In current market practice, the valuation of ships is a matter of agreement between the assured and the insurer. As long as an insurance contract is valid, the valuation of ships is determinable to the indemnity recoverable by the assured, regardless of whether such an indemnity is more or less than the actual pecuniary loss. For this reason, the ship valuation for the interest of the shipowners and their banks tends to be agreed on the high side of, or at least equal to, the current market value of the ship. Despite the benefits derived from a valuation higher than the ship's current market value, the shipowners and their banks may face risks arising out of an excessive ship valuation.

First, an overvaluation may constitute fraud as understood in section 27(3) of the MIA 1906, and such a fraud will affect the validity of the marine insurance contract.<sup>547</sup> To elaborate, in the absence of regularities in the valuation, the entire policy may be void in the following situations:

- (1) as intended by the related parties, the subject-matter insured has been fraudulently overvalued;<sup>548</sup>
- (2) such an overvaluation has turned the policy into one of gaming or wagering;<sup>549</sup> and
- (3) such an overvaluation does not constitute fraud, but it has changed the risk's ordinary business nature into speculation, and the statement of valuation has been found to be violating the principle of good faith.<sup>550</sup>

That is, if an excessive ship valuation has constituted a fraud, the insurer is entitled to avoid the policy. If the policy has been decided to be one of gaming or wagering, again the insurer is entitled to avoid the policy. Even there is no clear proof of the existence of fraud, if an excessive ship valuation is a material fact which is obligated to be disclosed to the insurer, the insurer is entitled to void the policy for the reason of non-disclosure. Where an H&M policy is void on the part of the shipowner's default, an MII policy may be triggered to cover the financial

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<sup>547</sup> See e.g. *Thames & Mersey Marine Insurance Co Ltd v Gunford Ship Co Ltd* [1911] AC 529 (HL) at 548.

<sup>548</sup> *Ibid* at 542 (Lord Shaw).

<sup>549</sup> *Glafki Shipping Co SA v Pinos Shipping Co (No. 1) (The Maira) (No. 2)* [1984] 1 Lloyd's Rep 660 at 666-667 (Hobhouse J).

<sup>550</sup> See *Ionides v Pender* (1873-74) LR 9 QB 531; *Inversiones Manria SA v Sphere Drake Insurance Co, Malvern Insurance Co and Niagara Fire Insurance Co (The Dora)* [1989] 1 Lloyd's Rep 69.

loss of the bank, provided the bank is not in privity with the shipowner. Since it is unlikely, in reality that an excessive ship valuation will be made without the knowledge of the bank, the bank can rarely rely on MII policies against the overvaluation risk. Therefore, the bank shall cautiously monitor matters in respect of ship valuation through loan agreements and other related covenants.

However, given that there are no distinct rules to follow, it is not easy to compute as to what constitutes such an excess in valuation that it may necessitate disclosure, or may taint the transaction with fraud.<sup>551</sup> A valuation in excess of the ship's market value is not necessarily fraudulent or so excessive as to require disclosure,<sup>552</sup> since there may be legitimate business reasons for a discrepancy between the market value and the insured value of the ship.<sup>553</sup> It has been recently suggested that there is no fraud and/or no need for disclosure so long as the overvaluation can be justified with reasonable explanations for the disparity, consistent with prudent ship management or other reasonable commercial reasons.<sup>554</sup> If the overvaluation is extreme and/or in multiples of the ship's market value, it may be regarded as a material fact which requires disclosure to the insurer.<sup>555</sup> In practice, the fixed value by the H&M policy is often agreed at a higher value than the ship's market value by reference to the amount of the outstanding loan. So long as the insured value is not extreme, a margin in excess of the amount of the outstanding loan is generally allowed.

Second, an excessive ship valuation makes it more difficult for there to be a CTL, because there is a CTL only if the cost of repairs has exceeded the ship's insured value, in most valued marine policies. If the cost of repairing a ship is uneconomic but is insufficient to trigger a CTL, the shipowners and their financiers may be trapped, as in the case of *The Kyla*.<sup>556</sup> The ship *Kyla*, which was fast approaching the end of her trading life, was under a time charter when she was badly damaged in a collision. Had the ship *Kyla* being repaired to the extent that she could have brought back into service, the repair cost would have

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<sup>551</sup> *Arnould* (n 230) para 12-21.

<sup>552</sup> *Thames & Mersey Marine Insurance Co Ltd v Gunford Ship Co Ltd* [1911] AC 529 (HL).

<sup>553</sup> *Ibid* at 542, 548. See also *Lidgett v Secretan (No. 2)* (1870-71) LR 6 CP 616 at 627 (Willes J).

<sup>554</sup> See *Strive Shipping Corp v Hellenic Mutual War Risks Association (The Grecia Express)* [2002] 2 Lloyd's Rep 88 at 158-159 (Colman J).

<sup>555</sup> See *Eagle Star Insurance Co v Games Video Co (The Game Boy)* [2004] 1 Lloyd's Rep 238 at 255 (Simon J).

<sup>556</sup> *Bunge SA v Kyla Shipping Co Ltd (The Kyla)* [2012] EWHC 3522 (Comm), affirmed [2013] EWCA Civ 734.

exceeded her repaired value (i.e. true value) but would have been less than her insured value, thus her damage was not sufficient to trigger a CTL. It was obviously uneconomic to carry out the repair work, thus the shipowners had sought to terminate the charter on the grounds that a frustration of the contract had resulted from the collision. The arbitrator agreed with the shipowners, but the charterers appealed this arbitral award to the Commercial Court on the frustration issue. The principal issue to be decided by the Court was whether a time charter was frustrated following the ship being involved in a collision which resulted in a repair cost that would exceed her market value. This particular charter contained an express continuing warranty, in which the shipowners had warranted to maintain the ship's H&M policy up to a specified amount throughout the period of the charter. Flaux J held that the presence of this warranty meant that the owners could not argue that repairing the ship and continuing with the charter were, at the time of the collision, commercially impossible, nor that the ship was a commercial loss. Contrary to the arbitrator's decision, the Court held that the charter was not frustrated and that the shipowners were obliged to repair *Kyla* as quickly as they reasonably could. Subsequently, the Court of Appeal refused an application to appeal the Commercial Court judgment.<sup>557</sup> However, *The Kyla* had a special feature – namely that the charter contained an express continuing warranty. In the absence of this warranty, how a court would respond to the abovementioned matters remains unknown.

In practice, the hull insurers normally do not have to pay until the repair work has actually been carried out and paid for. If the repair cost exceeds the ship's market value (especially when a ship is to be scrapped) but the shipowner is obliged to carry out the repair work, it may have to turn to its financier because it lacks the funding, and the financier will be put into a dilemma. If the financier chooses to fund an uneconomic repair, then there is a risk of non-payment by the hull insurer which will potentially dilute the security, and the financier may even be forced to accept a "negative equity" in the event that the financed ship is the only asset of the shipowner. If the financier refuses to fund an uneconomic repair, then the value of the security will be diminished to scrap, and the financed ship or her sister ship may be arrested by third parties such as the charterers. Considering the potential risks associated with an excessive ship valuation, the

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<sup>557</sup> *Bunge SA v Kyla Shipping Co Ltd (The Kyla)* [2013] EWCA Civ 734.

financier will probably require that the financed ship is given a valuation which is equal to her fair market value, and that she receives additional protections such as increased value insurance.

## 5.8 The role of insurance brokers

In marine insurance practice, it is common for brokers to take out marine policies on behalf of the assureds. A marine insurance broker is personally liable to the insurer for the premium; meanwhile, an assured is liable to the broker for the premium and the commission.<sup>558</sup> Accordingly, unless otherwise agreed, the broker has a lien on the policy for the service it has provided.<sup>559</sup> Acting as an agent for the assured,<sup>560</sup> the broker provides services such as advice and placement, post-contractual assistance and claims handling.<sup>561</sup> According to the general principle of agency law, the assured is bound by any error made by the broker while it is acting on behalf of the assured, provided that the broker does not act outside its actual or ostensible authority.<sup>562</sup> Therefore, if the broker fails to disclose any material fact of which it was aware to the insurer, it will be treated as a failure to disclose on the part of the assured, regardless of whether or not the assured was personally aware of the fact. In these situations, the insurer will normally have an option to avoid the policy and return the premium, and the insurer may normally retain the premium if any fraudulent action of the assured has been found.

In a commercial context, the relation between the assured, broker and insurer is a complex issue. As regards the influence of this particular relation on matters related to ship finance, two problems may arise. The first problem may arise from the broker's lien; and the second may arise if the shipowner arranges the ship financier's insurance through the same broker of the primary insurance. These problems, that ship financiers must keep an eye on, are considered in turn in this section.

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<sup>558</sup> Marine Insurance Act 1906 s. 53.

<sup>559</sup> Marine Insurance Act 1906 s. 53(2).

<sup>560</sup> See, e.g. *John W Pryke & Others v Gibbs Hartley Cooper Ltd* [1991] 1 Lloyd's Rep 602 at 614; *Searle v AR Hales & Co Ltd* [1995] CLC 738.

<sup>561</sup> *Arnould* (n 230) para 16-031.

<sup>562</sup> See *Rozanes v Bowen* (1928) 32 Ll L Rep 98; *Zurich General Accident and Liability Insurance Co v Rowberry* [1954] 2 Lloyd's Rep 55.

### 5.8.1 The issues of the fleet lien

Turning to the first issue, the broker's lien is not restricted to a specific lien in relation to the effecting policy on the particular transaction only, it can also be a general lien in relation to any balance on any insurance account which may be due from the assured.<sup>563</sup> In the event that a broker takes out insurance for several ships for the same owner, these are usually insured under a fleet policy, and the broker is entitled to hold the policy for any unpaid premiums of any ship in that fleet, even if such unpaid premiums are not attributed to the financed ship(s). This will not normally cause a problem for ship financiers who take out separate insurance for the financed ship,<sup>564</sup> or who have participated in the shipowner's insurance as the composite co-assureds.<sup>565</sup> However, if the ship financier is merely an assignee of the shipowner's insurance, its rights as the assignee may be prejudiced by the broker's lien.

Accordingly, it is strongly advisable for ship financiers to obtain enforceable contract considerations from brokers for the purpose of limiting the broker's lien to the outstanding premiums and charges attributed to the financed ship only, in which case the broker will not be able to set off premiums for the whole fleet against a claim in relation to the financed ship. An LOU issued by the broker may serve the purpose of waiving the broker's fleet lien, and this matter has been addressed in section 5.5.5.4.<sup>566</sup> It should be noted that brokers can only waive their liens on marine policies that are subject to English law. In other situations, ship financiers may have to seek the waiver in a similar form of undertaking from primary insurers. In the light of this, a better solution for financiers is to have brokers undertake to sign separate marine policies for each ship in the fleet instead of signing a fleet policy.

### 5.8.2 Arranging contingency insurance with a separate broker

A more complex issue may arise if the ship financier allows the shipowner to arrange contingency insurance on its behalf through the same broker who takes

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<sup>563</sup> Marine Insurance Act 1906 s. 53(2).

<sup>564</sup> Ship financiers in practice are unlikely to take out separate insurance for the financed ship, rather, they normally participate in the primary insurance as a co-assured, a loss payee, or an assignee: see Chapter 5, section 5.5 (Utilising the primary insurance).

<sup>565</sup> *Eide UK Ltd v Lowndes Lambert Group Ltd (The Sun Tender)* [1998] 1 Lloyd's Rep 389.

<sup>566</sup> See Chapter 5, section 5.5.5.4 (The effect of a notice of assignment). See also Chapter 5, section 5.5.6 (Letter of undertaking), where discussed general matters concerning undertakings.

out the primary insurance. It is strongly advisable that ship financiers take out a range of contingency insurance by themselves, and do so through brokers appointed by themselves. This is advisable for both legal and practical reasons, given that different types of ship financier require contingency insurance for similar reasons<sup>567</sup> – in the following discussions, the example of the ship mortgagee will be used for the purposes of demonstration. Two types of contingency insurance that are frequently used as a fallback plan to ship mortgagees are considered in the following paragraphs with regard to the reasons why mortgagees will not generally permit shipowners to arrange these covers on behalf of themselves, namely mortgagees' interest insurance (MII) and mortgagees' additional perils pollution insurance (MAPP). No matter who arranges MII or MAPP, the mortgagee is the assured of these types of insurance, but the shipowner is generally obliged to reimburse the premium in accordance with the loan agreement. In the light of this, if it is the shipowner's intention to arrange MII or MAPP on behalf of the mortgagee, this is most likely to be intended with a view to bargaining for the premium.

#### *5.8.2.1 Risks may arise if MII is arranged by the shipowner*

By way of background, where the shipowner's insurers decline to pay the loss, damage or liability resulted from insured perils which are *prima facie* covered by the shipowner's hull, disbursements, war risks or P&I insurance, subject to specific conditions of the MII policy, the MII insurer may indemnify the assured mortgagee for its financial loss. Scuttling (contriving a total loss by arson or the exploitation of a genuine accident) by the shipowner is a principal trigger of MII claims, and another trigger is the breaching of warranties by the shipowner. This crime or default is more likely to happen when shipowners come into financial difficulties, which is frequently the case in the current sluggish shipping market.<sup>568</sup> If the mortgagee has allowed the shipowner to take out MII on its behalf, risks may arise as follows:<sup>569</sup>

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<sup>567</sup> See Chapter 4, section 4.3.3 (The insurance of ship financiers), where considered different types of contingency insurance for ship financiers.

<sup>568</sup> Mellett (n 299) 105.

<sup>569</sup> *Ibid*; Marsh 'Owner Arranged Mortgagees Interest Insurance (MII)/Mortgagees Additional Perils Pollution (MAPP) Insurances' < <https://www.marsh.com/content/dam/marsh/Documents/PDF/UK-en/owner-arranged-interest-mortgagees-additional-perils-pollution-insurances.pdf> > accessed 30 October 2017.

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

- (1) Any act or omission, misrepresentation, non-disclosure or alleged non-disclosure by the shipowner's broker available as a defence under the primary insurance may be used as a defence against claims under any MII policy arranged by this broker, even if the assured mortgagee was not personally aware of those facts. If MII is taken out by the shipowner, there is no guarantee that full disclosure of all material information will be given to the MII insurer. In the event of misrepresentations or non-disclosures by the shipowner's broker, its dual roles of representing the shipowner and the mortgagee under the primary insurance and MII respectively will compound the complexities of the claim negotiations. It may result, at least, in the delay of settlement under the MII policy or, even worse, a reduced MII settlement or a refusal of settlement on claims under either the primary insurance or MII.
- (2) There is an obvious conflict of interests on the part of the insurance broker who represents the shipowner and the mortgagee at the same time, and three scenarios are considered here.

Turning to the first scenario, a broker instructed by the shipowner to save the insurance cost is very likely to compromise on more restrictive MII terms, at the expense of other coverage considerations. Given that there are no universally accepted wordings in the case of MII, choosing cheaper terms may result in the policy falling short of the scope and coverage that it could have provided if it were written in more comprehensive terms.

In the second scenario, the broker may arrange MII policies as a part of a package policy including both the primary insurance and MII, in order to obtain the cheapest terms. Such arrangements will definitely cause a conflict between the shipowner and the mortgagee. Let us take the example of where the claims leader of a package policy is planning to decline a claim under the primary insurance for the full claim amount, but is willing to settle the resultant MII claim at a lower amount. If the mortgagee has a separate MII policy, it could accept the payment to recover its net loss, ignoring any potential dispute between the shipowner and the insurer. However, if the mortgagee is bound by a package policy, it may be under pressure to refuse the MII settlement, as the shipowner and the broker would like to pursue the insurer through the legal system endeavouring to collect the full amount of the claim under the primary insurance.

The third scenario is that of a disputed claim where there is a conflict of preferred outcomes between the shipowner and the mortgagee. The shipowner's broker will inevitably be under pressure to put the interest of the shipowner above that of the mortgagee. This situation could have been avoided if the mortgagee had appointed its own broker to take out MII.

#### *5.8.2.2 Risks may arise if MAPP is arranged by the shipowner*

MAPP responds to the extent of the mortgagee's financial loss following a major oil spill for which the mortgaged ship is held liable, where the amount paid by the primary insurers is inadequate to cover the claims. In practice, mortgagees will usually advance the amount recovered under MAPP to the shipowner to cover its liability following the incident and to avoid the liable ship being seized. If the benefits of MAPP will ultimately be passed to shipowners, why would mortgagees insist arranging MAPP through their own brokers? They would mainly do so for a practical reason. If mortgagees take out MII and MAPP together through their own appointed brokers, this may ensure that the claims leader of both MII and MAPP is the same person. In the event that an incident triggers an MAPP claim, without the possibility of passing the claim to another contingency insurer (i.e. the MII insurer), the claims leader is more likely to examine the circumstances objectively than to seek ways to avoid the claim.

### **5.9 Direct access to reinsurance<sup>570</sup>**

Reinsurance has been said to be the insurance of insurers, which is treated by English law as a further policy on the original subject-matter of the direct insurance.<sup>571</sup> A reinsurance contract is an insurance contract between the primary insurer (or the reassured) and the reinsurer, not an assignment to the reinsurer of the reassured's liabilities towards the direct assured.<sup>572</sup> In the light of this, the direct assured cannot assert any interest in the reinsurance contract, so does the ship financier.

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<sup>570</sup> See, generally, Mellett (n 299) 18-19; *Ship Mortgages* (n 299) para 16.13; R Merkin (ed), *Butler and Merkin's Reinsurance Law Volume 2 (losseleaf)* (Sweet & Maxwell 2017) Chapter D1 (Assignment) and Chapter D2 (The Insolvency of Insurance Companies) (hereafter in this chapter, 'Reinsurance Law').

<sup>571</sup> *Arnould* (n 230) para 33-06.

<sup>572</sup> *Re Lancashire Plate Glass, Fire and Burglary Insurance Co Ltd* [1912] 1 Ch 35.



### **5.9.1 Why ship financiers want to have direct access to reinsurance?**

The mortgagee or the lessor (subsequently referred to as the lender) will want to have direct access to reinsurance in order to eliminate the solvency risk of the primary insurers – in other words, to avoid the primary insurers' ability to satisfy claims being affected by their adverse financial conditions. In practice, this issue is unlikely to arise if marine policies are placed in Lloyd's, because all of Lloyd's policies are guaranteed by Lloyd's central fund. If marine policies are taken out through a state-owned insurance company or the shipowner's own captive insurer, there is a risk to the solvency of the insurers.<sup>573</sup> Since state insurers or captive insurers are often not strong enough in finance to reinsure at Lloyd's or other major insurance markets, the lender's direct access to reinsurance may ensure that reinsurers will satisfy the payment of claims if the primary insurers become insolvent.

### **5.9.2 How to have direct reinsurance access?**

In the event of the insolvency of the primary insurers, there are mainly two ways for the lender to obtain direct course of actions against the reinsurers. First, the lender may take a full assignment of reinsurance from the reassured. Second, the lender may require a cut-through clause being incorporated into the reinsurance agreement, whereby permitting the lender direct course of actions against reinsurers in the event of the insolvency of the primary insurers. These two methods are considered in turn in the following paragraphs.

#### *5.9.2.1 The assignment of reinsurance*

As regards assigning the reinsurance contract, the rules of English law are identical to those that apply to the assignment of insurance. A ceding insurance company may assign its benefits of reinsurance contracts to the lender either under section 136 of the 1925 Act or in equity. However, such an arrangement is unlikely to protect the lender from the consequences of the ceding insurer's liquidation, because any assignment by the ceding insurer while insolvent would be liable to be set aside as a fraudulent preference under section 239 of the

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<sup>573</sup> Mellett (n 299) 19.

Insolvency Act 1986.<sup>574</sup> The terms of the reinsurance contract may affect the effectiveness of assignment, and the ceding insurer may not grant assignment unless the reinsurance contract is taken out on a facultative basis. For these reasons, the ceding insurer's rights under the reinsurance contract are generally incapable of assignment.<sup>575</sup>

When taking an assignment of reinsurance, the lender shall pay attention to local law relating to the ceding insurer and, especially, to the security registration requirements which are necessary to preserve the priority, with a view to making sure that such an assignment can survive the ceding insurer's insolvency proceedings.<sup>576</sup> In these cases, it is strongly advisable for the lender to obtain legal opinions from lawyers in the jurisdiction of the ceding insurer.

Where the lender has taken an assignment of marine insurance from the ceding insurer (or the reassured), as an alternative to an assignment of reinsurance, the lender may bring direct claims against the reinsurer by sub-assigning its rights against the reassured to the reinsurer, in return for direct payments by the reinsurer.<sup>577</sup> In this way, the lender as an unsecured creditor of the ceding insurance company may obtain a preference to those amounts set aside under the Insolvency Act 1986.<sup>578</sup>

#### 5.9.2.2 *The cut-through clause*

Broadly speaking, any term in a reinsurance agreement under which the reinsurer assumes liability towards third parties in the event of the reassured's insolvency or the case of other listed events can be regarded as a cut-through clause.<sup>579</sup>

The nature of a cut-through clause may be well illustrated as follows:

In respect of the risks reassured hereunder the reinsurer and the ceding company hereby agree that in the event that the ceding company shall go into the hands of a receiver, assignee, trustee or successor for the purpose of liquidation, or on account of insolvency and if written notice be given to the reinsurer of such an event then the reinsurer in lieu of payment to the company shall pay to the assured the reinsurer's share of any loss or losses incurred by the ceding company which are within the limit, terms and conditions of this policy. Provided that the liability of

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<sup>574</sup> *Reinsurance Law* (n 570) para D-0148 (Assignment).

<sup>575</sup> M Smith and N Leslie, *The Law of Assignment: The Creation and Transfer of Choses in Action* (2nd edn, OUP 2013) paras 17.87-17.92.

<sup>576</sup> *Ship Mortgages* (n 299) para 16.13.4.

<sup>577</sup> *Reinsurance Law* (n 570) para D-0148 (Assignment).

<sup>578</sup> *McMahon v AGF Holdings (UK) Ltd* [1997] LRLR 159.

<sup>579</sup> *Reinsurance Law* (n 570) para D-0151 (The nature of cut-through clauses).

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

the reinsurer to the assured shall be reduced by the amount of payments made by the reinsurer on account of the same loss or losses to the company and provided further that the reinsurer shall be entitled to deduct from the amount of loss or losses any premiums or other money due to the reinsurer under this policy. It is fully understood and agreed by the ceding company that it is a condition precedent to this policy that any payments made directly to the assured shall absolve the reinsurer from making any payments to the company or its receiver, assignee, trustee or successor and shall constitute a full discharge and release of the reinsurer from any and all further liability in connection therewith.<sup>580</sup>

A reinsurance agreement is a contract between the reassured and reinsurer. According to the doctrine of privity of contract, the reassured and reinsurer enjoy the privity of contract, prohibiting any person who is not a party to the reinsurance contract from enforcing rights under the reinsurance agreement. That is, the doctrine of privity of contract had previously prevented the enforcement of cut-through clauses under common law. The 1999 Act, however, changed this, permitting cut-through clauses contained in contracts which are governed by English law to be enforceable by third parties (or the lender in the present case). However, the 1999 Act can be – and frequently will be – expressly excluded from reinsurance agreements. If a reinsurance agreement does not exclude the 1999 Act, the effects of cut-through clauses are identical to loss-payable clauses contained in marine policies, entitling the lender to be paid directly by the reinsurer. A cut-through clause is generally triggered by named specific events provided in the clause (for example, the reassured defaulting on a payment, insolvency of the reassured, or upon the reassured's entry into a liquidation order). In addition, a cut-through clause may be evidence of an equitable assignment from the reassured to the lender,<sup>581</sup> although the clause alone is unlikely to constitute an equitable assignment.

To sum up, considering the drawbacks of the abovementioned methods, neither taking an assignment of reinsurance nor incorporating cut-through clauses alone can effectively secure the lender's interest in the reinsurance contract. The best way to protect lenders from the primary insurer's solvency risk is to combine these two methods, by having a cut-through clause backed up by an assignment of reinsurance provided by the primary insurer, either in favour of the direct assured (or the shipowner in the present case) or in favour of the

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<sup>580</sup> Ibid.

<sup>581</sup> *Iraqi Ministry of Defence v Arcepey Shipping Co SA (The Angel Bell)* [1979] 2 Lloyd's Rep 491.

lender.<sup>582</sup> In practice, it is more common to assign reinsurance directly to lenders. If reinsurance has been assigned to shipowners, they will tend to sub-assign it to lenders.

### **5.10 Pollution liability and insurance solutions**

Shipping pollution is intensively regulated not only by international law but also by national law, reflecting the public's concerns about the harmful effects of this particular pollution source. Historically, the body of legislation mainly focused on shipping pollution caused by the escape of oil which had been carried as cargo. In more recent years, a range of international conventions and local laws have been implemented to target a variety forms of shipping pollution, including pollution from bunkers and from hazardous and noxious substances (such as chemicals, gases and other volatile products), garbage and other wastes, ballast waters, ships which are committed for recycling, and most recently the atmospheric pollution from ships. If a ship has caused incidents which fall under the legislative regime that governs shipping pollution, the shipowner and other related parties to the liable ship (such as ship financiers) may incur not only substantial civil liabilities but also severe criminal sanctions and penalties.

Modern merchant ships are large and expensive, thus shipowners frequently raise external funding for the acquisition of ships. Among a variety of available financiers who provide funds for the acquisition of ships (both second-hand ships and newbuildings), shipowners mainly borrow from banks and other financial institutions under the financing structure of either the mortgage-backed loan or the finance lease. In the following discussions, we will consider the position of mortgagees or lessors (referred to as lenders) in the event of financed ships being held liable for causing pollution. Only the position of mortgagees and lessors are considered mainly for two reasons. Firstly, mortgage-backed loans and lease finance structures dominate the current ship finance market. Secondly, and more importantly, mortgagees and lessors are more likely than other kinds of ship financier to be held liable for pollution from ships.

At the time of agreeing lending, the lender is aware of – and accepts – the risk that a large oil spill or other severe pollution accidents may not only adversely

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<sup>582</sup> *Ship Mortgages* (n 299) para 16.13.3.

impact the borrower's financial strength but also diminish the value of collaterals. However, risks faced by the lender may be greater than this. In some cases (especially pollution cases in the US), the lender as a fund provider may incur direct liability for shipping pollution. The lender provides financial services rather than shipping services, thus it is naturally averse to exposure to pollution liability, especially pollution liability arising out of the operation of ships which are, in practice, beyond the lender's control. The issue of the lender's direct liability for pollution from ships, such as oil spills or hazardous substance releases, has attracted considerable attention in the financial community. This section will address lenders' concerns from two aspects: first, the risk to lenders in relation to their exposure to liability for pollution from ships; and, second, insurance solutions to pollution liability.

It must first be emphasised that liability in this section refers to civil liability. Criminal liability for pollution from ships, which is beyond the scope of this section, is mainly imposed by the International Convention for the Safety of Life at Sea (SOLAS)<sup>583</sup> and the International Convention for the Prevention of Pollution from Ships (MARPOL),<sup>584</sup> in countries which have adopted such conventions. The rules on shipping pollution are extremely complex, relating not only to international law but also to local law (especially the law of the flag state and port state). Generally speaking, the liability framework established by international conventions is binding only in those countries which have adopted such conventions. In countries which have not adopted such conventions, pollution liability may have to refer to local law. In the light of the complexity of the shipping pollution issue, discussions in this section are necessarily selective.

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<sup>583</sup> International Convention for the Safety of Life at Sea 1974, is the most important of all international treaties concerning the safety of merchant ships, which requires signatory flag states to ensure that ships flagged by them comply with minimum safety standards in construction, equipment and operation.

<sup>584</sup> International Convention for the Prevention of Pollution from Ships 1973, as modified by the Protocol of 1978, is one of the most important international marine environmental conventions. It was developed by the International Maritime Organisation and its objective is to preserve the marine environment in an attempt to completely eliminate pollution by oil and other harmful substances and to minimise accidental spillage of such substances.

**5.10.1 Lender liability for pollution from ships<sup>585</sup>**

The lender may in certain circumstances incur liability for pollution from ships, and these circumstances can generally be divided into two groups:

- (1) the lender has acquired the ship's ownership by way of security, without participating in the management or the operation of the ship;
- (2) the lender does not have any ownership right over the ship, but has participated in the ship's management to the extent that it is regarded as the ship's operator.

The first group of circumstances typically arise when using the finance lease structure, under which the ship's legal title is transferred to the lender, and the lender subsequently signs a bareboat charter with the borrower for the term of the loan. According to the bareboat charter, it is normally the borrower who possesses the ship and who is responsible for her daily management and/or operation. Under the finance lease structure, the lender will normally not be involved in the ship's management and/or operation; its primary security is its ownership of the ship. However, the finance lessor may incur liability for shipping pollution under international conventions and US legislation, merely as a registered owner of the ship. In the UK, this risk may be mitigated by creating a single shipowning subsidiary and vesting the lender's ownership of the ship in the subsidiary. Given that UK law will not normally pierce the corporate veil, the lender's exposure to the owner's liability for pollution from ships can be effectively limited by this process of vesting in a subsidiary, and the parent company held by the lender is safe under normal circumstances.

The second group of circumstances generally appear in the event that the lender has taken over the ship's management from the borrower. For example, the ship mortgagee forecloses the mortgage for the purpose of realising the security, and subsequently acts as an operator during the period of pending sale. However, if the lender can influence the ship's management and/or operation to the extent of affecting the pollution prevention standards, in the US, it may incur liability for pollution from ships even during the normal currency of the loan.

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<sup>585</sup> See, generally, CDL Rue and CB Anderson, *Shipping and the Environment* (2nd edn, Informa 2009) Part IV (Lender liability) (hereafter in this chapter, '*Shipping Environment*'); S Baughen, 'Lease finance and demise charters – lessors' risks and liabilities' in B Soyer and AM Tettenborn (eds), *Ship Building, Sale, and Finance* (Informa 2016).

*5.10.1.1 Lender liability under international conventions*

The liability regimes established by international conventions impose strict liability on owners of ships. Among those conventions which are currently in force, the UK has ratified three conventions. They are the 1992 International Convention on Civil Liability for Oil Pollution Damage (1992 CLC),<sup>586</sup> the 2001 International Convention on Civil Liability for Bunker Oil Pollution Damage (2001 Bunker Convention)<sup>587</sup> and the 2007 Nairobi International Convention on the Removal of Wrecks (2007 Nairobi International Convention).<sup>588</sup>

The 1992 CLC imposes strict liability on all shipowners, irrespective of their nationality or flag, and the shipowner is defined as ‘the person or persons registered as the owner of the ship or, in the absence of registration, the person or persons owning the ship...’.<sup>589</sup> Therefore, the finance lessor who is a registered owner of the ship falls into the scope of the 1992 CLC, and may incur pollution liability imposed by the convention, no matter whether or not it is involved in the operation of the ship. In the light of this, the finance lessor must be cautious with the demise charter’s insurance arrangements, in particular insurances taken out to cover pollution liabilities. In order to be better protected, the finance lessor can participate in the demise charter’s insurance as an assignee, a loss payee or a composite co-assured.<sup>590</sup> Likewise, the finance lessor also falls within the scope of the 2001 Bunker Convention as a registered owner. In the 2001 Bunker Convention, the term “shipowner” is defined more widely than in the 1992 CLC, in which ‘shipowner means the owner, including the registered owner, bareboat charterer, manager and operator of the ship’.<sup>591</sup> Under the 2007 Nairobi International Convention, the finance lessor once again may incur pollution liability merely for its role as a registered owner.<sup>592</sup>

Due to the severe potential consequences of pollution incidents, all three conventions have contained compulsory insurance requirements. Under article 7 of the 1992 CLC, if a ship carries more than 2,000 tons of oil in bulk as cargo, owners of the ship registered in a Contracting State are required to maintain

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<sup>586</sup> 1992 International Convention on Civil Liability for Oil Pollution Damage art. 1.3.

<sup>587</sup> 2001 International Convention on Civil Liability for Bunker Oil Pollution Damage art. 1.3.

<sup>588</sup> 2007 Nairobi International Convention on the Removal of Wrecks art. 1.8.

<sup>589</sup> 1992 International Convention on Civil Liability for Oil Pollution Damage art. 1.3.

<sup>590</sup> See Chapter 5, section 5.5 (utilising the primary insurance).

<sup>591</sup> 2001 International Convention on Civil Liability for Bunker Oil Pollution Damage art. 1.3.

<sup>592</sup> 2007 Nairobi International Convention on the Removal of Wrecks art. 1.8.

insurance or other financial security, as well as to supply a certificate confirming that liability insurance has covered their CLC liabilities.<sup>593</sup> It is the responsibility of the Contracting State to ensure that insurance or alternative security is in force in respect of any such ship wherever registered, entering or leaving a port in its territory, or where arriving at – or leaving – an offshore terminal in its territorial sea, if the ship carries more than 2,000 tons of oil in bulk as cargo.<sup>594</sup> Similar compulsory insurance requirements are seen under both the 2001 Bunker Convention<sup>595</sup> and the 2007 Nairobi International Convention.<sup>596</sup> However, the compulsory insurance requirements in the 2001 Bunker Convention only apply to the registered owner, and not to other persons falling within the definition of owner. That is, the bareboat charterer, manager and operator of a ship are not obliged to comply with the compulsory insurance requirements in the 2001 Bunker Convention.

The lender may incur liability for pollution from ships as an operator after taking over of the ship from the borrower, which typically occurs during the period of pending sale following a foreclosure of the ship mortgage. However, the 1992 CLC does not impose strict liability on the ship's operator. Accordingly, where cases are governed by the 1992 CLC, the lender without ownership of a ship will normally not incur any pollution liability, even where the ship is controlled by the lender. In contrast, shipowner is defined broadly enough in the 2001 Bunker Convention to include managers and operators of the ship. Therefore, in cases where the 2001 Bunker Convention applies, the lender who is actually in control of a ship may incur pollution liability arising out of operations, no matter whether or not it owns the ship.

#### *5.10.1.2 Lender liability under US law*

The lender who does not participate in the management and/or operation of a ship, but holds the ship's ownership purely for the purpose of security, may be exempted from pollution liability in some cases under US federal legislation. Where such exemptions do not apply, the lender is at risk of being held liable for pollution caused by the financed ship.

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<sup>593</sup> 1992 International Convention on Civil Liability for Oil Pollution Damage art. 7.

<sup>594</sup> *Ibid* art. 7.11.

<sup>595</sup> 2001 International Convention on Civil Liability for Bunker Oil Pollution Damage art. 7.

<sup>596</sup> 2007 Nairobi International Convention on the Removal of Wrecks art. 12.



(a) Statutory exemptions

The Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) imposes pollution liabilities on both the owner and operator of the ship,<sup>597</sup> but grants an exemption from such liabilities for the lender who is solely a secured creditor.<sup>598</sup> A similar environmental liability regime is also introduced by the Oil Pollution Act 1990 (OPA-90) under which, in the case of a ship, a responsible party means any person owning, operating, or demise chartering the ship.<sup>599</sup> Therefore the lender generally falls into the scope of OPA-90. When OPA-90 was originally enacted, it did not provide a similar exemption for secured creditors to the one which exists under CERCLA, thus the finance lessor who was solely a secured creditor faced significant risks arising out of owning a ship. However, the Coast Guard and Maritime Transportation Act of 2004 amended the definition of “owner or operator” in the OPA-90,<sup>600</sup> allowing the same exemption for secured creditors as those under CERCLA. As a result of this, if the lender holds the ownership of a ship primarily for the purpose of protecting its security interest, without participating in the ship’s management, it will not be easily exposed to shipping pollution liability under US law due to these statutory exemptions.

(b) Amendments of CERCLA

Although CERCLA clearly states a statutory exemption for secured creditors, such an exemption may be lost in certain circumstances. If a secured lender has been considered to participate in the ship’s management to an extent that could have influenced the borrower’s pollution prevention standards, it may be liable under CERCLA.

In *United States v Fleet Factors Corp (The Fleet Factors)*,<sup>601</sup> the Eleventh Circuit Court of Appeals’ decision suggested that a secured creditor ‘will be liable if its involvement with the management of the facility is sufficiently broad to support the inference that it could affect hazardous waste disposal decisions if it

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<sup>597</sup> 42 USC § 9607.

<sup>598</sup> 42 USC § 9601(20)(A).

<sup>599</sup> 33 USC § 2701(32).

<sup>600</sup> Pub L 108-293, 118 Stat 1028.

<sup>601</sup> 901 F2d 1550 (11th Cir 1990) (superseded by statute).

so chose'.<sup>602</sup> That is, the secured lender would not be excluded from CERCLA liability because of its participation in the management of the facility, but *The Fleet Factors* did not specify the level of actual participation that would be sufficient to support this inference. As a result, this case caused great concern in the financial community, since a secured creditor could still be liable for pollution from ships and there were considerable uncertainties regarding the scope of lender liability. Later, *The Fleet Factors* contention that the mere capacity or unexercised right to control facility operation would be sufficient to void the secured creditors' statutory exemption was rejected by the court in *In re Bergsoe Metal Corp.*<sup>603</sup> The US Court of Appeals for the Ninth Circuit held that a creditor must have exercised actual management authority before it could be held liable for CERCLA liability,<sup>604</sup> but it did not draw the line between "inspect the security" and "participate in the management of the facility".

The decision of *The Fleet Factors* had created uncertainty, as the secured lender could be held for CERCLA liability for its participation in the management of a polluting ship or facility, but there was no clear guideline for the lender in respect of which actions would constitute participating in the management. Subsequently, the United States Environmental Protection Agency (EPA) signed an administrative rule,<sup>605</sup> in which the confusion created by *The Fleet Factors* decision as regards the circumstances under which secured lenders might be determined to have participated in the management of a polluting ship or facility were clarified, and the rule took effect on 23 April 1992. However, the EPA rule was challenged in court and was invalidated for the reason that the EPA, as an administrative agency, did not have statutory authorisation to determine the scope of liability issues under CERCLA.<sup>606</sup>

The US Congress subsequently amended CERCLA under continued pressure from the banking and financial industries, and the amendment is known as the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996 (Asset Conservation Act).<sup>607</sup> The Asset Conservation Act largely reinstates

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<sup>602</sup> Ibid at para [25].

<sup>603</sup> 910 F2d 668 (9th Cir 1990).

<sup>604</sup> Ibid at para [25].

<sup>605</sup> 40 CFR §300.1100 (2008).

<sup>606</sup> *Kelley v Environmental Protection Agency* 15 F3d 1100 (DC Cir 1994), cert. denied, 513 US 1110 (1995).

<sup>607</sup> Pub L 104-208, 2501-5, 110 Stat 3309.

the EPA rule. As a result of the amendment, lenders will not lose the protection of the secured creditor exemption unless they have actually participated in the management or operation of a ship, and lenders who would have the capacity to influence – or the exercised right to control – the ship operations are still entitled to the secured creditor exemption.<sup>608</sup> In terms of how “participation in management” is understood, lenders are generally exempted from CERCLA liability if they have not been involved in the operational aspects of the enterprise, merely financial or administrative decision making will not result in the loss of the exemption protection,<sup>609</sup> and the Asset Conservation Act provides a list of activities which are expressly excluded from the participation in management.<sup>610</sup> However, the secured lender without participation in management may still lose the exemption protection under certain circumstances, for example, lessors using tax lease structures to finance ships for the primary purpose of deriving tax benefits.<sup>611</sup>

### 5.10.2 The insurance solutions

There are many ways to mitigate risks faced by lenders in respect of their potential liability for pollution from ships, among which insurance is an essential one. The primary function of insurance is risk transfer, which means that the assured may transfer the financial consequences of risks to the insurer through insurance contracts. Insurance itself cannot avoid the occurrence of pollution incidents and/or liability arising out of such incidents; however, it can help to prevent losses to a certain extent. It can do so, for example, through research and education led by insurance companies, or through the insurer requiring the assured to meet certain standards (e.g. double-hull tankers) before applying for the insurance.<sup>612</sup> In the event that lenders incur liability for pollution from ships, the payment made by insurers can fund the payment of damages, thereby releasing lenders from such liability in most cases.

In the light of the potential severe consequences of shipping pollution incidents, the international law and local law generally contain compulsory insurance

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<sup>608</sup> 42 USC §9601(20)(F)(i) (as amended).

<sup>609</sup> *Ibid.*

<sup>610</sup> 42 USC §9601(20)(F)(iv).

<sup>611</sup> *Shipping Environment* (n 585) 724-725.

<sup>612</sup> See Chapter 3, section 3.6.3.5 (Loss prevention).

## MARINE INSURANCE: GENERAL RULES AND LEGAL RISKS

requirements in relation to pollution liabilities. That is, ship operators are required to prove that adequate insurance has been taken out to cover such liabilities before they are allowed to trade freely. By the same token, insurers who provide such liability covers are generally required to be directly liable to the third party claimant. The compulsory insurance requirements are seen in, *inter alia*, the 1992 CLC, the 2001 Bunker Convention, the 2007 Nairobi International Convention, and the OPA-90 (US).

To ensure that financed ships are covered by such compulsory insurance, lenders will impose insuring obligations on borrowers (or demise charters in the case of lease finance) through loan agreements, covenants or charters. An example of this is clause 10(iii) of Barecon 2001, which provides:

The Charterers shall maintain financial security or responsibility in respect of third party liabilities as required by any government, including federal, state or municipal or other division or authority thereof, to enable the Vessel, without penalty or charge, lawfully to enter, remain at, or leave any port, place, territorial or contiguous waters of any country, state or municipality in performance of this Charter without any delay.<sup>613</sup>

If the charterers fail to make and maintain necessary arrangements to satisfy such requirements, then they shall indemnify the owners (i.e. the lessors in the case of leasing) against all consequences whatsoever (including loss of time) for any failure or inability to do so.<sup>614</sup>

Standard H&M insurance does not cover liabilities arising out of pollution from ships. Rather, such liabilities are normally covered by P&I insurance, thus P&I clubs have become the predominant pollution liability insurers. The “pay to be paid” rule of the P&I clubs does not apply in certain pollution claims, because the club may be required by law to submit direct liability (such as CLC liability) to the third party claimant. The level of pollution cover that is available from P&I clubs is high, since it is guaranteed not only by clubs individually but also through their reinsurance arrangements. However, oil pollution liability is subject to an overall limit of US\$1 billion per incident,<sup>615</sup> and this limit applies to each accident or occurrence in respect of each ship entered by – or on behalf of – an owner or

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<sup>613</sup> Barecon 2001 cl. 10(iii).

<sup>614</sup> *Ibid.*

<sup>615</sup> The limit, first introduced in 1970, rose progressively until it reached a level of US\$1 billion, where it remained for the 2017/2018 policy year.

demise charterer. In the light of this, lenders may require contingency insurance to better secure their interests in the financed ships. As discussed in section 4.3.3.3,<sup>616</sup> the most relevant cover is mortgagees' additional perils insurance.

### 5.11 The impact of economic sanctions on ship finance

Economic sanctions, which are typically a mixture of punitive legislative provisions, are imposed by one country or one super authority (e.g. UN or EU) on another country for the purposes of bringing to bear political and financial pressure. Sanctions take a variety of forms including, *inter alia*, travel bans, asset freezes, capital restraints, and trade restrictions. Economic sanctions have been used frequently during the past 20 years, as an alternative to military force, with the advantage of being lower-cost and lower-risk.

Recently, there has been a trend for sanctions to be directly targeted at shipping, and the most effective way of stopping shipping activities in breach of sanctions is to cut off marine insurance supplies, in particular P&I insurance. An example of this is the Iranian sanctions,<sup>617</sup> which has resulted in several cases coming before the English courts.<sup>618</sup> The EU sanctions on insurance for Iranian persons have now been lifted, and the EU sanctions on insurance relating to particular trades have mainly been lifted. Likewise, a majority of the US extra-territorial sanctions which previously restricted foreign insurers (i.e. insurers without US connections) to providing cover for Iranian trades have also been lifted. However, such a relaxation of Iranian sanctions is properly an indication of the effectiveness of these measures, rather than a sign of failure. In the light of this, the effects of current and future economic sanctions on shipping and ship finance should not be underestimated.

Ship financiers may be directly and indirectly affected by sanctions in many ways. For example, certain US sanctions against Iran directly apply to any financial institution that intentionally conducts or facilitates significant transactions with a designated Iranian bank or with the central bank of Iran. Given that the

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<sup>616</sup> See Chapter 4, section 4.3.3.3 (Mortgagees' Additional Perils Insurance).

<sup>617</sup> See, e.g. Council Regulation (EU) No 267/2012 and the United States Comprehensive Iran Sanction, Accountability, and Divestment Act of 2010 (CISADA).

<sup>618</sup> See *Islamic Republic of Iran Shipping Lines v Steamship Mutual Underwriting Association (Bermuda) Ltd* [2010] EWHC 2661 (Comm); *Arash Shipping Enterprises Co Ltd v Groupama Transport* [2011] EWCA Civ 620; *Sea Glory Maritime Co v Al Sagr National Insurance Co (The Nancy)* [2013] EWHC 2116 (Comm).

ambit of sanctions is broad, financiers have felt great compliance pressure<sup>619</sup> and, therefore, it is common practice to incorporate sanctions clauses into lending agreements and/or leasing agreements. Such clauses generally impose obligations on shipping companies to comply with applicable laws, and also create exit mechanisms in the event that the making or maintenance of loans becomes illegal through a change of law. Some sanctions may target shipping companies and/or insurers by restricting trades and/or forbidding insurance supplies. Although these sanctions do not directly apply to ship financiers, the profitability or repayment ability of their customers (i.e. shipping companies) will inevitably be affected, which in turn will impact the financing transactions.

Sanctions regimes are extremely complex. A wide variety of sanctions (with overlap) may target the same issues, so each case must be examined individually. This section does not address particular sanctions targeted at shipping, or the way in which such sanctions are directed at shipping companies, ship financiers and marine insurers. For the purpose of this research, two questions in relation to marine insurance are considered in this section, as follows:

- (1) What is the impact of compliance actions by marine insurers?
- (2) What is the impact of a breach of an applicable sanctions regime by the shipowner or its charterers?

#### **5.11.1 The compliance of marine insurers with the sanctions**

The sanction-making authorities have realised that cutting off insurance supplies, especially P&I insurance, is the most effective way to stop shipping activities from being carried out in breach of sanctions. Failing to comply with sanctions will put insurers at risk: not only at the risk of penalties (typically huge fines) but also at the risk of ruining their reputations. However, sanctions compliance is a big challenge to insurers. If insurers provide insurance cover for prohibited cargos or ships engaged in prohibited activities (even inadvertently), or if their customers (or insurance brokers) engage in prohibited activities or transactions with the target entity, they may be regarded as in breach of relevant sanctions.

In the light of this, insurers (P&I clubs and mutual associations included) generally require sanctions compliance clauses to be incorporated into policies

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<sup>619</sup> See *Al-Kishtaini v Shanshal* [2001] EWCA Civ 264; *DVB Bank SE v Shere Shipping Co Ltd* [2013] EWHC 2321 (Ch).

to prevent themselves being found in breach of sanctions. Such clauses can include either a sanction limitation and exclusion clause<sup>620</sup> or a sanction cancellation clause.<sup>621</sup> For example, Lloyd's Market Association (LMA) has published the 3100 Sanction Limitation and Exclusion clauses for its members, which can be used in both marine and non-marine policies, under which insurers are entitled to decline payments if to do so would put them in breach of sanctions. In *Arash Shipping Enterprises Co Ltd v Groupama Transport*,<sup>622</sup> the court held that the EU insurers, upon serving notice of cancellation, were entitled to cancel the policy of an Iranian controlled shipowner in reliance on a sanction cancellation clause contained in the policy and on the EU Regulation 961/2010. The P&I clubs have also changed their rules to meet the challenges of a sanctions era: if a ship entered with the club is employed in a carriage, trade or voyage where to do so would put the club in breach of sanctions, P&I covers in respect of the ship may be lost, and in certain severe situations, P&I entries shall cease.

Sanction limitation and exclusion clauses, or sanction cancellation clauses, or relevant rules of the club all impose significant risks on shipowners and their financiers, because once such clauses are triggered or such rules are violated, the insured ships are at risk of losing insurance protection, or at least, are at the risk of their marine covers being suspended. In theory, a financier who is a composite assured of the owner may require altering sanctions compliance clauses in relevant policies, for the purpose of being protected against the risk of a breach of sanctions by the shipowner, but the insurer is unlikely to agree to this in reality.

### **5.11.2 The risk of illegality**

If the shipowner or its charterers engage in activities or transactions which would constitute a breach of an applicable sanctions regime, then apart from the risk of triggering the abovementioned sanction compliance clauses, there is also the risk of illegality. Although sanction is not the unique cause of the illegality risk, the growth of sanctions over recent years has increased this risk, and a number of

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<sup>620</sup> See, e.g. Joint Hulls Committee Sanctions Limitation and Exclusion Clause JH 2010/009; Lloyds Market Association Clause LMA 3100.

<sup>621</sup> See, e.g. International Underwriters Association (IUA) 09-053 Special Cancellation Clause.

<sup>622</sup> [2011] EWCA Civ 620.

cases arising from shipping targeted sanctions have appeared in the English courts.<sup>623</sup>

#### 5.11.2.1 *The common law position*

Under English law, the rules in relation to illegality are extremely complex. Generally speaking, these rules are based on two principles: the first is that a person should not benefit from his or her wrongdoing, and; the second is that the law should not condone illegality. This section is not intended to consider the doctrine of illegality in depth since this topic constitutes a thesis of its own,<sup>624</sup> instead, a brief summary of the illegality issue in marine insurance is necessary, for the purpose of examining the impact of the shipowner or its charterers breaching an applicable sanctions regime.

The illegality defence may be used against both tort claims and contract claims. Under contract law, the illegality issue mainly appears in two situations: one is the contract being prohibited by statute, and another, is the contract being in violation of general common law rules or public policy. Generally speaking, the illegality rules under tort law may bar a person who has acted in an unlawful manner from claiming loss or compensation from any other person(s). Turning to contract law, a primary principle in respect of illegality is that parties to a contract shall not profit from their own unlawful act.<sup>625</sup> Accordingly, if the shipowner or its charterers are in breach of sanctions, then the marine insurance contract may be held invalid, and the P&I entry may cease, for the reason of being tainted by illegality.<sup>626</sup>

Apart from general common law rules, section 41 of the MIA 1906 implies a warranty of legality, which provides that 'There is an implied warranty that the adventure insured is a lawful one, and that, so far as the assured can control the matter, the adventure shall be carried out in a lawful manner'.<sup>627</sup> Any departure

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<sup>623</sup> See, e.g. *Islamic Republic of Iran Shipping Lines v Steamship Mutual Underwriting Association (Bermuda) Ltd* [2010] EWHC 2661 (Comm); *Sea Glory Maritime Co v Al Sagr National Insurance Co (The Nancy)* [2013] EWHC 2116 (Comm).

<sup>624</sup> Illegality in the context of marine insurance, see: *Arnould* (n 230) Chapter 21; F Wang, *Illegality in Marine Insurance Law* (Informa 2016). Illegality in the context of contract, see: H Beale (ed), *Chitty on Contracts* (32nd edn, Sweet & Maxwell 2015) Part 5, Chapter 16; E Peel (ed), *Treitel on the Law of Contract* (14th edn, Sweet & Maxwell 2015) Chapter 11.

<sup>625</sup> *Hall v Knight* [1914] p 1; *Beresford v Royal Insurance Company* [1938] AC 586.

<sup>626</sup> An extended discussion on the application of illegality rules in marine insurance cases: see *Arnould* (n 230) Chapter 21; Wang (n 624).

<sup>627</sup> Marine Insurance Act 1906 s. 41.



from such requirements on the part of the shipowner or its charterers constitutes a breach of warranty. Under the MIA 1906, if the assured is in breach of warranty, then the insurer will automatically be completely discharged from liability from the date of the breach, even if the breach is subsequently remedied, and even if the breach is entirely unrelated to the type of loss that has occurred. Accordingly, the consequences of breaching a warranty are severe: the insured ships are put in the position of operating without insurance protection from the date of the breach, even if such a breach were to be subsequently remedied.

This piece of law has been criticised as being too harsh on the assured. Consequently, the 2015 Act<sup>628</sup> has made some changes to the law relating to warranties in insurance contracts. These changes apply to all insurance and reinsurance contracts that incepted or renewed on or after 12 August 2016. Under the 2015 Act, if a warranty (express or implied) has been breached, the policy will be suspended from the time of the breach until the breach has been remedied, but the insurer will be liable for subsequent losses, provided a remedy is possible.<sup>629</sup> That is, the insurer's liability is no longer automatically discharged from the date of a breach of warranty; instead, section 41 of the MIA 1906 operates as a suspensive condition. Section 10(3) of the 2015 Act provides exceptions '(a) because of a change of circumstances, the warranty ceases to be applicable to the circumstances of the contract, (b) compliance with the warranty is rendered unlawful by any subsequent law, or (c) the insurer waives the breach of warranty',<sup>630</sup> in which situations, the insurer's liability under the insurance contract in respect of losses occurring will not be affected. In addition, in the case of marine insurance, contracting out of section 10 of the 2015 Act is possible, assuming the transparency requirements laid down in section 17 have been satisfied.<sup>631</sup>

#### 5.11.2.2 *The marine insurance cases*

The illegality issue in the context of marine insurance shall be examined not only under statute but also under common law. A number of cases in relation to

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<sup>628</sup> Insurance Act 2015 came into force on 12 August 2016.

<sup>629</sup> Insurance Act 2015 s. 10.

<sup>630</sup> *Ibid* s. 10(3).

<sup>631</sup> *Ibid* s. 17, where provides that '(a) The insurer must take sufficient steps to draw any disadvantageous term to the assured's attention before the contract is entered into or the variation agreed; and (b) Any disadvantageous term must be clear and unambiguous as to its effect'.

illegality issues arising from sanctions have appeared in the English courts, among which two decisions stand out – *Islamic Republic of Iran Shipping Lines v Steamship Mutual Underwriting Association (Bermuda) Ltd*<sup>632</sup> and *Sea Glory Maritime Co v Al Sagr National Insurance Co (The Nancy)*.<sup>633</sup>

(a) *IRISL v Steamship Mutual*

A ship of the claimant Islamic Republic of Iran Shipping Lines (IRISL) was entered with the defendant club; P&I insurance had covered pollution liability. HM Treasury issued the Financial Restrictions (Iran) Order 2009, under which transactions and business relationships between relevant persons and designated Iranian entities were prohibited, including IRISL. With the power to exempt specified acts from the Order, HM Treasury had issued a Licence<sup>634</sup> which provided that the club ‘may continue to provide insurance cover in accordance with the Blue Cards issued to IRISL for a period of three months starting on 30 October 2009 ...’.<sup>635</sup> However, the club terminated cover in respect of the ship the day before she suffered a casualty in the territorial waters of China, causing bunker oil pollution. The club denied liability.

The issues to be determined by the Court were (a) whether the terms of the Order and the Licence permitted the club to continue insuring IRISL against the risks required to be insured by the 2001 Bunker Convention,<sup>636</sup> and (b) whether the effect of the Order and the Licence was to discharge the insurance by reason of frustration.<sup>637</sup> The Court held that the Licence (as amended) would not have constituted a fundamental change in the nature of the cover,<sup>638</sup> and the effect of the Licence was to permit the club to continue providing IRISL with insurance cover to the extent of risks required to be insured by the Bunkers Convention. Turning to the second issue, the Order and the Licence did not discharge the insurance by reason of frustration since the Licence did not render the club’s obligations radically different: the cover was narrower, but the club’s obligation to

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<sup>632</sup> [2010] EWHC 2661 (Comm).

<sup>633</sup> [2013] EWHC 2116 (Comm).

<sup>634</sup> It was a further licence following previous two licences which granted the club to continue providing IRISL with insurance cover.

<sup>635</sup> *Islamic Republic of Iran Shipping Lines v Steamship Mutual Underwriting Association (Bermuda) Ltd* [2010] EWHC 2661 (Comm) at para [8].

<sup>636</sup> *Ibid* at paras [55-98].

<sup>637</sup> *Ibid* at paras [99-129].

<sup>638</sup> *Ibid* at para [73].

provide insurance cover did not change at all.<sup>639</sup> As a result, the club was obliged to indemnify IRISL in respect of its costs and liabilities arising out of the casualty, and the club was not entitled to an indemnity or reimbursement from IRISL in respect of liabilities incurred to third parties.

In the present case, the club withdrew cover when it was not prohibited from providing such a cover, but if the Licence had altered the nature of the insurance, the cover might have been held to be invalid for the reason that the whole insurance contract would have been frustrated by supervening illegality, and therefore, the club would have been discharged from liability, imposing significant risks on the shipowner and its financiers.

(b) *The Nancy*

The ship *Nancy* was insured under an H&M and war risks fleet policy. Her owners and managers were named as the assureds. Later, *Nancy* became a CTL by reason of fire (an insured peril) occurring in the port of Nakhodka. The assureds sought to recover their losses, including their sue and labour expenses. However, the insurers denied liability on five grounds, among which, the fifth ground was that there was illegality under US law arising from breach of US sanctions, and the policy was therefore tainted by illegality.

The court held that the insurers' defences would be dismissed and that the insurers would be liable for an insurance claim in respect of the ship *Nancy*. On the illegality issue, Blair J held that there was a breach of US sanctions by the shipowner,<sup>640</sup> but the insurers' claim in relation to section 41 of the MIA 1906 (warranty of legality) failed because such a breach was not part of the insured adventure, and also because the section 41 warranty only refers to English law.<sup>641</sup> Blair J went on to consider the illegality issue under common law,<sup>642</sup> and held that the unlawful freight payments by the assureds had no connection with the claim under the policy, and that the assureds were not seeking to profit in an unlawful manner. Thus the insurance cover was not affected. However, Blair J provided that 'It would be different in my view if at the time of entering into the

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<sup>639</sup> Ibid at paras [111-112] and [114-115].

<sup>640</sup> *Sea Glory Maritime Co v Al Sagr National Insurance Co (The Nancy)* [2013] EWHC 2116 (Comm) at paras [276-282].

<sup>641</sup> Ibid at paras [290-295].

<sup>642</sup> Ibid at paras [296-305].

policy, the assured intended to perform the adventure in a manner which involved a breach of US law....<sup>643</sup>

Although the policy was not affected in the present case, assuming illegality arising from breach of sanctions was closely connected with an insurance claim under the policy, or if the assured was intending to breach sanctions at the time of entering into the policy, it is possible that the policy would be vitiated by initial illegality.

### 5.11.2.3 *The position of ship financiers*

As mentioned above, the growth of sanctions has increased the illegality risk. Where the shipowner or its charterers are in breach of sanctions, the insurance contract may be tainted by illegality and the P&I entry may cease. In these cases, ship financiers who have taken an assignment of the primary insurance are subject to any illegality defence raised by the insurer,<sup>644</sup> and therefore have the same exposure to the illegality risk as the shipowner and its charterers. As regards a ship financier who has a composite interest in an insured ship, it may be protected against statutory illegality under section 41 of the MIA 1906.<sup>645</sup> However, where a policy is vitiated for the reason of being tainted by illegality under common law, it is not yet clear whether an insurance claim under the tainted policy brought by a composite co-assured will be affected.

If an insurance claim under the shipowner's marine insurance is declined by the primary insurers for the reason of illegality arising from sanctions, in theory the mortgagee may seek to recover its loss from the MII insurer,<sup>646</sup> provided such a breach cannot legitimately be attributed to the mortgagee. Whether the mortgagee is entitled to a claim under an MII policy is also subject to the policy's specific terms. Since there is no universally accepted wording in the case of MII, an MII policy may exclude the illegality risk. To the best of the author's knowledge, there is not yet such an MII claim, but with the sanction regimes becoming more rigid and more complex, an MII claim may be contested in the near future.

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<sup>643</sup> Ibid at para [302].

<sup>644</sup> See *Bank of New South Wales v South British Insurance Co Ltd* (1920) 4 LI L Rep 384. See also Chapter 5, section 5.5.5 (As an assignee).

<sup>645</sup> See Chapter 5, section 5.5.3.2 (Why to be a co-assured?), especially, the third benefit.

<sup>646</sup> Statutory illegality may be covered, however, it is not clear whether illegality under common law can be covered: see Chapter 4, section 4.3.3.1 (d) (Covered and excluded risks).

To reduce the negative impact of sanctions on the ship finance projects, lending banks currently adopt a strategy of “know your customer”, which essentially involves conducting due diligence checks on the parties involved in the ship finance projects, making sure that they are not on publicly available sanctions lists. However, the illegality issue may arise from a breach of sanctions by charterers (or even sub-charterers) of the financed ship, in which case, the efficacy of due diligence checks is limited. Moreover, ship financiers also require sanctions compliance clauses being incorporated into lending agreements and/or leasing agreements, for the purposes of protect themselves against sanctions exposure. However, to what extent financiers need to impose such compliance obligations on their customers is a difficult issue, which is beyond the scope of this section.

### **5.12 Conclusion**

Ship financiers need to be aware that marine insurance is a contract rather than a guarantee, and that it may be void or voidable. As mentioned above, things can go wrong under the policy, at any stage from the negotiation to the claim. Situations and suggestions provided in this chapter are merely illustrative. In the light of the international nature of shipping, legal issues in reality can be much more complex than those presented in this chapter. Accordingly, ship financiers shall properly manage legal risks, with the help of lawyers, insurance brokers and other professionals.

## CHAPTER 6

### **CONCLUSION: OPTIMISING THE ROLE OF MARINE INSURANCE IN SHIP FINANCE**

This research aims to explore the role of marine insurance in ship finance. Marine insurance, as a risk management tool, is frequently used by shipowners, shipbuilders and financiers to shift shipping risks away from their ship finance projects.<sup>647</sup> Shipping risks that have significant impacts on the success of ship finance projects have been identified and categorised into three groups, namely: risks associated with the operating cash flow, the value of ships, and the shipping market.<sup>648</sup> Ideally, financiers will first set out their risk management objectives, followed by identifying risks that need to be managed, implementing appropriate risk management techniques, and then reviewing the process on an ongoing basis. Among a range of risk management techniques, marine insurance has proved itself to be effective in transferring certain shipping risks from the project to the insurance pool.<sup>649</sup> However, due to the rule of insurability and commercial availability, marine policies available on the market may cover the counterparty risk (with conditions) and the pure risk; partly cover the operational risk, the delay in delivery risk and the political risk; generally cannot cover the freight rate risk, the operating and voyage cost risk, the ship price risk, the cyclical risk and the regulatory risk.<sup>650</sup> In the light of this, purchasing insurance cannot manage all risks; in terms of risks that can be transferred by purchasing insurance, it is worth considering this technique, although coverage gaps shall be carefully checked by professionals.

Despite the risk transfer role of marine insurance, it may also reduce capital costs, improve the liquidity of shipowners and shipbuilders, and provide peace of mind for financiers.<sup>651</sup> Marine insurers, for their advanced knowledge of risk and

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<sup>647</sup> See Chapter 3, section 3.6 (Marine insurance as a risk management tool in ship finance).

<sup>648</sup> See Chapter 3, section 3.5.1 (Essential elements), section 3.5.2 (Risks associated with the operating cash flow), section 3.5.3 (Risks associated with the value of ships), section 3.5.4 (Risks associated with the shipping market).

<sup>649</sup> See Chapter 4 (Marine insurance: insurable risks and coverage).

<sup>650</sup> See Chapter 4, section 4.4 (Conclusion).

<sup>651</sup> See Chapter 3, section 3.6.5.2 (The role of marine insurance in ship finance).

## CONCLUSION:

### OPTIMISING THE ROLE OF MARINE INSURANCE IN SHIP FINANCE

abundant capital, not only could conduct research and education on shipping risks,<sup>652</sup> but also could invest in shipping.<sup>653</sup>

Nevertheless, marine insurance is a contract rather than a guarantee. For this reason, the above mentioned roles of marine insurance can only be created and sustained if appropriate marine policies have been properly arranged. What types of marine policy are appropriate shall be evaluated on a case-by-case basis: all ships have three basic types of cover (hereafter primary insurance), namely hull and machinery insurance, protection and indemnity insurance and war risks insurance; optional covers which may be beneficial to ship finance projects include increased value insurance, loss of hire insurance, refund guarantee insurance, maritime lien insurance, builders' risks insurance, mortgagees' interest insurance, lessors' interest insurance, mortgagees' additional perils insurance and mortgage rights insurance. Risks covered by those covers, along with connections between optional covers and the primary insurance have been analysed in Chapter 4, section 4.3 (Marine insurance policies); it purports to assist financiers, shipowners and shipbuilders select appropriate insurance package to shift shipping risks away from their ship finance projects.

In terms of properly arranging marine policies, the law governs marine insurance contract, along with legal risks that may arise in the process of placement and claim have been discussed in Chapter 5 (Marine insurance: general rules and legal risks). It finds not all types of ship financier may directly benefit from marine insurance, because the law of marine insurance requires insurable interest. In contrast to a pure shareholder who has no insurable interest in the property of the company in which it holds shares, mortgagees and lessors are interested in financed ships, thereby they may participate in the shipowner's and shipbuilder's marine policies as either co-assureds, or assignees, or loss-payers. Merits and limitations of those three ways of utilising the primary insurance have been examined,<sup>654</sup> financiers shall adopt one way or combined ways depend on the particular circumstances of each individual case. Marine insurance may be void or voidable, that is, a variety of legal risks may appear

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<sup>652</sup> For example, P&I clubs have shifted business strategy from competing premium (call) to providing better service, for which research and education are essential parts of the service upgrade.

<sup>653</sup> See Chapter 3, section 3.6.5.2 (The role of marine insurance in ship finance).

<sup>654</sup> See Chapter 5, section 5.5 (Utilising the primary insurance).

#### CONCLUSION:

OPTIMISING THE ROLE OF MARINE INSURANCE IN SHIP FINANCE  
during the operation of marine insurance including (but are not limited to) risks in respect of subrogation, ship valuation, broker, the insurer's insolvency, pollution liability and economic sanctions targeted at shipping, these legal risks have to be carefully managed. To conclude, in order to optimise the role of marine insurance in ship finance, financiers shall, with the help of professionals, establish a clear risk management strategy, be familiar with related marine coverage, and manage legal risks cautiouly.



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