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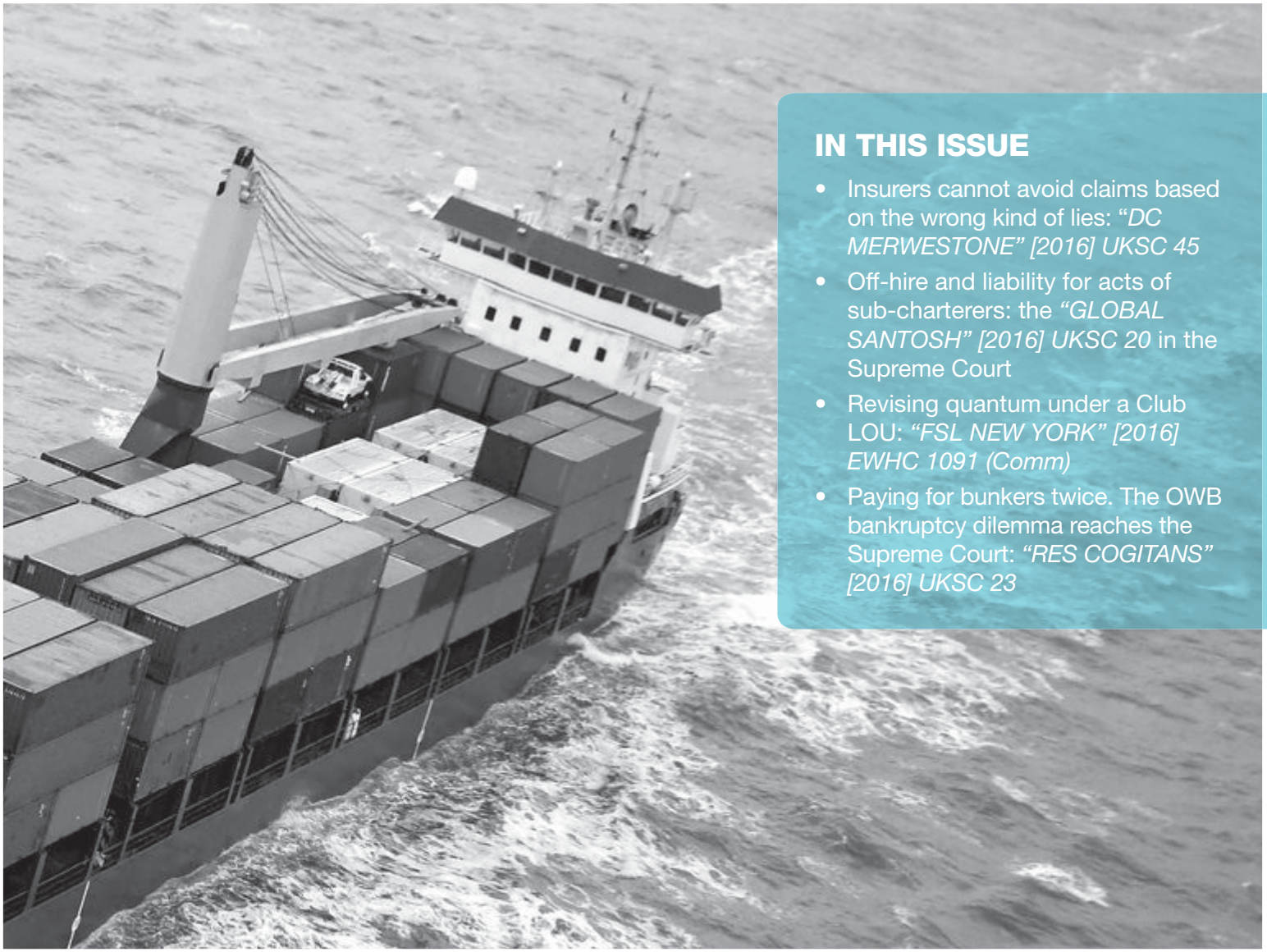

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INSURERS CANNOT AVOID CLAIMS BASED ON THE WRONG KIND OF LIES: *"DC MERWESTONE" [2016] UKSC 45*

It is rare for insurance law to make the popular press, far less national media. That this case, reported previously in our July 2013 and January 2015 Bulletins, has done so is testament to its widespread importance.

A relatively small leak in a ship's bow thruster room eventually led to the engine room being flooded causing irreparable damage to the main engine. At trial the cause of this was found to be a combination of negligence on the part of the crew and some independent contractors together with the unseaworthiness of the ship itself.

Such loss was covered under the ship's insurance. In the initial stages of the claim a director of the owner wanted to speed up the claim and developed fears that the owner might be found to be personally responsible for the negligence and unseaworthiness, giving the insurer rights to reject the claim.

The director sought, therefore, to bolster the claim. He recklessly misled the insurer as to the factual background. As matters developed the master and crew were dragged into this, resulting in outright lies.

This was all unnecessary. The claim was a good one, it needed no embellishment. At first instance, however, Popplewell, J. felt the law required him to reject the claim. He did so with great reluctance.

The underlying reason is that contracts of insurance have always been treated as a special category. They are said to be ones of utmost good faith. The parties are required to treat each other with much more openness than is to be expected in other commercial contracts. At common law this leads to various positions that would not be the case in other areas of contract.

Obviously, if a claim is wholly fabricated it can be rejected in full. Less obviously if the claim is fraudulently exaggerated the insurer can still reject it in full. Just to make that point clear, it is the whole of the claim that is lost, not just the exaggerated part of it. This is described as "the fraudulent claims rule".

Other lies fall short of this. Just as in this case, they could, in a purely objective sense, be considered as irrelevant. Regardless of whether what is being said is true or not, the claim would, in normal circumstances, be covered by the policy.

For many years such behaviour has been described as a "fraudulent device". The common law has discouraged their use in the insurance law context. This is often justified on the grounds of public policy.

Popplewell, J. decided he was bound by precedent (including a Lord Mance judgment in a different case when he was a Court of Appeal judge) on fraudulent devices to reject the claim. There is little doubt that he hoped to be overturned on appeal, but the Court of Appeal felt loss of the claim in full was an entirely appropriate outcome where a fraudulent device had been used.

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> **"In this case the lie is dishonest, but the claim is not.**

The whole tone of the majority judgments (Lord Mance, the only judge on the panel who could be described as an insurance specialist, dissenting) is the need to distinguish between different sorts of lies. They noted that Section 12 of the Insurance Act 2015, when it comes in to force on the 12th August 2016, preserves the fraudulent claims rule. Wholly fabricated claims and those inflated by fraud can, by statute, be rejected in full.

Parliament did not choose to codify anything in relation to the middle ground of fraudulent devices. This, their Lordships felt, gave them freedom to modernise common law principles. Lord Sumption, who gave the leading judgment, pointed out that this was the first time the Supreme Court (previously the House of Lords) had looked at whether the fraudulent claims rule extended to fraudulent devices.

By then Lord Sumption had sprung the first surprise. An eminent historian in his spare time, he pointed out that the term "fraudulent device" had been lifted from insurance policies dating back to the 1800s. This, he thought, rendered it "archaic". He substituted the modernised expression "collateral lie". He explained this as those given against a background where:

"the entire claim may be justified, but the information given in support of it may have been dishonestly embellished, either because the insured was unaware of the strength of his case or else with a view to obtaining payment faster with less hassle" and, more specifically, as *"a lie which turns out when the facts are found to have no relevance to the insured's right to recover"*

In the light of this judgment it is now settled law that the fraudulent claims rule does not extend to collateral lies. Lord Sumption examined the difference between those outright frauds which will forfeit the claim and collateral lies in relatively concise but highly detailed paragraphs. He produced a passage likely to become amongst the most cited in insurance law:

"The position is different where the insured is trying to obtain no more than the law regards as his entitlement and the lie is irrelevant to the existence or amount of that entitlement. In this case the lie is dishonest, but the claim is not. The immateriality of the lie to the claim makes it not just possible but appropriate to distinguish between them."

The reference to materiality is a guide to how such cases will need to be approached in future. The test will be whether the adverse impact of the lie goes to the heart of the legal recoverability of the claim.

Perhaps the easiest way to look at this is to consider if the true facts would provide a defence under the policy itself. In other words, would the true facts which the lies are seeking to hide or distort actually result in a valid claim on the policy. If so then despite the lies the claim on the policy will not be forfeit.

Under the old common law of fraudulent devices the lies were enough to forfeit the claim. Under the new law of collateral lies they are not.

Lord Mance delivered a powerful dissenting judgment:

"…I have had the benefit of reading the differently nuanced judgments prepared by Lord Sumption and Lord Hughes… Both wrestle from different angles with the difficulty of describing a fraudulent device as anything other than material to…the decision whether or not to settle a claim… To suggest that a lie which the insured felt necessary to promote settlement of a claim is immaterial or "collateral" if years later it can be shown that it was after all unnecessary to tell it mistakes the nature of the business".

His solution would still have been to take the lie at the time it was made and consider whether it led to a *"…significant improvement of the insured's prospects"*. It is difficult not to see the strength in such an approach. In the future it may well influence first instance tribunals in the way they assess the facts in forthcoming cases. They will then, of course, have to be very careful to couch the results in terms of the test favoured by the majority.

In essence, this is a pure policy decision. There is a long standing feeling that, particularly in the commercial context, insurance law is too favourable to the insurer. In the past, there were good reasons for this. The insured would have much more detailed knowledge of the risks they were seeking insurance for and of any claims they later brought than the insurer could expect to have. Technical advances have redressed that imbalance. The Supreme Court felt that in modern times the draconian consequences of a collateral lie did not reflect its true influence on the merits of the underlying claim. However, out and out fraud in support of claims which are invalid in whole or part will still result in them being forfeited under an insurance policy.

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OFF-HIRE AND LIABILITY FOR ACTS OF SUB-CHARTERERS: THE *"GLOBAL SANTOSH" [2016] UKSC 20* IN THE SUPREME COURT

The first instance and Court of Appeal decisions in this case appeared in the April 2013 and July 2014 editions of this Bulletin. The Supreme Court has now had the final say.

NYK time chartered the "GLOBAL SANTOSH" to Cargill. Cargill were granted liberty to sub-let the ship and there was a chain of sub charters, buyers and sellers.

The ship was delayed at discharge. Cargill continued to pay hire. Disputes broke out down the line. The buyers held back payment for the goods. The seller arrested the cargo. By mistake the ship also ended up under arrest.

Cargill put the ship off-hire for the period of the arrest. An additional clause in the charterparty permitted them to do so but this was qualified by the wording:

"…unless such … arrest is occasioned by any personal act or omission or default of the Charterers or their agents…"

The question was whether the parties down the contractual line could be considered as "agents" under the clause, although such parties would not be Cargill's agents in the strict legal sense.

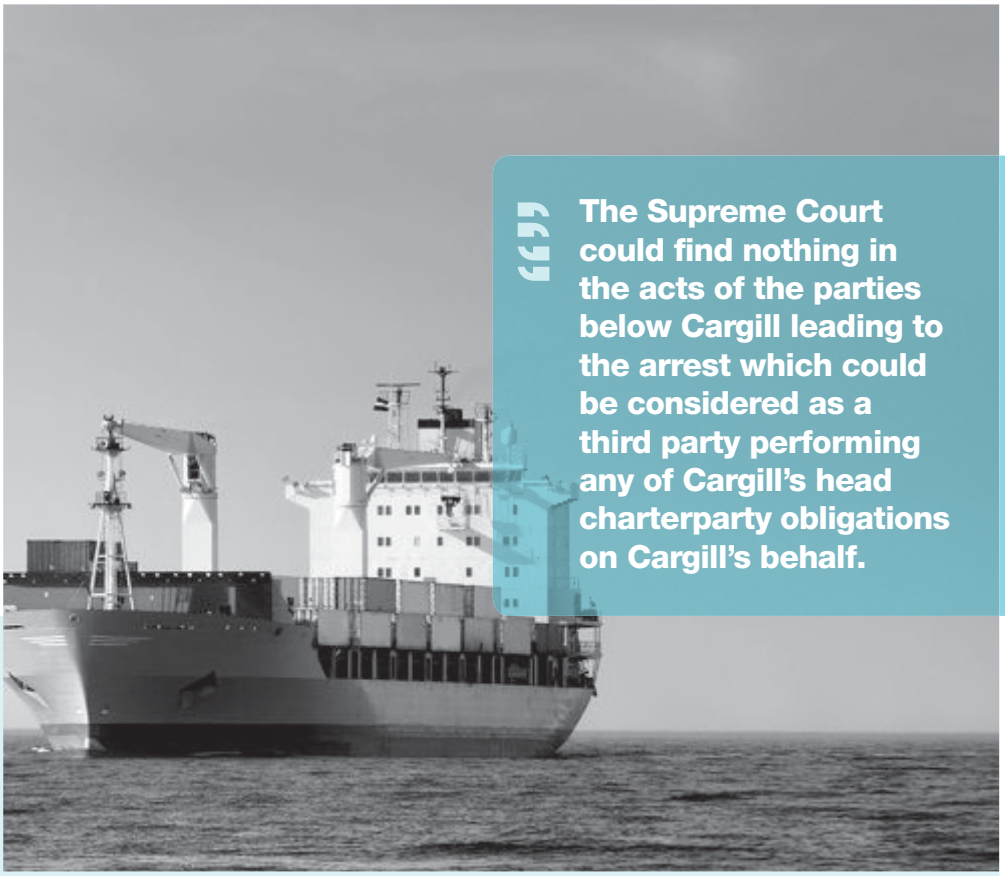
The Court of Appeal resolved the question by considering a charterer's "sphere of responsibility". They found that the delay fell within this. The proviso applied and the ship was not off-hire.

The Supreme Court reversed this decision by majority with Lord Sumption giving the sole judgment of that majority. The judgment accepts that "agent" as used here broadly refers to parties down the line from Cargill to whom they have delegated rights under the charterparty.

The scope of that agency did not, however, extend beyond functions which are the time charterer's obligations under the charterparty. There needed to be a link between the cause of the arrest and the function which the parties down the line performed as Cargill's "agent".

The Supreme Court could find nothing in the acts of the parties below Cargill leading to the arrest which could be considered as a third party performing any of Cargill's head charterparty obligations on Cargill's behalf. Although the charterparty required Cargill to perform cargo handling it did not impose any obligation as to the timing of discharge. As such, any acts or omissions relating to a failure to unload the cargo at or within a particular time could not fall within the scope of any agency.

To some, the Supreme Court's decision will appear somewhat narrow and uncommercial. However, if owners want to avoid off-hire in similar circumstances they will need carefully drafted clauses. NYK's Defence Club has published one. In a market where charterers have an upper hand it remains to be seen whether anyone will sign up to this. At least one thing seems tolerably certain, it won't become part of Cargill's standard terms.



"The Supreme Court could find nothing in the acts of the parties below Cargill leading to the arrest which could be considered as a third party performing any of Cargill's head charterparty obligations on Cargill's behalf.

REVISING QUANTUM UNDER A CLUB LOU: *"FSL NEW YORK" [2016] EWHC 1091 (COMM)*

The ability of P&I Clubs to issue internationally recognised security very quickly has either staved off countless arrests or led to the swift release of ships or other assets.

Clubs also, however, want to know what their potential liabilities are going to be for reserving and estimating purposes. They want to fix the quantum of their letters of undertaking (LOUs) and to provide them on standardised wordings.

It can be difficult to assess quantum in the immediate aftermath of an incident. The parties involved often want to have flexibility to revise this up or down. This case revolves around just such a situation.

An incident took place during loading, the ship was damaged and some cargo was spilled. The owner blamed the charterer, the charterer blamed the owner. An exchange of security took place. The one giving rise to this case was an LOU given by the charterer's club.

That LOU stated that:

"It is agreed that both Charterers and Owners shall have liberty to apply if and to the extent the Security Sum is reasonably deemed to be excessive or insufficient to adequately secure Owners' reasonable claims".

The LOU was also made subject to English law and the jurisdiction of the High Court.

The owner, as both sides accepted, found themselves under secured. They demanded an increase in security. When this was refused they targeted the club. They commenced an action arguing that under terms of the LOU the club was under an obligation to increase the quantum of the security.

They were under obvious difficulties. There is nothing in the LOU that can be construed as an express undertaking on the club's part to increase the quantum of the security. This left the owner to convince the court that such an obligation can be implied. The only term that could sustain this is the one quoted above.

This was not a happy choice of wording. *"Liberty to apply"* is a common technical term found in court orders to make it clear that the parties have a right to go back to the appropriate court and seek variations to an order. An LOU is not a court order but a contract, in this case between the owner and the charterer's club. As the judge, Mr Justice Blair put it:

"The words are much less easy to give meaning to when contained in a contract."

He did so by concentrating on the central contractual undertaking in the LOU, that the club will satisfy amounts awarded against their member up to agreed limits.

The LOU contained the usual undertaking that in consideration for the security, the other party would refrain from arresting assets. For Blair, J., the correct construction of the *"liberty to apply"* wording was that it overrode this undertaking. If the charterer refused to provide further security the owner would be free to take further action to obtain this. What Blair, J. would not accept is that the inclusion of this wording could, by implication, mean that the club also undertook to increase the level of security. It was pushing matters too far to say that by implication the wording also confers a power on the courts to vary the quantum of the LOU. This would have required express agreement by the parties.

There is also a more subtle line of reasoning which does explain the meaning of the words. They grant rights to the owner and charterer. Nothing similar is given to the club and, of course, the charterer is not even a party to the LOU.

Blair, J. found it *"odd"*, therefore, that you could end up construing the wording as permitting the owner a right to increase the security (or at least to apply to do so) as against the club, but the club no right to reduce the security as against the owner.

There was another factor that Blair, J. regarded as *"the most significant factor"*. The owner's construction would expose the club to a potentially unlimited liability. In theory, the owner could keep going back to the court seeking increases.

The conclusion from this case is that if a party holding an LOU wants to have rights as against an insurer to increase the level of security it will have to say so in clear unequivocal terms.

> **"It was pushing matters too far to say that by implication the wording also confers a power on the courts to vary the quantum of the LOU.**

PAYING FOR BUNKERS TWICE. THE OWB BANKRUPTCY DILEMMA REACHES THE SUPREME COURT: *"RES COGITANS" [2016] UKSC 23*

This is another Supreme Court decision where the earlier judgments have appeared in the July and October 2015 issues of this bulletin.

It concerns the owners' attempts to avoid having to pay for bunkers twice; once to OWB and secondly to the physical suppliers of the bunkers.

The owners based their case on legal arguments surrounding section 49 of the Sale of Goods Act 1979 ("SOGA"). They lost decisively on this all the way up from arbitration and have now done so before the Supreme Court.

The owners submitted that the contract for the bunkers was a "contract of sale" within the meaning of SOGA. Under section 49 of SOGA a claim for the price can only be made if the property in the goods is passed to the buyer. The argument went on that since the physical supplier had retained title in the goods, OWB could not do so and were not entitled to the price.

Lord Mance's judgment notes the major problem with this is that this contract is not one simply to transfer property in return for the price. Both parties were perfectly well aware that before the date for payment became due it was likely that the bunkers would already have been consumed. The terms of the contract contemplated this and allowed for it.

Even if some of the bunkers were unconsumed when payment became due, the contract transferred the property in the bunkers to the owners in return for payment of the price for all the bunkers, whether already consumed or not.

So the contract did not fall within the SOGA definition of a sale. Instead it was a unique, individual type of contract albeit one that shared common features with almost every other contract for the supply of bunkers.

Lord Mance also stated that even if he had decided it was a SOGA contract he would have found that the price was payable. That argument had not been open earlier because of a Court of Appeal precedent to the contrary. Lord Mance said he would have overruled this.

This judgment will not make pleasing reading either for any owners and charterers placed in a similar position by the OWB bankruptcy. The position as between the shipowner and the third party supplier is, however, still left open. It was suggested by the first instance judge that as a matter of English law the supplier was bound by the permission given to the owner to consume the bunkers. It is doubtful, however, that the risk of arrest by physical bunker suppliers has been eliminated. Owners should consider amending their bunker supply contracts to cover these issues.

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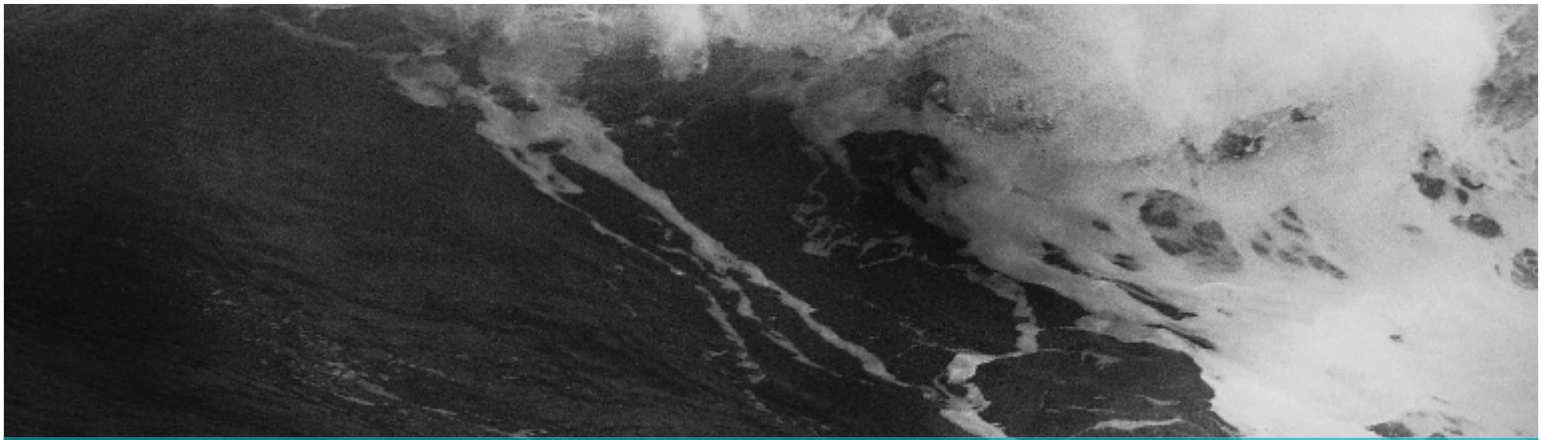

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