



FACULTY OF LAW
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Insurances in Ship Finance

JASM01 Master Thesis

Maritime Law

30 higher education credits

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Term: Spring 2013

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SUMMARY

The insurances involved in ship finance are of vital importance for the lender to achieve as small credit risk as possible. A vessel that serves as collateral for a loan and lacks adequate insurance cover will not give the bank the protection it was meant to give if it suffers damage or even worse becomes a total loss. This is particularly important since many shipowners nowadays consist of one-ship-companies that has not got much more valuable assets than the ship itself, thus leaving the mortgagee reliant on the maintenance of and earnings from the mortgaged vessel.

After many ship financiers have endured economic downturns, leading to financial distress in the shipping industry, the lending business has in general become more stringent. This can be reflected, not only in the loan agreement and its insurance requirements, but also by the way the banks and other ship financiers supervise and follow up the insurances involved. There are many types of insurances to keep track of since the insurance package required normally is very complex. It may consist of both shipowner's insurances and other insurances specially designed to protect the financier and its credit risk. Because of banks being more and more cautious, the latter type of insurances have become more popular and is a common requirement nowadays in order to have a loan granted.

There is a plethora of insurance documentation for the financier to obtain, go through and keep up to date with in order to ascertain that everything is in order and in compliance with the loan agreement. A Letter of Undertaking (LOU) shall be issued in favour of the bank and assignments of insurance shall be made in the correct manner. Furthermore, the quality of the underwriting security must be checked to make sure the insurances are placed with approved insurance companies with a payment capacity good enough to meet claims. If there is any cause of concern regarding the reliability of any of the insurers, replacement could be demanded, alternatively a cut-through clause or an assignment of the reinsurance as additional protection.

Recent casualties have highlighted the high risks ship operators (and consequently also the mortgagees) run and the massive claims that could follow in a worst case scenario. It is therefore important for ship financiers to be aware of the significant role the insurance package involved in a transaction serves and also the potential pitfalls that may occur if these are not regularly scrutinised by insurance experts.

The thesis examines shortfalls that may occur in the insurances involved in a ship finance transaction and also measures recommended to take as a mortgagee in order to avoid those shortfalls that are avoidable. A study on how downturns in the economy affect ship financiers' business, including its effect on the insurance package normally required in the loan agreement has also been carried out. It is concluded that the insurance cover, from a mortgagee's perspective, many times provide inadequate protection, something that is even more common during financial hardship. There are however measures available for the mortgagee to take in order to gain a stronger position and thus achieve a smaller credit risk. What is essential though is for the financiers to obtain knowledge about the potential coverage pitfalls and also to learn how these can be confined as far as possible.

SAMMANFATTNING

De försäkringar som är involverade i fartygs finansiering är av högsta betydelse för långivaren för att uppnå lägsta möjliga kreditrisk. Ett fartyg som utgör kreditsäkerhet och som har brister i sitt försäkringsskydd kommer inte vara till samma skydd för banken som var avsett om skada uppstår eller ännu värre om fartyget blir en totalförlust. Detta är extra viktigt idag då många fartygsägare består av bolag med endast fartyget självt som värdefull tillgång, vilket därmed lämnar banken beroende av dess skötsel och inkomst.

Efter att många fartygsfinansiärer har uthärdat lågkonjunkturer som lett till ekonomisk kris inom sjöfartsindustrin, så har utlånings villkoren generellt sett åtstramats. Detta går att skönja, inte bara i låneavtalet och dess försäkringsvillkor, utan även i sättet banker och andra fartygsfinansiärer granskar och följer upp de relevanta försäkringarna. Det finns många olika typer av försäkringar att hålla reda på då försäkringspaketet vanligtvis är väldigt komplext. Det kan bestå av både redarens egna försäkringar men även andra försäkringar som är speciellt skreddarsydda för att skydda financiären och dess kreditrisk. Som en följd av att banker blivit mer och mer försiktiga så har den förra typen av försäkringar blivit mer populära och är ett krav som blivit allt vanligare för att få ett lån beviljat.

Det finns en hel uppsjö av försäkringsdokumentation som financiären ska erhålla, gå igenom och hålla sig uppdaterad om för att försäkra sig om att allt är i sin ordning och i överrensstämmelse med låneavtalet. 'Letters of Undertaking' ska utfärdas utställda till banken och försäkringsöverlåtelse ska genomföras på rätt sätt. Dessutom så måste kvalitén på försäkringsgivarna kontrolleras för att säkerställa att försäkringarna är tecknade av godtagbara försäkringsbolag med betryggande betalningsförmåga, tillräckligt bra för att bemöta försäkringskrav. Om det föreligger några som helst tvivel avseende försäkringsgivarna så kan utbyte krävas eller alternativt krav på en 'cut-through clause' eller överlåtelse av återförsäkringarna för att uppnå utökat skydd.

Den senaste tidens fartygskatastrofer har uppmärksammat de stora risker som fartygsoperatörer (och därmed också panthavaren) är utsatta för och de massiva krav som kan uppstå om det värsta tänkbara skulle ske. Därför är det viktigt för fartygs financiärer att vara medvetna om den enormt betydelsefulla roll försäkringar involverade i transaktionen utgör och även de potentiella fallgropar som kan uppstå om dessa inte regelbundet hålls granskade av försäkringsexperter.

Examensarbetet undersöker problem och fallgropar som kan uppstå bland de försäkringar som är involverade i fartygs finansiering och även åtgärder som är rekommenderade att ta som panthavare för att undvika de som går att undvikas. Det har även gjorts en undersökning om hur lågkonjunkturer påverkar långivares verksamhet, och däribland även dess effekt på de försäkringar som vanligtvis krävs i låneavtalet. Slutsatsen är att försäkringarna, från en panthavares perspektiv, många gånger ger otillräckligt skydd, något som är ännu vanligare under svåra ekonomiska tider. Det finns dock åtgärder att vidta som ger panthavaren en starkare position och som därmed leder till mindre kreditrisk. Det grundläggande är för finansiärerna att skaffa sig kunskap om de potentiella brister i försäkringsskyddet och även hur dessa kan begränsas så långt som möjligt.

LIST OF ABBREVIATIONS

AIHC	American Institute Hull Clauses (June 2, 1977)
COFR	Certificate of Financial Responsibility
H&M	Hull and Machinery
IGA	International Group of P&I Clubs
IHC	International Hull Clauses (01/11/03)
ITC - Hull	Institute Time Clauses – Hull (01/10/83)
IV	Increased Value
LOH	Loss of Hire
LOU	Letter of Undertaking
LPA	Law of Property Act 1925
LPC	Loss Payable Clause
MAPP	Mortgagees' Additional Perils (Pollution)
MIA	the Marine Insurance Act of 1906
MII	Mortgagees' Interest Insurance
MRI	Mortgage Right Insurance
NMIP	The Nordic Marine Insurance Plan of 2013
NOA	Notice of Assignment
OPA '90	US Oil Pollution Act of 1990
P&I	Protection and Indemnity

CHAPTER 1

INTRODUCTION

1.1. Background

Maritime law embraces several different topics of which marine insurance and the ship mortgage are two of the most historical ones. Marine insurance is fascinating, not only because of its long history which offers present time solutions developed through long time practice, but also because of its uniqueness in the meaning that it still stands alone, separated from other areas of insurance. Today's mortgage originates from the old days *bottomry* which was when a shipowner, in order to lend money, had to pledge his ship as security for the loan. The money lender was entitled to take possession of the vessel and sell it if the borrower was in default.¹ The practice of bottomry developed in Greece during the 4th century but can be traced all the way back to the code of Hammurabi dated to the 18th century BC.² It resembles today's ship mortgage where the shipowner lends money to raise funding for financing the ship whereby the ship itself is used as collateral security for the loan.

Marine insurance and ship mortgage are interrelated topics and this essay will provide the reader with a presentation on how the ship mortgage is adequately protected by way of marine insurances. The ship financier will wish to minimise the credit risk by having the vessel as collateral security for the loan. The vessel will need to be adequately insured in order to serve as sufficient security. The insurances involved in a ship finance transaction are of many types and will be described further below in chapter 2 and 3.

¹ <http://legal-dictionary.thefreedictionary.com/Bottomry>.

² <http://www.insuranceregulatorylaw.com/2011/04/origins-and-development-of-insurance.html>.

The shipowner has several different types of insurances to protect his vessel which sometimes will be referred to as 'primary insurances' or 'underlying insurances'. These insurance policies will have the shipowner as the assured and the mortgagee will have his interest protected by way of an assignment of insurance. Mortgagees' Interest Insurance (MII), Mortgagees' Additional Perils (Pollution) Insurance (MAPP) and Mortgage Right Insurance (MRI) are designed to protect the ship financier in situations where the shipowner's primary insurance covers for certain reasons do not pay. These are now being widely used in the insurance market and they are taken out directly by the mortgagee who therefore will be noted as the assured. The shipowner as the borrower will however in general be the party liable for the premium costs also for these insurances since this normally is a requirement stipulated by the financier in order to have the loan granted.

Assignment of the shipowner's insurance policies is, as mentioned above, one way for the ship financier to protect the loan and his interest in the collateral vessel. The insurance policies shall from the mortgagee's point of view preferably contain wide terms and conditions together with reasonable warranties if any. The amount for which the vessel is insured shall also by margin exceed the outstanding loan amount and the underwriting security shall have good credit strength.

Big casualties like *Exon Valdez* has made an impact on the market practice and caused changes to relevant legislation in less than no time. Following the Exon Valdez oil spill in 1989 a new insurance product evolved in order to protect the mortgagee. At this time, the International Group of Protection and Indemnity Clubs (IGA) provided pollution cover limited to USD 300,000,000 which clearly was inadequate comparing the clean-up costs incurred as a result of the incident. This brought attention to ship financiers that realised they needed additional protection and MAPP was introduced on the insurance market 1990.³ Below follows a further description on

³ Gleaned from personal correspondence with representative of Aon BankAssure Insurance Services, Aon Benfield.

MAPP cover. This is another example on how mortgagees protect their credit but several other measures are needed in order to create the best possible safety net for the loan.

Banks have become more cautious in their lending business and it is getting more common for ship finance institutions to have their own in-house insurance experts that on a regular basis review and check the collaterals' insurance documentation. A separate branch of business of external insurance advisers and consultants has also developed in recent times. The role of this kind of external expertise is becoming more important and forms a by-product of the fact that banks are being more and more cautious.

1.2. Purpose and Scope

The purpose of this thesis is to examine insurances involved in ship finance. Banks and other lending institutions involved in ship financing must ensure that the credit risk is minimised and one way of doing this is to make sure that the ship as a collateral asset to the loan is being sufficiently insured against various risks it may face. Marine insurance from a bank's perspective will be analysed and the following questions are to be answered;

1. Which are the insurance cover issues and pitfalls a ship financier should be aware of?
2. What measures should a prudent ship financier take in order to ensure the collateral asset being sufficiently insured?
3. How do downturns in the economy affect ship financiers' business and the insurances involved?

The questions will be answered within the body of this essay. Risks faced by a ship financier will be described and measures available to minimise these are to be presented. By identifying current market trends and practice

the essay aims to give an up-to-date picture of marine insurance from the perspective of a mortgagee.

Marine insurance in itself is comprehensive and too wide to embrace in an essay like this. Limits have therefore been drawn in order to narrow the scope and what will be discussed in the following is confined to the mortgagee's aspects of marine insurance.

By first giving the reader an insight into marine insurance in general and subsequently concentrate on marine insurance from a ship financier's perspective, the intention is to present a niche within marine insurance that has become more relevant given the last few years when banks have undergone severe hardship because of the financial crisis. Standard insurance provisions in the loan agreement will be described as well as the insurance documentation used to give banks the protection and comfort needed to secure the credit. Different types of insurances as well as different insurance wordings are also to be analysed to see if there is anything from a mortgagee's point of view that is important to be aware of; for example gaps in the insurance cover or other pitfalls that could endanger the collateral.

Different types of mortgages, such as statutory and equitable mortgages used in common law and hypothec used in civil law will not be described in any further details and neither will the mortgagees' right and mortgagors' liabilities under the law of different legal systems. The essay will focus on ship financing through bank debts. Hence, when reference is made to a 'mortgagee' this shall be implied as being a bank. Equity finance and bond finance is therefore left outside the scope. What will be discussed however is the loan agreement between the mortgagee and mortgagor, and the obligations arising from this contract. There will also be a brief discussion on how to enforce the mortgage in the event the borrower is in breach of the loan agreement.

1.3. Research Methodology and Material

Various materials have been analysed, mainly articles accessed through electronic databases such as Lexis, Westlaw, Hein Online etc. Journals and books have also been used as well as legislation and standardised well known insurance wordings including comments to such wordings. Opinions from experienced marine insurance practitioners have been obtained through email correspondence and face to face meetings as a complementary source in order to get a proper view of today's market practice which does not necessarily correspond with theories described in books.

Some sources have been used fairly frequently throughout this essay. This can be explained by the specialised area addressed and thus the limited selection of sources available for use. Furthermore, the persons that have shared their expertise will not be mentioned by name due to industrial secrecy reasons. However, all sources have been carefully chosen and should be reliable to serve as material provider.

One of the methods used in this essay is the legal dogmatic approach, another one is the comparative method. The latter has been used to compare the standard insurance forms used in today's insurance market. The insurance practice in England and the Nordic countries have been compared as well and thus naturally also the common and civil law system. The legal dogmatic approach is used when discussing and describing the existing law and practice by looking at legislation, standard forms and relevant case law.

1.4. Disposition

In the following two chapters, different types of marine insurances will be described. The second chapter will focus on insurances the shipowner takes

out in order to protect the vessel against risks it is exposed to. The subsequent chapter will describe insurances specifically designed to protect mortgagees and the risks a ship financier faces. These two chapters will be of a descriptive nature and the purpose is to have them to serve as a base in order to enhance the understanding of the remaining chapters which will address the questions stated above. Chapter four and five will set the focus on marine insurance from a bank's perspective and chapter six describes discernible market trends within this area.

The final part of the essay consists of an analysis and conclusion chapter where the main points are presented and scrutinised in a closing statement which aims to tying the whole essay together.

CHAPTER 2

SHIPOWNER'S INSURANCES

2.1. Introduction

The United Kingdom and in particular London is, and has for a long time been, the centre of marine insurance. The vast majority of marine insurances taken out are placed in London. The main reason why large parts of the marine insurance business have ended up there is because of Lloyd's of London that started out in a little coffee shop on Tower Street in central London 1688.⁴ Lloyd's building, today situated on Lime Street in the City of London, is still a meeting place for insurance brokers and underwriters to carry out business. Lloyd's itself is not an insurance company but it is the world's leading insurance market.⁵ London is the city where the practice of carrying out marine insurance business has developed to what it is today. British legislation has therefore influenced and shaped the industry, not only within the United Kingdom but also the rest of the world. The Marine Insurance Act of 1906⁶ (MIA) in particular has played an important role. When it was drafted it aimed to codify the law and practice relating to marine insurance as it was applied back then. The Act is still in force and although it has survived over a century it is still highly reputable and obeyed by marine insurance practitioners as it lays down the main principles that are still to be applied.⁷

⁴ J.A. Herschaft, "Not Your Average Coffee Shop: Lloyd's of London-A Twenty-First-Century Primer on the History, Structure, and Future of the Backbone of Marine Insurance", *Tulane Maritime Law Journal* (2005), Volume 29, Number 2, p. 170.

⁵ <http://www.lloyds.com/Lloyds/About-us/History>.

⁶ English Marine Insurance Act 1906, An Act to Codify the Law Relating to Marine Insurance [21st Dec 1906].

⁷ K. Grönfors (ed) and L. Zetterman, *Intermediaries in Shipping*, Svenska Sjörettsföreningens Skrifter (1990), Number 69, Gothernburg, Akademiförlaget, p. 123.

This brief historical background aims to explain the reason why reference sometimes is made to English law and practice. The simple explanation is because this has influenced the rest of the world and plays an important role also outside the British borders. England's importance and influence is not confined to marine insurance; given the nation's long history as one of the greatest within shipping, the area of ship finance is also affected.

A ship financier that has a vessel as security for repayment of the loan must make sure the asset is sufficiently insured. Just take the scenario where a single ship company with barely any other assets of notably value than the ship itself borrows money from a bank against the ship as a mortgage. The bank will become almost exclusively dependent on the ship and the money it generates. If the ship becomes a total loss without any assigned insurance cover or with assigned insurance cover that does not pay due to the surrounding circumstances, the bank would have to find itself in a very unpleasant position. Most of the banks involved in ship finance today have become more cautious and more demanding when it comes to the insurances in relation to the collateral. They wish to underpin the credit in the best possible way and the insurance cover is certainly one important element in order to run as small credit risk as possible.

Before a loan is granted, the financier would want to make sure that the borrower is a trustworthy party and that the money made from the operation of the vessel by far exceeds the amortise requirements including interest. If the borrower gets forced to sell the vessel, the sales proceeds shall also preferably be of an amount big enough to clear the debt. An extensive insurance package shall be obtained and paid by the borrower, including Hull and Machinery (H&M), Increased Value (IV), War, Protection and Indemnity (P&I) and ideally also additional mortgagees' insurances.⁸ Furthermore, in order for the bank to enjoy the full benefits of the insurance

⁸ *The Banker's Guide to Insurance Aspects of Ship financing*, published by BankAssure Insurance Services, 2003, page 3-4.

policies, adequate assignments of the insurances needs to be made. This will give the financier a position as a loss payee and will thus become the party to whom the insurance proceeds are paid out to.

2.2. Hull & Machinery Insurance

H&M is a property insurance that protects the ship itself, its machinery and equipment.⁹ Depending on which insurance conditions the policy is subject to, cover will either be for loss of or damage to the ship arising from any of the specified perils in the insurance contract, or for all loss and damage caused to the ship apart from expressed exclusions. When the policy provides cover for all losses without limiting the cover to certain listed perils only, the insurance is placed on an ‘all risk basis’. When certain specific perils are listed in the policy, cover is placed on a ‘named peril basis’. Examples of insurance conditions on a named peril basis are the International Hull Clauses (01/11/03) (IHC), Institute Time Clauses – Hull (01/10/83) (ITC – Hull) and the American Institute Hull Clauses (June 2, 1977) (AIHC). The cover provided by the Nordic Marine Insurance Plan of 2013 (NMIP) on the other hand is wider since it is on an all risk basis. The London Clauses (ITC – Hulls and IHC) impose the burden of proof on the assured who will need to present evidence convincing the insurer that the loss falls under the cover. The NMIP on the other hand is taken a more shipowner-friendly approach, placing the onus on the insurer to prove that the loss falls outside the insurance cover.¹⁰ The ‘all risk basis’ is clearly the preferred basis both from a shipowner’s and a mortgagee’s perspective and, surprisingly enough, the NMIP is not priced much differently.¹¹

⁹ Skuld, *An Introduction to P&I Insurance for Mariners*, page 3. Available online at: http://www.fd.unl.pt/docentes_docs/ma/wks_MA_16683.pdf (9th February 2013).

¹⁰ NMIP, clause 2-12.

¹¹ *Supra*, note 8, page 9; *Supra*, note 3.

Some of the perils covered under the 'Named Peril' Conditions mentioned above are; fire, lightning, earthquake, perils of the sea, jettison, accidents in loading and discharging (in ITC - Hull and AIHC this peril is subject to a due diligence provision excluding cover if loss or damage resulted from want of due diligence by the Assured, Owner or Manager) and negligence of master, officer, crew or pilot (subject to a due diligence provision under all three conditions).¹² The Areas where the vessel is allowed to trade is also stipulated in the policy whereby limits are set by a Trading Warranty Clause¹³. It is important to comply with these restrictions as a breach may suspend the cover.¹⁴ The areas excluded for trading are areas seasonally hostile and if the assured wishes to enter any of these areas, prior agreement shall be obtained from the insurer and additional premium or amendments to the policy conditions may be required.¹⁵

Piracy can be covered under both H&M and War insurance. The NMIP and the AIHC excludes piracy from their H&M cover whilst the English clauses (ITC – Hull and IHC) do not.¹⁶ Since it is possible for the assured to place the different types of insurances on different terms, it is important to make sure that no gap occurs. If for example the H&M insurance is subject to the NMIP but the War insurance is subject to the Institute War and Strike Clauses Hulls – Time (01/10/83), none of the insurances will cover piracy.¹⁷ This could lead to the detriment of both the shipowner and the mortgagee since no claim could be made under neither of the policies. Furthermore, in a situation like this, it is highly unlikely that a mortgagee would be able to

¹² ITC – Hull, clause 6; IHC, clause 2; AIHC, lines 70-86).

¹³ See for example the American Institute Warranties 1.7.72; Institute Warranties 1.7.76; the Nordic Trading Warranties, clause 3-15.

¹⁴ *Supra*, note 9, page 4.

¹⁵ *Supra*, note 8, page 19.

¹⁶ NMIP, clause 2-8 and 2-9; AIHC, line 245; ITC – Hulls, clause 6.1.5; IHC, clause 2.1.5

¹⁷ NMIP, clause 2-8 and 2-9; Institute War and Strike Clauses Hulls – Time (01/10/83), clause 4.1.7.

clear the outstanding debt by claiming compensation under a MII policy since there never was an underlying cover in place.¹⁸

MIA section 55 regulates the question of causation and states that ‘the insurer is liable for any loss proximately caused by a peril insured against’ but is ‘not liable for any loss which is not proximately caused by a peril insured against.’ The distinction is not always clear cut. In *Leyland Shipping Co v Norwich Union Fire Ins Society*,¹⁹ the insurance contract provided cover for perils of the sea but it was also warranted free from all consequences of hostilities. The vessel was hit by torpedoes and had to be brought to port where it grounded at each ebb tide but floated again when the flood came. Consequently, due to the severe strains, the vessel broke her back, sank and became a total loss. The assured argued that the tide was a new cause which was proximate to the loss. The court on the other hand came to the conclusion that the chain of causation was unbroken from the time the vessel was torpedoed and that the warranty therefore protected the insurers from liability.²⁰

The H&M insurance does also normally cover some liabilities; collision liability is one example. The Running Down Clause covers the assured for liabilities arising from a collision with another vessel whereas the Fixed and Floating Objects Clause provides cover if the ship collides with object other than another ship.²¹ This is however an area where the H&M cover and the P&I insurance can miss-match and it is therefore important for the assured to make sure that this does not happen. If there was a gap in the underlying cover that would also negatively affect the mortgagee since MII normally would not cover. Generally speaking, in the event of a collision, H&M

¹⁸ The shipping financier’s need for Mortgagees’ Interest Insurance, *Gard News*, Issue No. 175, 2004.

¹⁹ (1918) AC 350 122.

²⁰ Trine Lise Wilhelmsen and Hans Jacob Bull, *Handbook in Hull Insurance*, Gyldendal Norsk Forlag AS, Oslo, 2007, page 125.

²¹ *Supra*, note 9, page 3.

insurance should protect the shipowner against damage and losses to his own vessel whilst the P&I insurance should cover damage to other property caused by his vessel. However, under AIHC and continental H&M conditions such as the Nordic, German and French, collision liability is covered in full unless the assured and insurer have agreed otherwise. The English clauses on the other hand only provides 3/4th collision liability cover and the remaining 1/4th will be covered under the P&I Insurance. Although the H&M insurance includes full collision liability cover, the insured value under this type of insurance implies a maximum limit of the amount payable. The P&I Insurance will therefore serve as complementary cover in large liability claims as it would cover any shortfalls under the H&M Insurance. In some situations the H&M insurance excludes collision liability absolutely and in those instances it is of utmost importance for the shipowner to make sure that full cover is provided by the P&I Association.²²

In the event of a claim, an assured must bear a certain amount of the costs himself, a deductible, before claims proceeds from the insurers can be submitted.²³ A shipowner can get lower premium by increasing the deductible but high deductibles could also be imposed on shipowners by the insurers due to bad claims record.²⁴

²² Skuld, *Safely with Skuld – How to prevent losses on board ship*, page 34-35. Available online:

<http://www.skuld.com/upload/News%20and%20Publications/Publications/Safely%20with%20Skuld%202005/FFO%20and%20RDC.pdf> (9th February 2013).

²³ *Supra*, note 9, page 3.

²⁴ *Supra*, note 8, page 19.

2.3. Increased Value, Disbursement, Hull Interest and Freight Interest

This type of insurance is basically obtained to cover an assured for additional costs and expenses following a total loss of the vessel such as costs for replacing a lost ship but also office expenses. Additional excess liabilities in terms of General Average, Salvage, Sue and Labour costs and sometimes also liabilities following a Collision are also included under this type of cover.²⁵

Traditionally, under the MIA, the hull policy was only allowed to cover up to an amount not higher than the market value of the vessel itself. This amount was also considered to be equal to the shipowner's 'insurable interest'. However, shipowners were successful in proving that additional expenses, in excess of the market value of the vessel, arose as a consequence of a total loss of the vessel and additional cover was therefore needed. The need for extra cover is recognised today and IV, Disbursement, Hull Interest and Freight Interest cover are available for shipowners on the insurance market.²⁶ The different names are really just a matter of which insurance conditions the policy is subject to; the NMIP calls the cover 'Hull Interest' and 'Freight Interest' whilst other clauses such as the English, German and French calls it 'Increased Value' and 'Disbursement'.²⁷

The standard wording of ITC – Hulls, IHC, AIHC and NMIP, all contain a limit not allowing more than 25% of the hull value to be taken out as IV Insurance.²⁸ It can however be agreed otherwise but in such circumstances it

²⁵ *Ibid*, page 10; <http://www.swedishclub.com/upload/174/18.increased-value-hull-interest.pdf> (9th February 2013).

²⁶ <http://www.swedishclub.com/upload/174/18.increased-value-hull-interest.pdf> (9th February 2013).

²⁷ *Supra*, note 8, page 10.

²⁸ ITC – Hulls, clause 21.1.1; IHC, clause 24.1.1; AIHC, line 215-217; NMIP, clause 14-4.

is important that the shipowner ensures that both the H&M and the IV insurers are aware and consent to it.²⁹ The allocation of these amounts must also be in line with the loan agreement if such agreement is in place.

Shipowners can save premium costs by obtaining IV Insurance to partially cover the vessel's market value. This is because the coverage provided for total loss under IV Insurance is cheaper than the total loss element under the H&M cover. It is however common for the insured values under both covers to exceed the market value of the vessel. This gives some leeway for market fluctuations during the insurance period.³⁰ Another reason, apart from those stated above, could be requirements to the amount insured in a loan agreement.

2.4. War and Strike Risks Insurance

The H&M Insurance excludes cover for warlike operations and the shipowner will therefore need a separate cover against these risks.³¹ Some risks typically covered under a War policy are arrest, revolution, terrorism, confiscation, war, civil war, seizure and strikers.³² The different conditions provide different scope of coverage but if the shipowner wishes to extend the cover, risks like sabotage (already covered by NMIP³³), vandalism, blocking and trapping can be included.³⁴ Certain specific risks are also

²⁹ *Supra*, note 8, page 10.

³⁰ *Supra*, note 26.

³¹ Susan Hodges, *Cases and Materials on Marine Insurance Law*, Cavendish Publishing Limited, London, 1999, page 557; ITC – Hulls, clause 23-25; IHC, clause 12; AIHC, line 239-255; NMIP, clause 2-8.

³² See for example NMIP, clause 2-9; the American Institute Hull War Risks and Strikes Clauses (December 1, 1977), clause 1-6; Institute War and Strike Clauses Hulls – Time, clause 1.

³³ NMIP, clause 2-9 (c).

³⁴ *Supra*, note 8, page 9.

normally excluded from the War policy; the following are some examples: Nuclear war, outbreak of war between any of the five great powers (China, United States, Russia, United Kingdom and France) and confiscation by the Flag State's government.³⁵ War policies do also contain a cancellation clause, entitling the insurer to cancel the policy by giving prior notice (typically one or two weeks) to the assured (and the mortgagee if the policy is subject to the NMIP).³⁶ The reason is historical and the cancellation clause was first inserted in War covers to save underwriters from overwhelming war exposures that were impossible to control. War risk underwriters monitor conflicts worldwide very closely today so that notice of cancellation can be given if needed. These clauses clearly impose complications for mortgagees since coverage can be ceased after only one week prior notice.³⁷ This is one reason why financiers with collateral security operating in hostile areas are recommended to take out an additional insurance policy of MRI in which the cancellation provisions are much more restricted.³⁸

War P&I cover is typically offered under a shipowner's primary war policy, normally up to a separate limit of the insured value under the H&M and IV added together. A pre-determined limit can also be provided, for example USD 300 million, independent on whether the H&M plus IV amounts to

³⁵ See for example Institute War and Strike Clauses Hulls – Time, clause 4; the American Institute Hull War Risks and Strikes Clauses (December 1, 1977), Exclusions (a-f).

³⁶ See for example NMIP, clause 15-8; the American Institute Hull War Risks and Strikes Clauses (December 1, 1977), Automatic Termination and Cancellation Clause (D); Institute War and Strike Clauses Hulls – Time, clause 5.1.

³⁷ *Supra*, note 8, page 20-21.

³⁸ Representative of Aon BankAssure Insurance Services, Aon Benfield, Presentation at Giek, Oslo 19 February 2013.

more or less.³⁹ The war P&I is not affected by the cancellation clause in the war cover but will only pay amounts in excess of the value of the vessel.⁴⁰

Terrorism is normally included under standard war conditions⁴¹ and the IGA used to offer War etc. P&I (including terrorism) cover up to a limit of either USD 50 Million or USD 100 Million; a supplementary cover to pay amounts in excess of the primary cover provided by the War Risks underwriters.⁴² Following 9/11, IGA decided to exclude cover against terrorism but it may be reinstated by payment of additional premium up to a limit of USD 500 Million (2010).⁴³

The trading limits under War Risks insurance are separated from those specified in the H&M policy. War cover normally include so called 'listed areas' confining areas where the ship is allowed to trade. When entering such listed area additional premium has to be paid.⁴⁴ The listed areas are normally political unstable with risks for warlike operations or afflicted by pirates. A 'held cover clause' is usually inserted in the policy, allowing the owner to breach the trading warranty but subject to payment of additional premium and promptly given advice to the insurer. Failure by the shipowner to comply with these conditions can have serious implications for the

³⁹ See for example the War P&I risk cover limit offered by Den Norske Krigsforsikring for Skib: https://www.warrisk.no/Internet/War_risk_cover/P+I_and_occupational_injury/ (11th February 2013).

⁴⁰ *Supra*, note 3.

⁴¹ See for example See for example NMIP, clause 2-9 (c); Institute War and Strike Clauses Hulls – Time, clause 1.5; the American Institute Hull War Risks and Strikes Clauses (December 1, 1977) do neither include nor exclude 'terrorism' (compare clauses 1-6 and the exclusions stipulated in clause a-f) but provide cover for 'Malicious acts or vandalism' (clause 5).

⁴² <http://www.swedishclub.com/upload/P&I1163/2013-01-pni-insurance-part-2.pdf>; *Supra*, note 8, page 21; Steven J. Hazelwood and David Semark, *P&I Clubs Law and Practice*, Informa Law, 4th edition, 2010, page 145.

⁴³ *Supra*, note 8, page 21; <http://www.standard-club.com/ProductsAndServices/page.aspx?p=79>.

⁴⁴ *Supra*, note 9, page 5.

mortgagee since coverage may be suspended.⁴⁵ If the ship intends to enter an area excluded by the trading limits and the shipowner (or charterer) think it is too expensive to pay additional premium, a separate cover can be taken out. Loan agreements normally specify war risks to be covered, without specifying the individual risks like for example piracy. This means that if the ship is about to enter an area affected by piracy, the shipowner can, without breaching the loan agreement, take out a separate war cover, excluding the risk of piracy. By doing this, the assured can obtain a much better price but for a cover that in many aspects is inadequate. It is doubtful whether a MII policy would respond following a piracy attack given the fact that there never was any underlying cover for this risk. Because of this, it is recommended that mortgagees make sure that some important individual risks are explicitly provided for in the loan agreement.⁴⁶

Just like piracy, the Missing Vessel Clause could be found under both War and H&M. As such, it is important to make sure no miss-match leads to gap or overlap of coverage which could cause problems both for the assured and mortgagee. The Missing Vessel Clause developed many years ago when the communications between ships and shore was carried out with not always reliable communication tools. Historically vessels did disappear without a trace and for no obvious reason. In a situation like this, the war and H&M underwriters could argue which policy should respond and the assured would be caught in the middle with underwriters refusing to settle the claim. To avoid an undesirable position like this, a Missing Vessel Clause was inserted in policies stating for example that a loss like this should be deemed to fall under the war policy. Some clauses of this type states that the loss should be recoverable 50% by H&M underwriters and the remaining 50% by the War insurers.⁴⁷

⁴⁵ *Supra*, note 8, page 19; Steven J. Hazelwood and David Semark, *P&I Clubs Law and Practice*, Informa Law, 4th edition, 2010, page 145.

⁴⁶ *Supra*, note 3.

⁴⁷ *Ibid.*

Circumstances are different today however since well-developed communication gear and weather forecast often provide sufficient information in order to assess the cause of the loss. The same need to include such a clause does therefore not exist anymore since if the cause of the loss can be identified, the claim could be submitted to the correct underwriters.⁴⁸

The NMIP includes a Missing Vessel Clause which states that such loss should be considered as falling under the H&M policy.⁴⁹ From a mortgagee's perspective, a typical MII wording offers protection to the bank, after a waiting period of normally one year, if the War and H&M underwriters dispute about which policy should pay.

2.5. Loss of Hire Insurance

A requirement to take out Loss of Hire (LOH) insurance is not yet a standard provision in loan agreements but there is an increasing trend to have this type of cover included as well.⁵⁰ It can be described as a 'nice to have insurance' that rich owners tend to take out although, ironically, these are the ones that need it the least.⁵¹ LOH covers the shipowner for the loss of earnings under a charter party but also for capital and operational costs following damage to the ship covered under the H&M policy.⁵² The existence of a charter party is required to claim loss of hire or freight but LOH insurance can also cover a ferry for its daily running costs whilst the

⁴⁸ *Ibid.*

⁴⁹ NMIP clause 11-7, Part Two (Hull Insurance).

⁵⁰ Richard Henderson, *Ship Finance Law*, Watson Farley and Williams, page 41.

⁵¹ *Supra*, note 38.

⁵² Robert T. Lemon II, Allocation of Marine Risks: An Overview of the Marine Insurance Package, *Tulane Law Review*, Volume 81:1467, 2007, page 1477; <http://www.swedishclub.com/upload/174/22.loss-of-hire.pdf> (10th February 2013).

vessel undergoes repair.⁵³ The loss must have been caused by a peril insured against under the H&M cover but War LOH can also be purchased to obtain cover against losses caused by perils covered under the War Risk policy.⁵⁴ Claims following actual or constructive total loss of the vessel are excluded under this type of cover.⁵⁵

LOH insurance is written on a basis, allowing the assured to claim a specified amount for a specified number of consecutive days in excess of a deductible in form of a waiting period, normally two weeks. An upper limit is also set by the maximum number of days the assured can claim coverage per policy year.⁵⁶ The policy could for example stipulate cover for a daily amount of USD 15,000 on a 14/90/180 basis. This means that the policy would start pay after the commencement of 14 days, a daily payment of USD 15,000 would then be made for a maximum of 90 following days. If the assured suffers more losses during the same policy year, 180 days of compensation will be the overall limit. However, reinstatement of cover is normally possible to obtain against payment of additional premium if the assured exhaust the maximum days coverable at an early stage of the policy period.⁵⁷

⁵³ Robert T. Lemon II, *Allocation of Marine Risks: An Overview of the Marine Insurance Package*, Tulane Law Review, Volume 81:1467, 2007, page 1477; *Supra*, note 8, page 12.

⁵⁴ Robert T. Lemon II, *Allocation of Marine Risks: An Overview of the Marine Insurance Package*, Tulane Law Review, Volume 81:1467, 2007, page 1477; <http://www.swedishclub.com/upload/174/22.loss-of-hire.pdf> (10th February 2013).

⁵⁵ Robert T. Lemon II, *Allocation of Marine Risks: An Overview of the Marine Insurance Package*, Tulane Law Review, Volume 81:1467, 2007, page 1478.

⁵⁶ *Ibid.*

⁵⁷ <http://www.swedishclub.com/upload/174/22.loss-of-hire.pdf> (10th February 2013).

2.6. Protection & Indemnity Insurance

P&I Clubs provide mutual insurance where shipowners as members insure one another severally.⁵⁸ The IGA consists of 13 P&I Clubs, located worldwide, providing approximately 90% of the world's ocean-going tonnage P&I cover. Coverage include liabilities arising out of personal injury to crew and passenger, pollution, wreck removal, collision liability (in excess of what is already provided under the H&M cover), loss or damage to cargo, losses arising from negligence of Master and crew and other third party liabilities that can arise while operating a ship.⁵⁹ Each year, all clubs within the IGA issue an annual rule book specifying the cover provided and the terms of entry.⁶⁰ It is not mandatory for each member to obtain the full package of cover provided by the club; each member can negotiate with the club and agree upon protection to meet individual needs.⁶¹ The member will receive a Certificate of Entry each year stipulating the name of the member and the vessel entered in the club and also the cover provided, including any restrictions or additions. This document, however, is not an insurance policy.⁶²

In order to have the vessel protected by the P&I Club it must be classed and remained in class during the whole period of entry, be in possession of required safety certificates and also comply with requirements of the Flag State.⁶³

⁵⁸ J. Iam, Murray, *The Protection and Indemnity Club and Bankruptcy: An English Perspective*, *Tulane Law Review*, June 1985, No. 59, section 1445.

⁵⁹ <http://www.igpandi.org/> (10th February 2013); *Supra*, note 8, page 10.

⁶⁰ *Supra*, note 8, page 24.

⁶¹ Steven J. Hazelwood and David Semark, *P&I Clubs Law and Practice*, Informa Law, 4th edition, 2010, page 50.

⁶² *Supra*, note 8, page 24.

⁶³ See for example clause 28.4.1, 28.4.3 and 29.1.4 of *Skuld, Statutes, & Rules, 2013*.

The structure of the P&I clubs' insurance arrangement are unique and complex. It can be described as different layers of cover where the individual club pays an 'in house retention' of USD 9 million. In excess of this, all clubs within IGA share the loss up to an overall limit of USD 70 million. Large claims above this amount will be protected by one of the largest reinsurance programs in the world, providing cover up to USD 3 billion for a shipping casualty.⁶⁴

From a mortgagee's perspective, the first retention of USD 9 million is the only amount that could have an impact on the credit. Liabilities above this are, as described above, pooled and reinsured. A shortfall on the first USD 9 million payment would probably not be recoverable under a MII policy.⁶⁵

⁶⁴ Marine Markets underwhelmed by \$3bn IG renewal quote, *The Insurance Insider*, 16 January 2013.

⁶⁵ *Supra*, note 3.

CHAPTER 3

MORTGAGEES' INSURANCES

3.1. Introduction

Compensation from the shipowner's insurances following a claim cannot be taken for granted. Underwriters can avoid the policy in certain situations; one example is if the assured is found to be in breach of a warranty, other examples are described below. Although the policies had been assigned adequately to the benefits of the mortgagee, that would not have made any difference since the assignee will be regarded as being in the same position as the assignor and the underwriters will therefore be able to use the same defences against the assignee as they would have been able to use against the assignor. This is also described more in detail below.

The three most common insurances for marine financiers are MII, MAPP and MRI. They all protect different risks that a mortgagee can be exposed to. It is up to the financier which different covers shall be required. MRI which is a fairly expensive cover is for obvious reasons not as necessary for ships and offshore assets operating in traditionally safe countries compared to nations suffering from political instability. MAPP is in particular important for ships trading in American waters, mainly because of the US Oil Pollution Act of 1990 (OPA '90), but is also a comforting extra cover for the mortgagee to have although the vessel operates elsewhere. Major oil spills with clean-up costs for enormous amounts of money have made financiers aware of the potential detrimental impact this could have on their credit.

All the above mentioned insurances are specially designed to protect ship financiers and the market trend shows that they are becoming more and

more popular in the insurance package required by the lender before funds are advanced to the borrower.

3.2. Mortgagees' Interest Insurance

It is now almost market practice to include MII in the insurance package for vessels that are being collateralised against a credit facility to its owner. Many ship owning companies are single-ship companies with the vessel as the only available asset to provide security against a loan. Therefore, from a lender's perspective, it is of vital importance to protect the ship as collateral by all available means.⁶⁶ The owner's marine insurances normally required in a ship finance transaction, i.e. H&M, IV and War, shall all ideally be assigned to the mortgagee through a Notice of Assignment (NOA) accompanied by a Loss Payable Clause (LPC) attached to the policies. The mortgagee will then be the sole loss payee in the event of claims above a pre-agreed amount stated in the LPC. The shipowner will only be entitled to claims proceeds above the mortgagee's indebtedness. However, as stated in MIA section 50(2), an assignee cannot be placed in a better position than the original assured, and as such, the insurers will be entitled to invoke the same defences against the mortgagee as they could have done against the assignor. This means that the assignment will be worthless if the assigned policy does not respond to a claim. As already mentioned above, the English clauses are named peril based and impose the burden on the assured to prove that the loss is covered. These clauses also contain warranties of which a breach entitles underwriters to avoid the policy.⁶⁷ In a situation like that a MII policy would respond and recover the mortgagee's indebtedness. This is the reason why the primary insurances cannot be seen as a guarantee

⁶⁶ *Supra*, note 8, page 107.

⁶⁷ C.f. MIA section 33(3).

for the ship financier and additional MII protection is therefore needed.⁶⁸ Other situations where MII would protect the mortgagee when the primary insurances do not cover is in the event of cancellation of the shipowner's policy due to non-payment of premium, non-disclosure, misrepresentation, scuttling, breach of trading warranty, unseaworthiness and vessel out of class or without obligatory ISM certificate. Furthermore, MII will also protect the mortgagee in a situation where the P&I club rejects to put up security following an arrest and where a third party claim is not met, resulting in a maritime lien being created which 'primes' the mortgage.⁶⁹

MII is a 'contingent' policy and not a 'difference in condition policy'. By this is meant that the basis of coverage under the MII is the same, with just a few exceptions, as under the primary insurances apart from a breach or cancellation event (see the examples above). So in order for the MII to 'kick in', the loss should be prima facie covered by the underlying policies. However, as indicated above, the MII policy is not always strict 'contingent'; some MII wordings also cover the mortgagee if the shipowner fails to prove a loss as caused by a 'peril of the seas'.⁷⁰ Since the scope of MII cover is dependent on the underlying policies, it is of utmost importance that the mortgagee carefully monitors these policies to make sure they are in place. A LOU issued by the shipowner's insurance broker, addressed to the bank, is crucial since it imposes obligations on the broker towards the bank that puts the bank in a stronger position. For example, in a 'standard' LOU, some of the undertakings the broker needs to abide is to notify the bank if they cease to be the broker of the assured, to advise the bank in the event of material changes in the coverage or if they receive notice of cancellation by any underwriter.⁷¹

⁶⁸ Roger Billis, High noon for mortgagee interest insurance, *International Financial Law Review Marsh* 1987, page 37.

⁶⁹ *Supra*, note 18.

⁷⁰ *Ibid.*

⁷¹ *Supra*, note 8, page 39.

Although a MII policy often ‘captures’ uncollectable claims under the primary insurances, there are exclusions also under this cover. The mortgagee will not be able to bring a claim under a MII for events outside the scope of the shipowner’s underlying policies (wear and tear for example) or for excess deductibles under the shipowner’s policies. Nor do MII policies cover situations where the underwriters under the primary policies fail to meet a claim due to insolvency.⁷² This is why loan agreements normally allow banks to approve the underwriting security for the H&M, IV and War policies. Mortgagees will also normally have the right to require replacement of an underwriter that is no longer approved due to downgrading or some other reason.

A MII policy aims to put the mortgagee back in the position he would have been in if the underlying insurances had paid the claim in full. The amount insured relates to the sums insured in the underlying policies which in turn relates to the asset value and outstanding debt. An additional amount of 10%-25% is in general added to the MII sum insured in order to cover interest and additional expenses that can arise when monitoring and maintaining loans in default.⁷³ The amount payable under a MII policy is the lesser of the primary insurances’ amount insured, the outstanding loan amount, or the MII sum insured.⁷⁴

The assured’s duty of disclosure under a MII policy is not straightforward. It is a complex dilemma and the core problem is that the more the assured knows about the shipowner and his business, the more likely it is that the MII underwriters refuse to settle a claim due to non-disclosure. The best way for the mortgagee to supervise the borrower’s business is therefore through conditions in the loan agreement regarding ISM certificates, compliance of Flag State requirement, maintenance of class and minimum requirements of sums insured. One way for the lender to reduce the risk of

⁷² *Supra*, note 68, page 37.

⁷³ *Supra*, note 18.

⁷⁴ *Supra*, note 68, page 38.

alleged non-disclosure is by establishing with the underwriters the information that needs to be disclosed at the inception and during the insurance period.⁷⁵ Another way is to use a separate insurance broker for the placing of the shipowner's insurances and the placing of the lenders MII insurances. If the same broker is used there is an increasing risk for the MII underwriters to allege non-disclosure since every piece of information the borrower's broker is made aware of then needs to be passed to the MII underwriters in order to comply with the duty of disclosure. Failure to disclose a shipowner's financial difficulties could render the MII policy void. The shipowner's broker is expected to receive more information about the business and financial status of his client than an independent MII broker. Another reason to use separate brokers is conflict of interest. The shipowner is the principal and primary client of his broker. If the same broker served as the bank's agent, it would not be possible to act in the best interest of both clients since they have different needs and interests; this is particularly clear in the event of a MII claim.⁷⁶

The Institute Mortgagees' Interest Clauses (1/3/97) Clause 337-97 states that the underwriters of the MII policy will pay a claim as soon as the mortgagee can establish that either every possible attempt has been made to collect the claim from the shipowner's insurances, or alternatively after a 'final court judgement' or 'arbitration award' has been received in favour of the shipowner's underwriters. A third way to get paid is by referring the matter to an arbitrator in order for the mortgagee and the MII underwriters to agree upon the payment issue.

The paradox in this situation is that the mortgagee might end up in two proceedings whereby arguments needs to be made in an arbitration against the MII underwriters that the action against the shipowner's underwriters is deemed to fail whereas that action might still be on-going with the mortgagee participating on the shipowner's side, staying optimistic in the

⁷⁵ *Supra*, note 8, page 109.

⁷⁶ Stephenson Harwood, *Shipping Finance*, Euromoney Books, London, 1991, page 354.

event the proceedings against its own underwriters turns out to be unsuccessful.⁷⁷ Furthermore, obtaining a ‘final judgement’ may take several years depending on the court system in the jurisdiction proceedings are brought in. A case might need to go through quite a few appeals before the required ‘final judgement’ can be given.⁷⁸ To make it all even more complicated, there is no clear-cut definition of what constitutes a ‘final judgement’; English law for example does not even have a definition. In order to avoid this, the mortgagee should wish to include a time for payment clause in the MII policy stating that the claim can be collected after a waiting period of for example one year from the day the shipowner’s underwriters first rejected the claim. If the shipowner’s underwriters subsequently agree paying, the MII underwriters will get their money back and the mortgagee will receive money from the shipowner’s policy proceeds in accordance with the assignment of insurance.⁷⁹

MII is in general lucrative business for underwriters since the claim frequency is relatively low. However, during economic downturns MII claims tends to rise as a result of more claims under shipowners’ policies. This is an outcome from increased likelihood of; owners getting involved in illegal or high risk trade, cancellation of policies due to non-payment of premium and vessels being unseaworthy due to poor maintenance as a result of cutting down costs to save money.⁸⁰

⁷⁷ *Supra*, note 68, page 38.

⁷⁸ *Supra*, note 8, page 108.

⁷⁹ *Supra*, note 18.

⁸⁰ *Ibid.*

3.3. Mortgagees' Additional Perils (Pollution) Insurance

MAPP provides the mortgagee cover for oil pollution claims that exceeds the shipowner's pollution cover under the P&I insurances. It is not a cover like MII that 'kicks in' when the underlying policies do not pay for certain specific reasons, mainly fault on behalf of the shipowner, instead it is an additional cover that will pay the mortgagee and compensate up to the outstanding debt in the event the primary pollution cover turns out to be insufficient. A MAPP policy is drafted as an adjunct to a MII policy to make a combined policy whereby MII covers non-payment, partly payment or discretionary payment by the P&I club and MAPP covers for insufficient pollution cover. The insurances are needed as confiscation could follow from an unsatisfied claim.⁸¹

Until the 1980s, the clubs within the IGA offered unlimited pollution cover to their members.⁸² This unlimited cover was later abolished and the clubs introduced a cap on pollution damage which 1989 was set to be USD 300,000,000. The reason why this cap was introduced was because of the potential size of liability claims that could arise following major casualties and also as a reaction to the enactment of OPA '90.⁸³ This act was implemented to the US legislation after the *Exxon Valdez* oil spill 1989. The clean-up operation following this major casualty exceeded USD 5,000,000,000. As mentioned above, the oil pollution cover offered by the IGA clubs was at that time set to be USD 300,000,000 but has now been increased to the current limit of USD 1,000,000,000.⁸⁴ Ship financiers became aware of this risk that could threaten their credit and MAPP cover

⁸¹ *Supra*, note 76, page 355.

⁸² *Supra*, note 50, page 43.

⁸³ *Supra*, note 3.

⁸⁴ Unpublished material provided by Aon Benfield, BankAssure.

came to be a requirement in many loan agreements following this event, especially in respect of oil tankers.

OPA '90 imposes unlimited liability in the event a shipowner or ship operator is found guilty for an oil spill as a result of wilful misconduct, gross negligence, breach of federal safety regulation, construction regulation or operating regulation. Even more extensive legislation applicable in the individual states can also be established. Since there is no mortgagee exception within OPA '90, US tort law allows a claimant to prime the mortgage. The mortgagee runs the risk of losing the collateral security as a US court can confiscate the vessel if the pollution claim is not met. Other assets belonging to the shipowner or ship operator can also be confiscated, including other vessels under the same direct or indirect ownership.⁸⁵ The American government is given great powers to take out on a vessel that is found liable for a pollution accident within US jurisdiction. For example, if the vessel becomes a total loss, authorities will have the possibility to seize the insurance proceeds and use the money for clean-up costs. The insurance proceeds would typically be paid straight to the mortgagee in accordance with the NOA and LPC but by way of the OPA '90 wording, American authorities could overrule these mortgagee's rights. If the vessel only suffers small damage or no damage at all, the US government could seize the whole vessel and gain funds for clean-up by way of a forced sale. The mortgagee would not be able to claim priority over the sale proceeds.⁸⁶

Certificate of Financial Responsibility (COFR) is another notion under the OPA '90. Vessels bigger than 300 gross tonnage are required to comply with the COFR regulations.⁸⁷ Adequate evidence of liability coverage must be provided; it is not enough with the cover offered by any of the IGA

⁸⁵ *Supra*, note 76, page 355.

⁸⁶ *Supra*, note 84. .

⁸⁷ <http://security.obriensrm.com/go/doc/4411/1421827/Certificate-of-Financial-Responsibility-COFR->, (26 February 2013).

clubs. The level of COFR required depends on the size of the vessel. The reason why the American authorities do not find P&I cover adequate is because of the ‘third party indemnity’ concept and the so called ‘pay to be paid’ rule according to which the club theoretically can avoid a claim unless the shipowner pays the injured party first.⁸⁸ The ‘pay to be paid’ rule is however very rarely invoked and an assured member entered into one of the IGA P&I clubs should be confident that the club will pay a claim.⁸⁹ The provider of a COFR guarantee must compensate the difference between the P&I compensation and the financial guarantee in force. This means that the COFR guarantor will be left with the full claim in the event the P&I club refuses to pay.⁹⁰

Tankers and oil rigs operating within a distance where an oil spill would threaten US waters are clearly most likely to cause a massive oil spill that triggers a MAPP policy to pay. However, other vessels that could be held responsible following a collision are also at risk.⁹¹ If more than one vessel is involved in a casualty causing a massive oil spill, the P&I clubs typically offer their limited cover per entered vessel. This means that the limit will be multiplied subject to the number of vessels involved which are held liable.⁹²

Whilst most nations have ratified conventions limiting the liability for shipowners to an amount below the cover provided by the IGA, some important nations have not; Brazil and United States are the most notable ones.⁹³ This means that vessels trading within these areas could end up being responsible for pollution claims above the P&I cover and a MAPP policy would protect the mortgagee should such a claim become reality. This is the reason why some ship financiers insert a condition in the loan

⁸⁸ *Supra*, note 84.

⁸⁹ *Supra*, note 3.

⁹⁰ *Supra*, note 84.

⁹¹ *Supra*, note 76, page 355.

⁹² *Supra*, note 84.

⁹³ Handbook 2012/13 ITOPF, page 41.

agreement requiring MAPP in the event a vessel enters any of the areas not subject to the owner's limitation of liability.⁹⁴ There is also a risk that signatory states with the limitation of liability for shipowners implemented in their legislation ignores the ratified conventions as a response to the public uproar resulting from a major oil spill.⁹⁵ If there is no MAPP in place and the P&I cover is exhausted following a large claim, the mortgagee will have to compete against the claimant as an injured party who will have a claim against the vessel which normally takes precedence over the mortgagees' interest in the vessel. MAPP would protect the financier in a situation like this as the policy would pay the mortgagee up to an amount satisfactory to clear the outstanding debt.⁹⁶

The insured amount is recommended to be the amount of the outstanding debt plus an uplift of 10% - 20% to cover interest and additional expenses that could arise. This is the same approach used when buying MII insurance.⁹⁷ Unlike the shipowner's policies that normally (and preferably) are placed on an agreed value basis, MII and MAPP are not. The financier will always need to prove the financial loss suffered in order to be able to obtain compensation under the policies. This means that MII or MAPP insurances taken out for 120% of the outstanding loan many times results in 'free premium' for the insurer that rarely needs to pay the full amount insured.⁹⁸

To date there has not been any claims paid under a MAPP policy although this might just be a matter of time. So far, major oil spills have fallen under jurisdictions where the responsible party has either managed to pay the clean-up costs from the balance sheet, or has been able to limit the liability

⁹⁴ *Supra*, note 3.

⁹⁵ *Supra*, note 84.

⁹⁶ *Supra*, note 50, page 43.

⁹⁷ *Supra*, note 84.

⁹⁸ *Supra*, note 3.

to an amount under the P&I cover which therefore has been sufficient to meet the claim.⁹⁹

3.4. Mortgage Rights Insurance

MRI is political risk insurance taken out in the name of the mortgage bank. The insurance protects the financier in the event it becomes impossible to enforce the legal rights under the loan agreement to repossess or repatriate the vessel. This type of cover has been described under several different names; Mortgage Right Insurance, Political Risks, Collateral Deprivation Insurance and Repatriation Insurance are some examples.¹⁰⁰

The cover should be considered by mortgagees lending money for vessels or offshore assets operating in political unstable areas where there is an existing risk that the government takes action against the collateral and therefore threaten the credit.¹⁰¹ The main concern is when a financier lends money to a foreign owner or operator and when the vessel is registered and flagged in a foreign country since this means that the vessel will be subject to the laws and government orders of that country. It is in particular important for a financier to bare this in mind if the country in question is a developing country with an unstable political or economic state.¹⁰² This means that it is a lot easier to assess the risk for fixed assets such as oil rigs since the area where it operates can be easily identified. Vessels as movable assets on the other hand make it more difficult for an underwriter to consider the risk the collateral is exposed to. Since the area needs to be identified in order to set the right level of premium, this cover is more common if there is a clear trading pattern in place known in advance which

⁹⁹ *Supra*, note 84; *Supra*, note 3.

¹⁰⁰ *Supra*, note 8, page 128.

¹⁰¹ *Supra*, note 84.

¹⁰² *Supra*, note 8, page 128.

include unstable regions. A MRI policy will protect the mortgagee against governmental action preventing the financier to exercise its rights under the mortgage. MRI protection is less common if the mortgaged vessel has unknown trading routes since it is much more difficult to evaluate the risk and since no underwriter is willing to provide 'blanket coverage' without identifying the hazardous area or areas.¹⁰³

The shipowner's war policy could in many instances be found insufficient for the mortgagee. A MRI policy will for example not be voided due to any action or inaction of the owner. Furthermore, although 'confiscation' is covered under many war policies,¹⁰⁴ this protection is in reality deficient in many ways. One reason is because of the inclusion of a cancellation clause, allowing the war underwriters to cancel the policy by giving one or two weeks' notice. This gives the financier little protection since coverage most likely will be cancelled during times when protection is needed the most. The war underwriters could also decide to leave the cover in place but for a much higher premium, if there is an increased risk in the region. Another downside with the owner's war policy is the exclusions contained therein. For example, it excludes cover for confiscation by the government in which the vessel is owned or registered. Confiscation due to breach of trading regulation or quarantine is also excluded under many war policies and these reasons are very common to be used as motives when a vessel is seized in an unstable region.¹⁰⁵ Furthermore, an exclusion clause for confiscation arising from a financial cause is also common. From a mortgagee's perspective, the cover provided for non-repossession due to default under the loan agreement, is perhaps the most important peril covered under a MRI policy.¹⁰⁶

¹⁰³ *Supra*, note 84.

¹⁰⁴ See for example Institute War and Strike Clauses Hulls – Time, clause 1.6.

¹⁰⁵ See for example Institute War and Strike Clauses Hulls – Time, clause 4.1.4 and 4.1.5.

¹⁰⁶ *Supra*, note 84.

The insurance period for a MRI policy is normally 3-5 years whilst the shipowner's war policy is limited to 12 months. The MRI policy therefore removes any uncertainties regarding the underwriting capacity if the situation in the insured region has gone worse during the first 12 months period. In the same way, higher rates due to an increased risk will be avoided. The MRI underwriters have also very limited rights of cancellation of the policy; non-payment of premium is one and change of ownership or if the vessel permanently leaves the insured country is another situation justifying the underwriter to cancel the insurance contract. The long term basis and the limited cancellation rights are the main reasons why MRI cover is expensive to take out. This will not affect the bank directly though since the loan agreement normally states that premium costs shall be borne by the borrower.¹⁰⁷

¹⁰⁷ *Ibid.*

CHAPTER 4

INSURANCES IN THE LOAN AGREEMENT

4.1. Insured Value

The insurance section in the loan agreement will typically include requirements that the insurances are in place before drawdown but also kept in place during the lifetime of the loan. Apart from specifying the different types of insurances the owner is obliged to take out, significant provisions for the financier are the requirements in relation to the insured value. In order to decide the required insured value, the starting point is to look at the outstanding loan amount as well as the vessel's fair market value. A standard requirement in the loan agreement obliges the borrower (i.e. the shipowner) to insure the vessel for a value equivalent to or more than 120% of the outstanding loan amount. The loan agreement will also typically require the insured value to be at least equal to the vessel's fair market value. The rationale behind these thresholds is to make sure that the insured amount also will cover the mortgagee for any interest occurred for the period between the loss and date of payment which normally takes 3-6 months. The amount shall also be sufficient to recover the financier any fees incurred whilst collecting the insurance proceeds.¹⁰⁸ It is also market practice to include a requirement obliging the borrower to obtain H&M insurance for a value at least covering 80% of the market value of the vessel. The reason behind this is because H&M cover, as explained above, will pay in the event of damage to the vessel and its equipment as well as in the event of a total loss. The IV insurance on the other hand will only respond to a total loss. This means that if there is a casualty that does not

¹⁰⁸ *Supra*, note 50, page 43.

result in a total loss but nevertheless amounts to a loss exceeding the value stipulated in the H&M policy, the IV policy would not pay, thus resulting in a gap in coverage. Normally, the basis used by underwriters when deciding whether a casualty should be considered as a total loss or not, is if the damage amounts to 80% or more of the market value (if it does it will be considered as a total loss). Hence it is prudent and best practice to have insured under the H&M policy 80% of the market value to ensure that there is no possibility of a casualty occurring that would result in the H&M policy paying 100% of the insured value but the Increased Value policy not responding (because the 80% threshold has not been met).¹⁰⁹

4.1.1. Valued and Unvalued Policies

According to MIA section 1, an assured shall be indemnified to the extent agreed between him and the insurer. The extent of indemnification will depend on which type of policy the insurance is subject to. The policy can be written on an unvalued or valued basis. A valued policy is a policy where the insured value is agreed to be the value of the subject matter and thus the amount to be paid to the assured in the event of a total loss.¹¹⁰ If a policy is written on an unvalued basis, the assured must provide evidence as to the value of the loss. Section 28 of the MIA defines an unvalued policy;

‘An unvalued policy is 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 herein-before specified.’

The onus is on the assured to prove the value of his loss. This can be difficult and also time consuming. Furthermore, an unvalued policy could

¹⁰⁹ *Supra*, note 3.

¹¹⁰ MIA section 27.

lead to a loss for the ship financier following an economic downturn resulting in dropped market value of the insured vessel. The actual loss might in that case not be recovered up to the amount of the outstanding loan if the loan was granted during good times when the vessel was afforded a much higher market value.¹¹¹

As such, an agreed value basis is the preferred type for both shipowner and the mortgagee and it is also the most common type of policy used for vessel insurances. Most loan agreements will require a valued policy so that the mortgagee is well protected against market fluctuations.¹¹² A policy on an agreed value basis will enable the mortgagee to certify recovery of the full loan amount by requiring an insured amount based upon the outstanding loan in the way described above.

It is common to have the vessel insured for a greater amount than its market value. This means that the fundamental principle of indemnity under marine insurance rarely applies strictly.¹¹³ An agreed value is conclusive between the insurer and the assured and it is only under very limited circumstances the underwriter will be allowed to avoid the policy on the basis that it is grossly overvalued. In *Slattery v. Manse*¹¹⁴ it was held that the insurer may avoid the contract if the subject matter insured had been overvalued by the assured and the underwriter was unaware of this and also deemed not to have knowledge about it. Under these circumstances the insurer can avoid the policy by alleging misrepresentation of value or nondisclosure. Another situation allowing the underwriter to avoid a policy on an agreed value basis is if the assured has acted fraudulently regarding the over valuation of the vessel. Merely an over valuation does not give rise to a right to avoid the policy, it is only when the underwriter is unaware of the over valuation and

¹¹¹ *Supra*, note 8, page 19.

¹¹² *Ibid.*

¹¹³ Marko Pavliha, *Overview of Marine Insurance Law*, IMO International Maritime Law Institute Malta, January 11-15, 2010, page 3.

¹¹⁴ [1962] 1 Lloyd's Rep 268.

also in the absence of good commercial reasons to explain it. The line between over valuation for good reasons and over valuation for fraudulent reasons are to be drawn by the court.¹¹⁵ In the *The Game Boy*¹¹⁶ the underwriters was allowed to avoid the contract. The assured had, prior conclusion of the insurance contract, presented documentation to the insurer implying a vessel value of USD 1,8 million; the true value was in fact not more than USD 100,000. Crucial was that the assured was aware of the over valuation and the underwriter had relied upon the documentation presented to him. The misrepresentation had therefore been made in bad faith.

An agreed value is not only conclusive and binding upon the underwriter; the same applies for the assured in the event of underinsurance. Thus, if the value stated in the policy is less than the actual value of the vessel, the underwriter is only liable to compensate the amount stated in the policy.¹¹⁷ After all, the premium has been based on the policy value and not the true value.

4.2. Checking the Mortgagees' Insurance Documentation

The mortgagees' insurance documentation needs to be checked both prior and after drawdown. Most of the major ship finance banks have their own internal insurance expertise but still, a requirement for an external insurance advisor's opinion tends to become more and more common in loan agreement as a result of banks being more cautious in their lending business. The insurance advisor will review the owner's insurances to ensure they are in place, give the correct scope of coverage, are underwritten by quality

¹¹⁵ Susan Hodger, *Cases and Materials on Marine Insurance Law*, Cavendish Publishing Ltd, London, 1999, page 191-192.

¹¹⁶ [2004] 1 Lloyd's Rep 238.

¹¹⁷ *Supra*, note 114, page 191; *Steamship 'Balmoral' Co Ltd v Marten* [1902] AC 511, HL.

insurers, do not contain inappropriate warranties or conditions and that the mortgagee's interest is noted and the insurances are correctly assigned. Since the credit normally has a lifespan of several years and an insurance policy typically only lasts for one year, annual due diligence checks should also ideally be provided in order to make sure that there has not been any changes in the insurance conditions that are to the detriment of the bank.

4.2.1. Cover Note

The cover note issued by the shipowner's insurance broker contains a summary of the insurance that has been placed. Preferably this shall include the assured and co-assureds, the insurance period, the sums insured, deductibles, conditions, warranties and also a list of the underwriting security and their respective percentage share.¹¹⁸

The mortgagee would wish to be noted as a 'mortgagee' in the cover note and not as a 'co-assured'. The reason for this is to be absolutely certain that liability for payment of premium is avoided.¹¹⁹ Instead, the bank's interest should be noted by way of a NOA attached to the policy (see further below) which entitles the bank to take 'ownership' of the policy or take part in claims negotiations. Furthermore, the LPC which also shall be attached to the cover note states that insurance proceeds above a certain threshold shall be paid directly to the mortgagee. This means that the practice of NOAs and LPCs solves the issue without requiring the bank being noted as co-assured. Although it is highly unlikely, at least under English law, that the bank could be held responsible for payment of outstanding premiums, under other jurisdiction the regulation may look different. As such, for best practice, the mortgagee should avoid being named as co-assured in the cover note and instead protect its interest by way of an attached NOA and LPC.¹²⁰

¹¹⁸ *Supra*, note 8, page 32.

¹¹⁹ *Supra*, note 50, page 42.

¹²⁰ *Supra*, note 3.

Another thing that needs to be checked once the cover note has been issued is the insured value. This must be in compliance with the requirements in the loan agreement that most often are based upon the outstanding loan amount and the vessel's fair market value as described above. The H&M value shall also be compared against the IV value in order to ascertain that there is no breach of a disbursement warranty. Common practice is to have a split of 75/25 but higher IV split may be agreed.

A loan agreement may specify which standard insurance conditions the insurances shall be subject to, e.g. the NMIP, AIHC, IHC or ITC – Hulls. Preferably the loan agreement shall not be too specific since these conditions are constantly updated. If the agreement specifies which standard insurance conditions the insurances shall be subject to, it is best to add a line stating something like 'or equal insurance conditions accepted by the insurance market'. The preferable conditions from a shipowner's and mortgagee's perspective available on the market today is the NMIP. Not only because this is on an all risk basis but also because of its special provisions in chapter 7, providing the mortgagee similar protection as a broker's LOU (see more below).¹²¹

The underwriting security, which will be described more in detail below, is obviously one of the most crucial things to review in order to make sure that the risks are well protected. The first thing to check is the credit strength of the insurance company. Helpful is if the companies have been awarded rates by any of the major rating agencies. The loan agreement may require a minimum rating and also allow the mortgagee to require replacement of any insurer that no longer is approved by the bank.

¹²¹ *Ibid.*

4.2.2. P&I Certificate of Entry

The P&I Certificate of Entry is evidence of the P&I insurances issued by the P&I Club in which the shipowner is a member. The certificate of entry must be read in conjunction with the club rules in order to get a full picture of the cover.¹²² All IGA clubs offer relatively similar protection with most of the cover limits exactly the same.

One thing to bear in mind while checking the P&I entry is in which way the mortgagee's interest is noted in the documentation. Just like under the marine risk insurance policies, the ship financier should preferably be noted as 'mortgagee' and not as an additional insured to avoid responsibility for unpaid premiums to the club.¹²³ However, one difference is that the mortgagee is no loss payee in the same way as under the marine policies attaching a LPC. Since the P&I cover is a policy of third party indemnity no claims will be payable to the bank and the only thing the mortgagee would want to ensure is that the vessel remains entered in the club. In the event of default, the bank will be recipient of any return of premium or any free funds available from a claim. By noting the financier as 'mortgagee' in the Certificate of Entry, the club will issue their LPC which effectively is the P&I club's equivalent to a broker's LOU where the club for example agrees to give the bank 14 days prior notice if it intends to terminate the membership.¹²⁴

What also is important is to check and compare the collision liability provision in the Certificate of Entry with its equivalent in the H&M policy to ensure 4/4 is covered and no mismatch has occurred.

¹²² *Supra*, note 8, page 152.

¹²³ *Ibid*, page 42.

¹²⁴ *Supra*, note 3; *Supra*, note 8, page 42.

4.2.3. Letters of Undertaking

It is common practice for loan agreements to require the borrower to have LOUs issued by his insurance broker in the favour of the mortgagee. The LOU obliges the broker to have a signed NoA and a LPC attached to the insurance policies.¹²⁵ There are also other duties and obligations accepted by the broker towards the mortgagee in a standard LOU although this is one of the most vital ones.

The broker has an important role in handling the shipowner's insurances. The broker will not only give service advice and handle claims but also collect the insurance proceeds and then distribute it to the shipowner. Although the shipowner is the broker's primary principal, the LOU puts the bank in a more favourable position in the event there is a dispute regarding the owner's insurances. Thus, the LOU is a separate contract between the broker and the mortgagee. The recommended LOU wording is the London Market Brokers Committee Standard Letter of Undertaking. Obligations of the broker contained therein are the following; abide the LPC, give notice to the bank if it cease to be the shipowner's appointed broker, inform the bank of material changes in the policy, inform the bank promptly if it has received notice of cancellation from any of the underwriters, upon request advise status of premium payment and also status of renewal negotiations.¹²⁶

A LOU does also normally include a waiver of the statutory lien the broker has on insurance proceeds in accordance with MIA section 53(2). Such a waiver is required to ensure the effectiveness of any assignments of insurances to the mortgagee. If the broker does not waive this right he will be enabled to exercise his lien on the proceeds.¹²⁷

¹²⁵ *Supra*, note 50, page 43; See also ITC – Hulls clause 5.

¹²⁶ *Supra*, note 8, page 38-39.

¹²⁷ *Supra*, note 50, page 43.

As mentioned above, NMIP chapter 7 gives the mortgagee certain protection similar to a broker's LOU. However, this chapter applies between insurer and financier and certain banks might feel that this does not fully bind the broker themselves. Therefore, in addition to chapter 7 a standard LOU should preferably be issued, obliging the broker to for example notify the mortgagee if the policy is cancelled by any of the underwriters or if the policy has been amended. Since the broker is not directly responsible for payment of premium under Norwegian law, a Norwegian broker will not have a lien upon the policy like their English counterpart has. Therefore there is no need for a lien waiver in a LOU issued by a Norwegian broker.¹²⁸

Sometimes the insurances are placed directly with the insurer without using a broker as intermediary. In that case, the mortgagee should request the insurer to issue an equivalent to the broker's LOU. The wording and thus obligations towards the mortgagee should preferably be the same although excluding certain parts, for instance the section referring to the 'broker's lien'.¹²⁹

P&I clubs do also issue LOUs to mortgagees. This document is different however from a broker's and insurer's LOU. It confirms to the mortgagee that the vessel is entered into the association and the club rule stating that membership will come to an end if the vessel is mortgaged is waived. Furthermore, the club undertakes to give prior notice to the mortgagee if it intends to cease the membership of the borrower. The P&I clubs do not acknowledge assignment of insurances but a LPC can be included in the certificate of entry stating that any free funds from a claim should be payable to the mortgagee. As stated above, this is very rare because of the third party indemnity character of the policy.¹³⁰

¹²⁸ *Supra*, note 3.

¹²⁹ *Supra*, note 8, page 41.

¹³⁰ *Ibid*, page 42.

4.2.4. Assignment of Insurances and Loss Payable Clauses

When a bank or other financier commits itself to a ship finance transaction it will need a confirmation from the shipowner that the insurances required in the loan agreement are to be endorsed with NOAs and LPCs in favour of the bank. Assignment of the shipowner's insurances is a requirement in the vast majority of ship finance loan agreements. An assignment of a marine insurance policy will give the assignee all rights and benefits arising from that insurance contract including returns of premiums and claims proceeds.¹³¹ As such, the mortgagee can be confident that in the event of a major casualty, any insurance proceeds will be paid directly to them in order to clean the outstanding debt.¹³² Other rights (apart from the right to receive claims proceeds and returns of premium) included under the assignment are; right to bring a claim under the policy, right to take over the pursuit of a claim and the right to receive full information about the policy.¹³³

Under English law there are two types of assignments; legal assignment and equitable assignment. A legal assignment is an assignment that complies with either the MIA section 50 or the Law of Property Act of 1925 (LPA) section 136. An equitable assignment on the other hand is any other assignment that does not fulfil the requirements under any of the previous mentioned Acts. What differ these two types of assignments in practice is only the fact that under an equitable assignment the assignee will not be able to bring a claim directly against the debtor; it must join the assignor in the proceedings, either as a joint claimant or joint defendant.¹³⁴

¹³¹ Stephenson Harwood, *Shipping Finance*, Third edition, Euromoney Books, London 2006, page 225.

¹³² *Supra*, note 76, page 139.

¹³³ *Supra*, note 8, page 37.

¹³⁴ *Three Rivers v Bank of England* [1996] QB 292; *Supra*, note 50, page 74.

In order for it to be an effective legal assignment under the LPA, the assignment must be in writing, signed by the assignor and it must also be absolute (i.e. it cannot be partial or shared with another party).¹³⁵ Furthermore, for the assignment to be effective against the insurer, he must have been served with a notice of the assignment.¹³⁶ The assignment must only be signed by the assignor to fulfil the first requirement; however it is common practice to also obtain the signature of the assignee. It is important to check that no prior consent is required which, if not obtained, could render the assignment invalid.¹³⁷ The second requirement stating that the assignment must be absolute applies even if the purpose of the assignment is to serve as security for the repayment of a loan only. An assignment may seem absolute on its face but conditions allowing the assignor to exercise certain rights over the property could result in the assignment not being considered as in compliance with this requirement. The test to be applied is that the insurer must know, without feeling the need to raise any queries, that payment is to be made to the assignee and not the assignor.

Apart from the general rule dealing with assignment in the LPA section 136, the MIA section 50 deals particularly with assignments of a marine insurance contract. An assignment under MIA is an alternative rather than a substitution to an assignment under the LPA.¹³⁸ In *Williams v Atlantic Assurance Co*¹³⁹ and *Raiffeisen Zentralbank Österreich AG v Five Star General Trading*¹⁴⁰ the English Court of Appeal examined whether the assignment fulfilled the requirements under either Act separately and would acknowledge the assignment as a legal assignment if it met the requirements

¹³⁵ *Raiffeisen Zentralbank Österreich AG v Five Star Trading LLC* [2001] EWCA Civ 68; [2001] QB 825; *Supra*, note 76, page 141; *Supra*, note 8, page 37.

¹³⁶ *Williams v Atlantic Assurance Co Ltd* [1933] 1 KB 81.

¹³⁷ *Supra*, note 130, page 228.

¹³⁸ *Williams v Atlantic Assurance Co* [1933] 1 KB 81, CA, and *Raiffeisen Zentralbank Österreich AG v Five Star General Trading LLC* [2001] EWCA Civ 68, [2001] QB 825, [2001] 3 All ER 257.

¹³⁹ *Co* [1933] 1 KB 81, CA.

¹⁴⁰ *LLC* [2001] EWCA Civ 68, [2001] QB 825, [2001] 3 All ER 257.

in one of them. MIA states that a policy of marine insurance is assignable unless otherwise is explicitly stated. The assignment can be made either before or after a loss has occurred and once the policy is assigned by endorsement on the policy or any other customary way, the assignee may sue on the policy in his own name. For the assignment to be effective the assured must have an insurable interest in the subject matter insured under the policy. The assignment must also be for the whole beneficial interest arising from the policy; it is not sufficient for an assignment under MIA if the assured retains some of the interest in the policy.¹⁴¹

A fundamental principle under English law is that an assignee can never be put in a better position than the assignor.¹⁴² Thus, in the event of a claim, the insurers are entitled to raise the same defences against the assignee as they could have raised against the assignor.¹⁴³ Consequently, if the shipowner as assignor has been in breach of his duty of utmost good faith, the insurers can avoid the policy and refuse payment to the bank on this ground even though there is no such duty imposed upon the mortgagee.¹⁴⁴ The same applies if the assured caused the loss by means of wilful misconduct.¹⁴⁵ A MII policy would in this instance respond and is therefore an important supplement in a ship financier's insurance package. Worth mentioning though is the case *Trident Beauty*¹⁴⁶ in which the mortgagee was granted a better position because of the surrounding circumstances. In this case the borrower was a party of a time charter under which hire was paid to the bank as assignee 15 days in advance. The vessel went off hire for a period long enough for the charterer to be entitled to claim repudiation from the owners. The

¹⁴¹ Raiffeisen Zentralbank Österreich AG v Five Star General Trading LLC [2001] EWCA Civ 68, [2001] QB 825, [2001] 3 All ER 257.

¹⁴² MIA section 50(2).

¹⁴³ William Pickersgill & Sons Ltd v London & Provincial Marine and General Insurance Co Ltd [1912] 3 KB 614 and *The Litson Pride* [1985] 1 Lloyd's Rep 437.

¹⁴⁴ *The Litson Pride* [1985] 1 Lloyd's Rep 437.

¹⁴⁵ *Graham Joint Stock Shipping Co. Ltd. v. Merchants' Marine Insurance Co. Ltd.* [1922] 13 Ll L Rep 509; [1924] AC 294.

¹⁴⁶ *Pan Ocean Shipping Ltd v Creditcorp Ltd* [1994] 1 All ER 470.

charterparty contained a clause entitling the charterer to claim refund of the hire from the owner when it had been duly paid but not earned. The question in this case was whether the bank as assignee was under the same duty as the owner to repay the hire. Two legal principles were in conflict; the principle that an assignee cannot be put in a better position than the assignor and the principle that only the benefits arising from a contract can be assigned. The House of Lord came to the conclusion that the right of the assignee to receive hire was independent from the obligation to refund it. Thus, since only the benefits of the charterparty had been transferred, the assignee was entitled to keep the hire although the owner was obliged to refund the charterer. This is clearly a comforting decision from a mortgagee's perspective.¹⁴⁷

The relationship between the assignor and assignee is determined by the content of the assignment itself. The relationship between the assignee and the debtor, that is, the relationship between the mortgagee and the insurer, is dependent on a NOA given to the insurer. The assignment will not be effective against the insurer until such notice has been given. The insurer must accept the notice and from that time on, payment cannot be made to the original assured and neither can the assured and the insurer enter into agreements that would have detrimental effect on the assignee.¹⁴⁸ If the insurer pays insurance proceeds directly to the assured although there is an assignment in place, the insurer might even have to pay the claim twice, the second time to the correct loss payee.¹⁴⁹ Or, to put it like Lord Macnaghten did in *William Brandts Sons & Co v Dunlop Rubber Co*,¹⁵⁰ 'If the debtor ignores such a notice, he does so at his peril'.

¹⁴⁷ *Supra*, note 130, page 225-226.

¹⁴⁸ *Brice v. Bannister* [1877] 3 Q. B. D. 569 295; *William Brandts Sons & Co v Dunlop Rubber Co* [1905] AC 454.

¹⁴⁹ *Supra*, note 76, page 141.

¹⁵⁰ [1905] AC 454.

If the assigned insurances are subject to any of the English clauses (ITC - Hulls or IHC), the notice given must not only be in writing; it must also be signed by the assignor.¹⁵¹ However, since a policy of marine insurance many times contains a long list of co-assured, including for example crewing agents and technical managers, it is usually only the primary assured with an interest in the proceeds after a physical loss that is required to sign the NOA. This is industry practice and the reason is that it would not be realistic and certainly very impracticable if every single co-assured would be required to sign the notice.¹⁵²

Although there is no time limit when notice must be given, it is in the interest of the mortgagee to have this done as soon as practicable after funds have been advanced to the shipowner. The reason for this is firstly that the assignment will not be effective until this has been done and secondly because the priority ranking of assignments is determined by the time notice was given to the insurer.¹⁵³ This means that the assignee's interest will be subject to any other assignees' interest that has given the insurer prior notice.¹⁵⁴ The priority ranking is thus determined by the date when notice is given and not by the date when the assignment was granted. However, under English law there is a cardinal principle in respect of equitable claims saying that in order to obtain priority of an earlier assignment the test of being a bona fide purchaser without notice must be met. Thus, if the assignee of a later assignment knew about a prior assignment of which notice had not yet been given to the debtor, he will not be ranked above the earlier assignment since he would have failed the test.¹⁵⁵

¹⁵¹ LPA section 136; ITC – Hulls clause 23; IHC clause 5.

¹⁵² *Supra*, note 3.

¹⁵³ *Supra*, note 76, page 141.

¹⁵⁴ *Dearle v Hall* (1828) 3 Russ 1; *Pfeiffer Weinkelleri-Weineinkauf GmbH v Arbuthnot Factors Ltd* [1988] 1 WLR 150.

¹⁵⁵ *Supra*, note 50, page 74.

A NOA endorsed upon a marine insurance policy shall be followed by a LPC stipulating how the insurance proceeds shall be paid out. Common practice is for the mortgagee to require the full amount in the event of a total loss whilst a monetary threshold normally is set for partial losses stating that insurance proceeds up to a stipulated amount of for example USD 1,000,000, can be paid directly to the assured.¹⁵⁶ Although there is a requirement under both the MIA and LPA that the assignment shall be absolute in order to be effective, it is accepted that the mortgagee renounces its right to collect smaller claim amounts and instead allows the owner to obtain compensation up to the stated cap in the LPC.¹⁵⁷

It is common practice to have the marine policies assigned to the mortgagee, however, the P&I clubs within IGA prohibit assignment of their members' rights unless the club has given its consent.¹⁵⁸ The P&I clubs acknowledges the limited interest of mortgagees by way of the issuance of their LPC instead.

¹⁵⁶ *Supra*, note 8, page 38.

¹⁵⁷ *Supra*, note 3.

¹⁵⁸ *Supra*, note 50, page 73.

CHAPTER 5

COVER ISSUES IN INSURANCE POLICIES

5.1. The Concept of Warranties

A warranty in an insurance contract is not to be mistaken for a warranty in an ordinary commercial contract. In the latter type of contract a warranty is subsidiary to the contract itself and a breach would only give the aggrieved party a right to sue for damages. In an insurance contract on the other hand a warranty is an undertaking by the insured that goes to the root of the contract of which a breach would entitle the insurer to avoid the contract and thus refuse payment. A warranty can either be something that shall be done, something that shall not be done, something that the insured shall make sure exist or something that the insured shall make sure does not exist. The reason for including a warranty in an insurance contract is to avoid high risk scenarios like insuring an unseaworthy vessel.¹⁵⁹

MIA section 33 defines a warranty as;

'A warranty...is a condition which must be exactly complied with, whether it be material to the risk or not. If it be not so complied with, then, subject to any express provision in the policy, the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date.'

¹⁵⁹ D.J. Ranson, *Legal Aspects of Insurance*, The Chartered Insurance Institute, Cambridge, 1991, page 65.

The concept of warranties derives from the common law system and does not exist under civil law although similar conditions can be found.¹⁶⁰ Many civil law countries are sceptical to the concept and if a policy containing a warranty is governed by the law of any of the Scandinavian countries, it can be set aside for being an unreasonable burden on the assured.¹⁶¹

The reason why civil law countries' criticise this is because they find the warranty being too harsh on the assured. The insurer will be able to avoid the contract although the breach was totally irrelevant for the occurred loss. There is no requirement for there to be a 'material breach' nor is there a requirement for a 'causative breach'. The common law system has however developed ways to mitigate the harshness of warranties. A 'held cover clause' is one example and the English interpretation rule '*contra preferentem*' is another.¹⁶² A held cover clause is a clause that protects the assured from suddenly losing cover as a result of a warranty breach. With such clause included in the policy, the assured will still be covered although there is a breach of a warranty, if extra premium is paid.¹⁶³ *Contra Preferentem* is a principle applied in situations where the policy is unclear of whether a clause constitutes a warranty or not. If using this principle whilst construe the contract, any ambiguity will be determined in favour of

¹⁶⁰ See for example NMIP clause 3-14 (loss of class) and clause 3-21 (change of ownership).

¹⁶¹ CMI Yearbook 2000, *Marine Insurance*, The CMI Review Initiative, page 95; Sweden, Lag (1915:218) om avtal och andra rättshandlingar på förmögenhetsrättens område §36; Norway, Lov om avslutning av avtaler, om fuldmagt og om ugyldige viljeserklæringer [avtaleloven] (1918/4) §36; Denmark, Lov om Aftaler og andre retshandler på formuerettens område (1986/600) §36.

¹⁶² John Hare, *The Omnipotent Warranty: England v The World*, Paper presented at International Marine Insurance Conference, University of Antwerp, November 1999; Donald O'May and Julian Hill, *O'May on Marine Insurance*, Sweet & Maxwell, London, 1993, page 79-80.

¹⁶³ Donald O'May and Julian Hill, *O'May on Marine Insurance*, Sweet & Maxwell, London, 1993, page 80; See also for example ITC – Hulls clause 3.

the assured.¹⁶⁴ Furthermore, the onus to prove a breach of warranty lies on the underwriter.¹⁶⁵

From a financier's perspective, a policy containing warranties is clearly unpleasant because of the consequences of a breach that could lead to avoidance of the policy by the underwriters. As a third party reliant on the shipowners insurances, the financier has no chance to avoid a warranty breach, it is the shipowner's acts and omissions that has an impact on the policies. If for example the shipowner fails to comply with the safety regulations required in the ISM Code this would, if not fixed within a given time, result in the ship losing its class. Under the marine, war and P&I insurance it is a requirement that the vessel shall be classed and remained in class. Thus, if the shipowner fails to comply with this, the insurance will not respond to a claim and the bank will be exposed to a great risk unless there is a MII policy in place.¹⁶⁶

To avoid such a scenario, as already described, the bank would want to make sure that the mortgaged ship is operated by high quality ship operators that maintain the vessel properly in the right manner. The mortgagee does also in general include a 'vessel covenant' section in the loan agreement that requires for instance compliance with the ISM Code. Thus, in the event of non-compliance, the borrower will be in default also under this contract and not only under the insurance policies. In order for the bank to be absolutely certain that a policy including warranties will not affect its position or credit risk, a MII policy should be obtained, alternatively, if the insurance is placed on the NMIP, make sure that the policy expressly makes reference to

¹⁶⁴ John Hare, *The Omnipotent Warranty: England v The World*, Paper presented at International Marine Insurance Conference, University of Antwerp, November 1999.

¹⁶⁵ *Simons v. Gale (The Cap Tarifa)* (1957) 2 Lloyd's Rep. 485; (1958) 2 Lloyd's Rep. 1 P.C.

¹⁶⁶ *Supra*, note 3.

the inclusion of chapter 8-4 which could be described as a limited MII cover.¹⁶⁷

5.2. Underwriting Security and Cut-Through Clauses

For the mortgagee the underwriting security is one of the main things to carefully scrutinise on a regular basis throughout the insurance period. It is common practice under marine insurance to have several underwriters sharing the risk and therefore only be responsible to pay a claim up to the proportion they have underwritten. This market practice gives the best protection both to the insured and insurer; if only one insurer undertook the whole risk and the vessel suffered a major loss this could strike hard against the sole underwriter and also the insured if the claim is not paid in full.¹⁶⁸

If there is more than one insurer underwriting the risk, which is normally the case, there is also in general one appointed claims leader. The claims leader, also called the leading underwriter, is the underwriter responsible to handle the relation with the insured party. The lead underwriter should preferably be well-known in the insurance market with experience in the type of cover underwritten so as to encourage following underwriters to sign the same risk. If a fully signed insurance contract subsequently needs to be amended, it is sufficient for the leading underwriter to agree upon the changes on behalf of the other underwriters. This could otherwise result in a very long and burdensome process if all underwriters were required to give their approval.¹⁶⁹ The leading underwriter is also responsible for claims

¹⁶⁷ *Ibid.*

¹⁶⁸ Gleaned from personal correspondence with the Chief Financial Officer of The Swedish Club.

¹⁶⁹ F.D. Rose, *Marine Insurance: Law and Practice*, First Edition, 2004, section 1.18, 6.6, 6.16.

settlement, claims procedure and some other matters relevant when there is a claim on the policy, with all other underwriters obliged to agree and follow the decisions made by the leader.¹⁷⁰ A ‘follow the leader clause’ is usually inserted in the policy and a fairly recent case describes the effect and scope of such clause. In *PT Buana Samudra Pratama v Maritime Mutual Insurance Association (NZ) Ltd*¹⁷¹ the insured vessel ran aground on its way to tug another grounded vessel. One of the following underwriters held that it was not obliged to follow the decision of the lead underwriter, arguing they were not liable to pay the claim due to breach of a warranty saying that the vessel was not allowed to undertake towage services. The follower meant that a ‘follow the leader clause’ only applies when the claim falls within the terms of the insurance contract and not if there is a dispute as to the question of liability. The court disagreed and pointed out the importance of the ‘commercial purpose’ of such clause. This was meant to include cost and time savings, and also to make co-insurance more attractive to potential assureds. A ‘follow leader clause’ shall therefore not be interpreted in the restricted manner made by the following insurer in this case. The clause implies what it says, that is, to follow the leader in all settlements and all decisions.¹⁷²

It is important for the mortgagee to ensure the risk being secured by qualified insurers with satisfactory credit strength and payment capacity. A helpful tool to use when checking the underwriting quality is the rating each and every insurer has been awarded by any of the major rating agencies. Not all insurers have been rated and the main reason for this is the cost involved. Standard and Poor’s which is one of the leading credit rating agencies charges a price based upon the insurer’s premium income. Big insurance companies will therefore pay more than smaller companies to obtain a

¹⁷⁰ See for example IHC (1/11/33) clause 42; NMIP clause 9-2.

¹⁷¹ [2011] EWHC 2413 (Comm).

¹⁷² Addleshaw Goodhard, *E-Alert*, November 2011, available online at: http://www.addleshawgoodhard.com/cdc/asset_store/document/follow_the_leader_144347.pdf.

rating. Nowadays it is not very unusual to find a minimum rating requirement in the loan agreement. If an insurer is awarded a lower rating than stipulated (normally a Standard and Poor's rating of A- or BBB+), the mortgagee would have the right to demand replacement of that share.¹⁷³

The four main credit rating agencies specialised in insurance are Standard and Poor's, A.M. Best, Moody's Investors Service and Fitch Ratings. These companies operate globally and are well recognised in the insurance sector. When checking the creditworthiness of an insurance company several different factors are taken into account; industry risk, liquidity and corporate strategy are some examples.¹⁷⁴ When evaluating the risk of marine insurance and in particular hull insurance the following elements can be assessed by the underwriter: ownership/management, type and age of ship, flag state, classification society, previous casualties, insured value, shipowner's credit rating and the number of port detentions, if any. The management and age of the ship are crucial factors to consider. A study made by Peter Christmas shows that ships over nine years run a significantly higher risk of suffering casualties than ships below that age. Furthermore, a ship aged 15-19 years has a casualty frequency twice as high compared to vessels aged 10-14 years.¹⁷⁵ All these aspects are fundamental for marine underwriters when deciding whether to take a risk or not.

For a mortgagee, as mentioned above, the rating of the underwriting security is helpful when evaluating their quality. Although it would be desirable to have the full risk underwritten by top rated insurers, it would in fact be sufficient with a few lower rated insurers as long as the outstanding loan amount is not reliant on any of their shares.¹⁷⁶ It is not always possible for the insured to choose the best rated insurers. In India for example the

¹⁷³ *Supra*, note 167.

¹⁷⁴ Dimitris N. Chorafas, *Operational Risk Control with Basel II*, Butterworth-Heinemann, 2003, page 255 and 258.

¹⁷⁵ *Ibid*, page 269.

¹⁷⁶ *Supra*, note 38.

insurance market was nationalized 1973 through the General Insurance Business (Nationalization) Act, leaving all non-life insurance business to be carried out by four state-owned insurance companies.¹⁷⁷ Although the monopoly was dismantled 2000, these companies still hold a significant market share in the Indian market (58% in 2011).¹⁷⁸ There are however ways to enhance the protection in situations where the primary insurers lacks adequate financial strength. The mortgagee can require the inclusion of a cut-through clause which allows the insured or loss payee to claim the reinsurance proceeds directly from the reinsurer if the primary insured fails to pay the full amount because of insolvency. A cut-through clause will thus help insurance companies that lack the size or rating needed to gain shares on the insurance market by being backed by their reinsurers' strength and rating.¹⁷⁹ This is a helpful mechanism when the primary insurers available are limited. The mortgagee may also demand a cut-through clause when the share of a primary insurer is considered as worryingly big and extra support is needed in order for the insurer to gain approval.

There are a few legal implications concerning cut-through clauses; the first being the doctrine of privity of contract and the second being the principle of equality of all unsecured creditors. The latter principle was enshrined in the *British Eagle International Airlines Ltd v Compagnie Nationale Air France*¹⁸⁰. The House of Lord ruled that no contractual provision affecting how to distribute the assets of an insolvent estate should be enforceable.

¹⁷⁷ National Insurance Company Limited, New India Assurance Company Limited, Oriental Insurance Company Limited and United India Insurance Company Limited; Parveen Nagree-Mahtani, *Insurance Law Regulations in India*, Nishith Desai Associates, 2002, page 2, available online at:

<http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan021309.pdf>.

¹⁷⁸ Tower Watson, *Indian Market Non Life Insurance Update*, India, Issue 19, September 2011; Tapen Sinha, PhD, *The Indian Insurance Industry: Challenges and Prospects*, page 11, available online at:

<http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan025798.pdf>.

¹⁷⁹ Robert M. Hall, *Cut-Through and Guarantee Clauses*, 2001, page 1.

¹⁸⁰ [1975] 1 WLR 758, [1975] 2 All ER 390.

However, since a cut-through clause is designed to make the reinsurer directly liable to the original insured without payment through the reinsured, the clause will most likely be feasible and not prevented by the 'Eagle principle'. The doctrine of privity of contracts saying that it is only the contracting parties that are entitled under it could prevent the effectiveness of a cut-through clause as the primary assured and reinsurer lack contractual connection. This issue is however addressed by The Contracts (Rights of Third Parties) Act 1999 which states that a third party may enforce his rights in a contract although he is not a party to it, as long as the contract expressly provides that he can do so. As long as there is nothing in the contract that states otherwise, The Contracts (Rights of Third Parties) Act 1999 will apply.¹⁸¹

Yet, since the legal position of cut-through clauses is not crystal clear, the mortgagees should be made aware of its limitations. Still, there is a possibility that the liquidator acting on behalf of the insolvent insurer will challenge the legality of such clause. Taking this into account, there is another solution for the mortgagee providing more comforting protection. Assignment of reinsurance which must be approved by both the reinsurer and insurer will allow the insured direct negotiation and settlement rights against the reinsurer. Therefore, this arrangement is to be preferred in order for the mortgagee to secure the outstanding loan with extra back up form reinsurers.¹⁸²

5.3. Fleet Policies

It is common to have the insurances placed as a fleet policy since this in general gives the shipowner discount on the insurance costs. However, what

¹⁸¹ *Re/insurance insolvencies – some subtleties*, Elborne Mitchell Solicitors, September 2007, page 7.

¹⁸² *Supra*, note 3.

is important for the mortgagee to be aware of is that the broker in this instance has a right to set off claims proceeds from a claim arising from one fleet vessel against unpaid premiums for another fleet vessel. Furthermore, the broker may cancel the policy for other fleet vessels because of non-payment of premiums due to one of the fleet vessel. The real problem arises when an insured fleet contains some vessels mortgaged to one financier and other vessels mortgaged to another financier or not mortgaged at all.¹⁸³

In order to cope this, the mortgagee should demand further undertakings by the insurance broker, limiting the right of offset to only apply for the vessel against which a claim is being made. This extra undertaking would be ideal from the mortgagees perspective although it nowadays is becoming more common for brokers to use another approach extending their fleet lien to all vessels mortgaged to the bank. This would entitle the broker to offset outstanding amounts due for one vessel mortgaged to the bank against claims proceeds for another vessel mortgaged with the same financier.¹⁸⁴

Many insurance policies include the line ‘Each vessel is deemed to be a separate insurance’. Although some is of the opinion that such sentence has the same effect as a fleet lien waiver, the legal position has never been established in court proceedings. In consideration to this, it is always recommended to obtain a fleet lien waiver if the insurances form part of a fleet policy.¹⁸⁵ The NMIP include a similar undertaking but in respect of the insurers’ right to offset and not the brokers.¹⁸⁶ This is deemed to be sufficient for placement through Nordic brokers since the MIA giving the broker a lien on the policy does not apply.¹⁸⁷

¹⁸³ *Ibid.*

¹⁸⁴ *Ibid.*

¹⁸⁵ *Ibid.*

¹⁸⁶ NMIP clause 7-4 last sentence.

¹⁸⁷ MIA clause 53(2).

5.4. A Borrower in Financial Hardship

Economic downturns in the shipping business can have detrimental effects on shipowners and their mortgagees. What tends to control the market situation is the level of freight rates. Dropped freight rates result in declined ship values since the market demand for ships in times when freight rates are low obviously is extremely little.¹⁸⁸ A shipowner under hard financial pressure needs to reduce costs by cutting corners which could strike hard against the mortgagee. During distressed times there is an increased likelihood that the shipowner's insurances gets cancelled due to non-payment of premium. Insurance cover could also be deprived as a result of inadequate ship maintenance in order to save money, leading to unseaworthiness of the vessel.¹⁸⁹ Furthermore, if the vessel loses class or changes classification society, the H&M insurance and P&I cover will most likely terminate automatically.¹⁹⁰

When reaching the critical point it becomes inevitable for the mortgagee not to take action against the borrower's default. Instead of enforcing the mortgage there are a few options available for the mortgagee if the borrower is willing to cooperate. One alternative is to create a new owning company to which the vessel is transferred. The reason behind the transfer is to avoid creditors of the old company although maritime liens continue even though the ownership of the vessel changes. Furthermore, in certain jurisdiction, a transfer of ownership in order to avoid creditors may be declared unenforceable. However, if the transfer is made to an affiliate against full value of the vessel, the legal standpoint is different. In this instance, the

¹⁸⁸ Emma Rowley, *The Telegraph*, Trouble in shipping turns ocean into scrapheap, 9th April 2012, available online at: <http://www.telegraph.co.uk/finance/newsbysector/transport/9194091/Trouble-in-shipping-turns-ocean-into-scrapheap.html>.

¹⁸⁹ *Supra*, note 18.

¹⁹⁰ See for example ITC – Hulls clause 4; IHC clause 13; NMIP clause 3-14; The Swedish Club Rules 2013/2014, rule 10.

original owning company can use the sales proceed received to clear the existing debts and the bank will also be repaid by the old owner although funds will need to be advanced to the new owner. If the original owner manages to clear all previously existing maritime and statutory liens in conjunction with the transfer, the new owner should be able to continue the operation of the vessel without claims from former creditors. Another option available is for the owner to voluntarily sell the vessel for its market value to a third party and use the proceeds to clear the mortgage. This is a recommended solution if the market value exceeds the outstanding loan amount. Also, since the sale appears to be voluntary it will also be easier to obtain a higher price. A third alternative is for the mortgagee to sell the vessel in accordance with its rights as a mortgagee. One drawback is however that the buyer would want a guarantee from the mortgagee in respect of former creditors holding rights attached to the ship in form of maritime or statutory liens.¹⁹¹

5.4.1. Mortgage Enforcement

If the borrower is in default and not willing to cooperate with the mortgagee to resolve the situation there are actions available for the mortgagee to take in order to enforce the mortgage. One option is to take possession of the vessel and either continue its operation and use the earnings to pay off the loan, or to sell the vessel and use the sales proceeds to clear the debt. Another option is to involve the court, have the ship arrested and subsequently sold through a court sale. Finally, under English law, one last option remains which is foreclosure, resulting in the mortgagee being the owner of the vessel. However, the legal standing of this last alternative is uncertain and will therefore not be discussed in detail.¹⁹² Before determining which route to take, consideration should be given to the following; the

¹⁹¹ *Supra*, note 50, page 82-83.

¹⁹² *Ibid*, page 64.

priority ranking of claims in respect of the sales proceeds according to the applicable law, how quick the sale can be carried out, the costs of an auction sale and finally, whether or not the applicable law recognise the mortgagee's right to take possession of the collateral vessel and sell it.¹⁹³

The situations when the mortgagee is entitled to take possession of the vessel are almost invariable expressly stated in the loan agreement. Under common law however, two situations give rise to this right regardless of any contractual provisions, namely if the borrower is in payment default or acts in a way impairing the security.¹⁹⁴ A mortgagee in possession of the vessel will be entitled to keep the earnings generated from the operations and trade, although on the other hand, the mortgagee will also be liable for the expenses incurred whilst the vessel is in its possession.¹⁹⁵ The potential liabilities that may arise are the reason why mortgagees in general tries to stay away from repossessing ships and instead use their power of sale, either through a private sale or through court sale following an arrest of the vessel. Both options have advantages and disadvantages which the mortgagee should consider before determining which is the most suitable for each case. A private sale is in general quicker, less costly and the mortgagee will also most likely obtain a higher price. On the other hand, since a private sale does not 'clear' the ship from existing encumbrances, the mortgagee may have to indemnify the buyer for any existing maritime liens attached to the vessel at the time of sale.¹⁹⁶ The mortgagee is also obliged to take reasonable precaution to obtain a genuine market price and furthermore, not to sell the vessel to itself.¹⁹⁷ A court sale is advantageous in the sense it relieves the vessel from any encumbrances hence giving the purchaser clean

¹⁹³ *Ibid*, page 66.

¹⁹⁴ Nigel Meeson, *Admiralty Jurisdiction and Practice*, 4th Edition, 2011, section 10.132.

¹⁹⁵ *Ibid*, section 10.164; See also The Merchant Shipping Act 1995, Schedule 1, paragraph 10(a).

¹⁹⁶ See for example The Merchant Shipping Act 1995, Schedule 1, paragraph 9; *Supra*, note 50, page 67-68; *Supra*, note 8, page 100.

¹⁹⁷ *Farrar v. Farrar Ltd* (1988) LR 40 Ch.D. 395; *Martinson v. Clowes* (1982) LR 21 Ch.D. 857.

title.¹⁹⁸ This is therefore a good alternative if the mortgagee is unwilling to indemnify the buyer against existing liens.

¹⁹⁸ The Tremont (1841) 1 Wm Rob 163; The Acrux [1962] 1 Lloyd's Rep 405.

CHAPTER 6

MARKET TRENDS

6.1. Ship Finance

After the prosperous years between 2003 and 2008, came the financial crisis which had a massive impact on the shipping industry. Several new ships were ordered, particularly 2007, because of the thriving economy. These new vessels were ready for delivery just after the world economy had collapsed, leading to a market supply of vessels well above the demands.¹⁹⁹ Consequently, freight rates as well as vessels' asset value dropped which, together with an increased oil price, intensified the negative trend.²⁰⁰ Moreover, the price of steel has increased resulting in a scrap value of vessels not much below its price after selling it to continue operating on the sea.²⁰¹ Banks as fund providers for ship investors have naturally also been afflicted by the downturn in the shipping sector, ending up with collateralised assets with a value far below the outstanding loan amount. This often leads to breach of loan covenants which normally includes requirements of the collateral's value to be within a certain range of the loan. This leads to lenders agreeing to waive covenants or in the worst scenarios to enforce the mortgage.²⁰²

¹⁹⁹ Dr. Martin Stopford (MD Clarkson Research ServicesLtd), *A Year of Decisions For Shipping – How Will The Markets Develop?*, FT Deutschland Ship Finance Conference, Hamburg 2010, page 3; *QFinance, Shipping Industry, Market Analysis and Trends*, page 1, available online at: <http://www.qfinance.com/sector-profiles/shipping>.

²⁰⁰ *The Maritime Executive*, Shipping Plagues: Rising Oil Prices, Declining Freight Rates & Vessel Oversupply, 14th March 2012.

²⁰¹ *Supra*, note 187.

²⁰² *Standard & Poor's, Global Credit Portal, RatingsDirect*, Declining Asset Values Are Putting International Shipping Companies At Risk Of Breaching Loan Covenants, 7th December 2011, page 2 and 5, available online at:

Because of all these difficulties, many European banks have decided to pull back from ship financing business and tightening covenants for their clients. Instead of offering new business, focus is on high quality core customers.²⁰³ Asian banks on the other hand continue to provide funding for ship financing to existing and new clients. This is mainly because shipbuilding is such an important business in this part of the world. It has been reported that China aims to import half its oil on national owned vessels; if this goal is implemented, non-Chinese oil tankers will suffer heavily, resulting in even lower rates and asset values for this type of vessels.²⁰⁴

Because of many banks holding back their funding for ship financing, shipping companies have been forced to use other methods to finance their vessels. Consequently, the bank debt market has decreased and an increasing trend is instead to use bond and equity finance. Bonds are favourable for the borrower in comparison to bank debt in many aspects because it is more flexible when it comes to terms of covenants, it offers longer credit periods without requirement of annual amortizations and it is not always a precondition to set up security. The drawback on the other hand is that the interest rates in general are significantly higher compared to a bank debt, something that might prevent investment given the infected climate in the economy.²⁰⁵

http://www.standardandpoors.com/spf/upload/Ratings_EMEA/2011-12-07_DecliningAssetValuesArePuttingInternationalShippingCompaniesAt.pdf.

²⁰³ *Supra*, note 199; Joseph Gorgles, ABN AMRO Bank, Head of Transportation West-Europe, *Current Trends in Ship Finance, 3rd Mare Forum in Ship Finance*, Presentation in Istanbul, Turkey 22 March 2011, available online at:

http://www.mareforum.com/ISTANBUL_III_PRESENTATIONS/GORGELS.pdf.

²⁰⁴ *Supra*, note 201, page 2 and 5.

²⁰⁵ Stuart H. Gelfond, Vasiliki B. Tsaganos and Melina Kapeliou, *The Deal Pipeline*, Recent Trends in Shipping Finance, 22 June 2012, available online at:

<http://www.friedfrank.com/index.cfm?pageID=25&itemID=6561>.

6.2. Marine Insurance

Within the insurance sector, the last few years have been troublesome for underwriters. Large claims featured 2012 with *Costa Concordia* and *Rena* as the undoubtedly most costly casualties. In fact, the average size of insurance claims 2012 was by far the highest in history. Although, excluding claims for total loss, the remaining claims were less costly 2012 than the preceding couple of years. As already mentioned, when a shipowner undergoes financial hardship, increased deductibles can generate savings by way of lower premium costs. Increased deductibles in general might therefore explain the trend 2012 being less small claims and increased total loss claims.²⁰⁶ What also strikes hard against insurers is the large number of ships that are over insured because of covenants in loan agreements requiring the insured amount to be 120% of the outstanding debt. Given the decrease in vessel values the last few years, many bank debts are of higher amounts than the value of the collateral asset. Hence, the 120% requirement often results in the collateral vessel being insured for an amount by far exceeding its market value.

Furthermore, what also concern underwriters are the size of newly built vessels that now are being delivered. Due to the economic and environmental climate, in order to be more efficient, these new vessels are massive. Maersk has ordered twenty ships with a size of 18,000 TEU. These vessels will be nearly 60 meters wide and 400 meters long; the Eiffel Tower is 324 meters high which by comparison might provide the reader a better picture of how big these container ships actually are. It is not hard to understand the concerns amongst insurers given the potential liabilities following a casualty involving a ship of this size.²⁰⁷

²⁰⁶ Cefor, The Nordic Association of Marine Insurers, *Annual Report 2012*, page 15 and 18.

²⁰⁷ Marsh, *Marine Practice*, Marsh Insights: Marine Market Monitor, July 2012, page 1; <http://www.worldslargestship.com/the-ship/#page/economy-of-scale/compare-it>.

The 13th of January 2012 was the day *Costa Concordia* ran aground outside Italy. To date, this is the largest insurance claim ever made, exceeding *Exxon Valdez*, and will cost hull and liability underwriters about USD 1,000,000,000 altogether.²⁰⁸ Just a few days earlier *Rena* was broke in half after having run aground some months earlier outside the coast of New Zealand. This casualty is estimated to result in liability costs of USD 300,000,000 and a H&M cost of USD 19,000,000 which makes it the third largest claim ever after *Costa Concordia* and *Exxon Valdez*. The wreck removals have for both these incidents (*Costa Concordia* and *Rena*) been extremely costly. This can be explained partly by the lack of specialized equipment required to carry out these operations which drives up the prices.²⁰⁹

The market situation for mortgagees' insurances has naturally also been affected by the financial crisis. Underwriters are nowadays more cautious when underwriting risks and the policy wording is critically analysed before deciding whether to sign it or not. When the economy was at its top cycle between 2003 and 2008, mortgagees' insurance underwriters signed almost every slip presented to them. Some insurers have, due to the current financial situation, decided to draw back their business completely from this type of risk. The mortgagees' insurance business is however on the whole continuously good business since banks are a lot more cautious now when advancing funds although some business have been lost due to certain banks refusal to go through with new deals. A consistent trend the last few years has been the increasing willingness of underwriters to sign big loan deals for big energy assets whilst it has become almost impossible to obtain full security for mortgagees' insurances in respect of a small loan amount with an old small tonnage vessel as collateral. Another reaction from the economic downturn is the increasing popularity of equity and bond finance

²⁰⁸ *Ibid*, page 1; <http://www.worldslargestship.com/the-ship/#page/economy-of-scale/compare-it>.

²⁰⁹ *Supra*, note 206, page 8; <http://www.worldslargestship.com/the-ship/#page/economy-of-scale/compare-it>; *Supra*, note 167.

deals. It is possible to obtain similar mortgagees' insurances for equity finance as for bank finance but for bond deals this is more complicated but surely still feasible.²¹⁰

²¹⁰ *Supra*, note 3.

CHAPTER 7

ANALYSIS AND CONCLUSION

7.1. Cover Issues and Pitfalls for a Mortgagee to be aware of

Although the mortgagee is confident and relies on the borrower that the insurances taken out to protect the collateral vessel are adequate, there are, as described above, cover issues and pitfalls that the mortgagee should be aware of. Some are more apparent than others but attention should be paid to them all and the first step towards sufficient insurance cover is obviously awareness of their existence.

When it comes to the underlying insurances, the mortgagee and mortgagor both wish to have as wide conditions as possible and preferably very few, or even better no, warranties. This means they can have a good dialogue when deciding what type of cover is deemed to be necessary. The majority of standard clauses available on the insurance market are on a named peril basis.²¹¹ This can cause problems to the assured since he bears the burden of proof and thus must provide evidence showing that the loss was caused by one of the listed perils in the policy. Causation is sometimes very hard to trace and if there is lack of proof, the underwriters will refuse to pay compensation. Providing evidence is many times difficult, time consuming and also expensive. These are clearly reasons why the assured would wish to avoid this type of policy. Similar reasons explain why the assured (and mortgagee) also must ensure that the stipulated insured value in the policy is an agreed value. An agreed value would relieve the assured from the burden of presenting evidence to convince the underwriters the value of the loss.

²¹¹ See for example IHC clause 2; ITC – Hull clause 6; AIHC lines 70-86.

Many times the cover notes explicitly stipulate the value being on an agreed basis and the absolute majority of hull policies are. However, there are occasions when the cover note lacks indication on whether the value in fact is agreed. Although this almost certainly is a matter of sloppiness, it is, for the sake of good order, important to have the agreed value basis stipulated in the policy, just to avoid any potential disputes with underwriters.

Another concern for the mortgagee is if the policy contains warranties. While some warranties are included in almost every policy, such as a warranty stating that the vessel must be classed and remained in class, other warranties could be seen as unreasonable, especially from a mortgagee's perspective. The mortgagee is not party to the contract, only assignee and loss payee. The mortgagee has no ability to control the acts of the assured more than through requirements in the loan agreement. If there is a breach, the cover collapse and there is no way for the mortgagee as an assignee to obtain compensation. What can be seen as unjust is the fact that there is no requirement at all in respect of causation between the breach and loss. Furthermore, the breach must not necessarily be a material breach, the underwriters will nevertheless be able to avoid the contract. It is quite surprising that the concept of warranties has survived and still applies in many insurance contracts. Its origin is England and the English concepts tend to live long, given the nation's appraisal of history and tradition. Another reason is the widespread practice of common law as a result of the British Empire. But who knows, it might just be a matter of time until the warranty becomes just an archaic obsolete concept. This would certainly be something highly appreciated by shipowners and ship financiers.

Another important issue to be aware of as a mortgagee is the unfortunate chance of miss-matching conditions so that gaps or overlaps occur in the insurance cover. The missing vessel clause, collision liability and piracy are risks that could be subject to such miss-match and are therefore extra important to keep an eye on. If a professional broker is placing the insurances this should obviously not happen. However, the war insurance

can be placed with a different broker than the hull insurance and the P&I cover is normally taken out without an intermediary. Communication between the parties involved is therefore crucial. But still, everyone make mistakes and it is for that reason important for the mortgagee to review the cover notes and certificates of entry in order to make sure these clauses are in place and good order. What makes a gap extra unfortunate for a mortgagee is the fact that a MII policy would not respond due to lack of underlying cover. In order to eliminate the chances of miss-matching, the same standard clauses should be used throughout the insurances. This is because they are designed to be placed as a whole package, covering everything including H&M, IV and war. The collision liability is an exception and to get matching cover without doing any extra relocation of clauses, the English standard conditions shall be used. These cover three fourths collision liability whilst the P&I club covers the remaining fourth. If other clauses are used, NMIP for example, the P&I club must be made aware in order for them to exclude their standard one fourth from the cover.

The war cancellation clause, giving war underwriters the right to cancel the policy subject to one week prior notice, is also clearly something that could cause the mortgagee trouble. Many war risks could last for a longer period, thus enabling underwriters to cancel the policy when it is needed the most. As soon as coverage cease whilst the assured is exposed to war acts, the credit becomes jeopardised. Expensive losses could follow and if the assured has not got a balance sheet big enough to cover these he could obviously encounter difficulties with the repayment of the loan. It is therefore important, especially for vessels trading in political unstable regions, to have MRI cover in place. Although MRI is expensive, it is recommended for mortgagees to consider, given the insurance costs it would take to replace a cancelled war policy for a vessel already exposed to warlike operations. Another issue for the mortgagee to be aware of regarding the war coverage is how to formulate the loan agreement. Some cover issues could be avoided through good wording. Especially the war requirement should preferably define some of the perils to be included in the

cover and amongst them ‘piracy’. Traditionally loan agreements do not specify perils like ‘piracy’. This opens up for the shipowner or charterer, depending of who is in charge for the insurances, to obtain a cheap additional separate cover, excluding piracy, when the vessels enters any of the conditional areas. If the conditional area is frequently hunted by pirates, an additional cover covering ‘war risks’, although excluding ‘piracy’, could be obtained for a very low price without being in breach of the loan agreement. War cover excluding piracy will also have an unfortunate impact on a MII policy since this only responds if there had been underlying piracy coverage in the first place. However, what might seem a bit paradoxical is the fact that a MII policy most certainly would respond if a vessel breaching the trading limits, without obtaining additional separate cover, suffered loss due to piracy. The reason is because the underlying policy in this instance covered the risk of piracy.

Finally, the last insurance issue to highlight is the risk of mortgagees to be held reliable for premium payments if they in the cover notes and certificates of entry are noted as ‘co-assured’ instead of ‘mortgagee’. In the event the primary insured fails to pay the insurance premiums, this obligation can be imposed upon the co-assureds instead. Banks with their deep pockets are likely to be underwriters’ first target. By being noted as ‘mortgagee’, this risk is avoided even though the right of receiving claims proceeds, bringing a claim under the policy and receive information about it still consists, although as a result of the insurance assignment.

7.2. Measures to be taken by the Mortgagee to ensure Sufficient Insurance Cover

Some of the most important insurance issues and pitfalls for the mortgagee to be aware of was mentioned in the previous section. This section will

instead focus on measures available in order to avoid such hitches. One of the foremost important measure for a mortgagee to take is to obtain mortgagees' insurances. Taking the issues raised above, mortgagees' insurances would normally respond to a claim relating to breach of warranties, overlap of piracy, missing vessel clause or collision liability and also the consequences following underwriters' invocation of the war cancellation clause. In some instances it is extra important to obtain this extra cover. In respect of vessels operating in American waters, the mortgagee should well consider obtaining MAPP and the same applies for MRI for vessels trading in political unstable regions. MII should preferably be included in all insurance packages although it should be even more thought through during economic downturns. If the mortgagees' insurances contain a 'final judgement clause', it shall preferably be replaced by a 'time for payment clause'.

If mortgagees' insurances have been taken out, the bank should be advised not to gain too much information about the borrowers' business. The borrower should instead be controlled through covenants in the loan agreement, hence keeping the mortgagee on a fair distance from the mortgagor's day to day business. Close scrutiny would dilute the mortgagee's chances to succeed in claims proceedings against the underwriters.

Apart from obtaining mortgagees' insurances, the bank must always request the placing broker to issue a LOU, including a fleet lien waiver if the collateral vessel forms part of a fleet policy. The LOU obliges the broker to keep the bank informed should anything relevant in the insurances change. It also confirms NOA and LPC being endorsed to the policies.

What also is important for the mortgagee to get involved in is which standard conditions the insurances are to be subject to. At the moment, the most favourable ones available on the market from a mortgagee's perspective, is the NMIP. NIMP provides the best cover in many aspects

because of its 'all risk' basis and specially designed clauses offering protection to the mortgagee, for example chapter 7 and clause 8-4. It is possible to require the insurances to be subject to NIMP in the loan agreement although, due to regular updates of the conditions, the precise version should preferably be left out. If the insurances instead are subject to any of the English clauses, the mortgagee should, especially if there is no MII in place, ensure that a 'held cover clause' is included in relation to the warranties contained in the policies.

Having regard to the above about insurance issues, pitfalls and recommended measures for the mortgagee to take, it clearly shows the mortgagee's need to have insurance experts to regularly review and make sure the insurance documentation is in order. If there is no internal insurance advisor within the bank, external expertise could be engaged. One advantage with hiring external experts is that they many times are more 'in the market', surrounded by insurance practitioners, thus picking up market news and trends easier than internal advisors. Unfortunately it is not enough to ensure that the insurances are in place just before and after drawdown; insurances are renewed, usually annually, and the renewed clauses and underwriting security might have changed. Checking the underwriting security is particularly important as MII does not respond in the event the underlying insurances are not paid due to underwriters' insolvency. If any of the insurance companies are questionable, a cut-through clause or assignment of reinsurance should be requested. Furthermore, it is not unusual for the shipowner to change broker at some point during the life time of the credit, meaning that new LOUs should be issued.

7.3. Economic Downturn's Effect on Ship Financiers and Insurances Involved

A shipowner struggling financially is able to make savings by increase the insurance deductible or take out a higher proportion of IV. Both these measures will reduce the premium costs. To have the insurances taken out on a fleet policy will also reduce the costs although the mortgagee in this instance must be made aware so that a fleet lien waiver could be requested and issued by the insurance broker. MII protection is extra important for mortgagees to obtain during economic downturns because of increased likelihood of insurance cancellation because of unseaworthiness, vessels out of class and non-payment of premium. The borrower is normally obliged to pay also for the MII premium. However, during times when the shipowner is on the brink of bankruptcy, the mortgagee may chose to step in and take over the premium payment, just for the comfort of having an MII policy to underpin the credit.

Economic recession leads to lower trade volumes which in turn lead to decreased freight rates and consequently lower market values on vessels. This vicious chain causes trouble for the shipowners in several ways. One problem is to find underwriters willing to insure vessels up to the mortgagees' requirements. When the borrower or borrower's broker is struggling finding underwriters, it may become tempting to seek less qualified security more inclined in writing doubtful risks due to lack of business. One reason why underwriters are reluctant in writing these risks is because a vessel insured for a much higher amount than its market value could possibly encourage a shipowner to fraudulently scuttle the ship in order to release insurance proceeds. The insurance companies are in particular cautious to over insure small shipping companies in times when they are struggling financially. A small shipowner is often personal liable

for the debt and a successful fraud can be the decisive factor between bankruptcy and staying afloat.

7.4. Conclusion

Looking at the future and taking all the above into account, given banks' rising awareness of the significance of insurances involved in ship finance, this area will certainly continue to grow. Many banks pulled out from ship finance after the financial crisis but the economy will stabilize and some banks may decide to return to the business. Encouragement can be given by informing about mortgagees' insurance and other protective measures to take in order to secure the credit. In the end, everyone wants the deal to go through so why not do whatever is necessary to make it happen. Lending business, when it is well considered, can be very lucrative. The increase in taking out mortgagees' interest insurance as a result of banks being more cautious is also something for underwriters to rejoice. For them, mortgagees' insurances normally generates in a steady premium income with very few claims. It is also in the insurance broker's interest to obtain knowledge in this area in order to understand a mortgagee's insurance requirement and thus be able to place the insurance in accordance with them. It is obviously not ideal for a broker to be asked to have an underwriter replaced or a clause inserted whilst the policy period is running. An understanding in this area amongst all parties involved will simplify and effective the businesses concerned.

Another change we might see in the future is relocation from European based ship financier to Eastern Asia and maybe also South American based given the high growth economy in Brazil. The financial crisis affected European banks hard and in combination with the rising importance of shipping in the East Asia region, banks in this area will most likely take over parts of the ship financing business. From an insurance aspect, London will probably remain as the main centre with Lloyd's market as a major

insurance provider. However, it is possible to see a growth in the Scandinavian insurance market, one reason being the NMIP that has gained popularity far outside the Nordic borders. With its up-to-date insurance conditions, drafted by representatives from both shipowners and insurers, it offers a complex package of insurance, more shipowner and mortgagee friendly than its English counterparts. Scandinavian underwriters are in general more familiar with these conditions compared to underwriters in the London market. They are therefore also more willing to undertake a risk subject to these conditions which means that, if NMIP increases in popularity, the Scandinavian underwriting market may as a consequence gain more business.

After the above attempt to foresee future market developments, some last few words will now sum up the final findings of the previously raised questions. With reference to the above discussion, it has been shown that there are measures available for ship financiers to take in order to avoid insurance issues and pitfalls that could threaten the credit if not taken. For example, make sure the policy is placed on an all risk and agreed value basis with the same standard conditions throughout the insurance package to avoid miss-matching. Furthermore, banks should obtain mortgagees' insurances to protect the loan from being affected by potential breach of warranties and conditions in the underlying policies and also to avoid shortfalls under the war cover and P&I pollution limit. The financier shall scrutinize the underwriting security and make sure the NOA and LPC are attached to the policies in the customary manner which also shall be confirmed by a broker's letter of undertaking issued in favour of the mortgagee.

The financier needs to be extra cautious during economic recessions when borrowers sometimes try to 'cut corners' on the insurances in order to save money. The foremost important thing is for the banks to increase their knowledge in this area so they know which measures to take in order to gain a stronger position under the insurance covers. With a comprehensive

insurance package as safety net, the banks will feel more safe and secure when granting a loan.

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