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Preface

This isssue of MarIus comprises a selection of theses written by our LLM students over the last couple of years.

The selection illustrates the versatility of subjects chosen by our LLM students and at the same time the wide field of interest of the Institute.

We congratulate the authors of the articles with their successful work and wish our readers joyful reading.

Trond Solvang

Right of affirmation in a charterparty context under English law

"The Aquafaith"

Monika Midteng

Acknowledgement

I am heartily thankful to my supervisor, Trond Solvang, associate professor at the Scandinavian Institute of Maritime Law (University of Oslo), whose guidance, support, encouragement and precious comments on chapter drafts enabled me to develop an understanding of the subject in its details as well as complexity.

Lastly, I offer my regards and blessings to all of those who supported me in any respect during the completion of the project.

Monika Midteng
13 January 2013

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1 Introduction

The shipping market is characterized by high fluctuation range and obvious periodicity, which affects not only the fleet planning of shipowners but also the charterers ability to meet their obligations. When the market falls substantially, the charterer might not be able to meet hire payments out of earnings on the employment of the vessel. Often the charterer will write to the owner, seeking reduction in agreed rates. The shipowner may in turn persist on the fulfillment of the original contract. The charterer may respond by attempting to negotiate a lower rate in exchange for a longer duration, etc. If the worst comes to the worst, the charterer may redeliver the vessel early, in breach of contract. Another scenario is a ”plain” premature redelivery of the vessel, without connection to a market downturn, e.g. one month prior to the expiry of the charterparty.

In both situations, the shipowner and the charterer will be interested in grasping their legal position – what are the legal consequences of such repudiation[1] and what rights and obligations does such breach confer on them. The question of primary concern is whether the shipowner has the right to reject the charterer´s repudiation and affirm the contract. If the answer is negative, the shipowner is obliged to take the possession of the ship and his only remedy will be a claim for damages with the corresponding duty to mitigate. In practice, a considerable level of uncertainty, in respect of the shipowner´s right to affirm the contract, has led to a prevalent policy of accepting repudiation with a consequent claim for damages, even in situations where the charterer was not insolvent. That way, owners avoid potential significant losses which could arise should the shipowner wrongly interpreted his legal

[1] The term ”repudiation”, as used in the thesis, is meant to embrace both 1. the verbal notification of unwillingness or inability to perform and 2. non-verbal, actual defaults, i.e. anticipatory breach by self-created impossibility or substantial breach justifying termination.

position, affirmed and performed[2] the contract, and subsequently learned from arbitrator´s/court´s decision that he was only entitled to a claim in damages.

Early delivery can be considered as a nearly eternal problem in the context of the charter-party relationship. It has a reappearing tendency on the agenda of maritime lawyers, defence clubs and defence departments of P&I clubs. Also, shipowners and charterers are very much interested in the accurate assessment of their negotiating and settlement position. The aim of the thesis is therefore to explore the legal position under the English law relating to the right of affirmation in case of charterer´s repudiation.

The following questions in particular will be addressed in the thesis:

i) What is the main rule under English law in connection with the right of affirmation? And what are the competing principles behind that rule?

ii) What are the various tests applied by English courts in connection with the availability of the right of affirmation?

iii) What factors are considered relevant when deciding on whether the innocent party has the right to affirm the contract?

iv) What are the practical implications of the current state of law in connection with the right of affirmation?

The methodology used throughout the thesis is based on an analysis of primary and secondary sources relating to the chosen topic. The examination of relevant English case law forms the substance of the thesis. I have opted for an analysis in a chronogical order, starting with a discussion of the decision in *White & Carter*, which can be considered to be the ”roots” of the current system, since it constitutes a point of reference

[2] The word perform in the context of the thesis refers to the performance of the duties of the owner under the charter, which is discussed further under subheading 3.3.3.1.1 and 3.4.3.1

in all subsequent cases. The decision is discussed in detail in the second chapter under the heading ”Right of Affirmation”. Under the same chapter I will focus the attention on conflicting policy legal principles and policy considerations, which were explicitly or impliedly weighted by the court. The purpose of the first chapter is to lay a general ground for the treatment of the right of affirmation under English law.

Subsequently, in the second chapter ”Right of affirmation in the charterparty context – selected decisions”, I will place the topic in the context of the charteparty relationship. In this connection several English judgments will be analysed. The presentation of the facts of each case will be limited to those factors which were relevant for the courts´ ruling on the owners right of affirmation. I will start with a theoretical discussion of the courts´ reasoning and then draw some conclusions following from the judgment. The thesis is not meant to be an exhaustive examination of every decision connected to the theme of the thesis, but rather it focuses on the most influential judgments only. In this connection, the last discussed will be the recent *Aquafaith* decision, from April 2012, which sparked a lot of interest between lawyers and shipping market participants.

The analysis is supplemented by a limited reference to judgments from other common law jurisdictions, where I found it appropriate and of potential interest to readers. Further, I will refer to secondary resources, primarily citations of contract law textbooks, articles and standard books on charterparties.

Even though, the right of affirmation within a charterparty relationship was in England and internationally subject to a considerable interest during the years, there was to my knowledge no publication specifically devoted to a systematic research of the topic. The thesis should be therefore considered as an attempt to fill this gap.

2 Right of affirmation – the main rule

2.1 Introduction

The general rule established in common law is that ”whenever a party to a contract manifests his intention to another party that he will no longer be bound by the contract, the other party may either affirm or cancel the contract.”[3] This is also known as “right of affirmation”, i.e. right of an innocent party, faced with a repudiation or breach of contract, to elect to continue his own performance in the hope either of earning his contract price or of obtaining a decree of specific performance against the wrongdoer. “This right is often referred to as the rule in *White & Carter*[4], a decision of the House of Lords on appeal from the Court of Session of Scotland. The case is regarded as authoritative at common law.”[5] In the following I will present the facts of the case and the reasoning of the court within the parameters of this thesis. As such I considered pivotal to discuss the speech of Lord Reid and Lord Hodson in majority. Nevertheless, I have also included the examination of the dissenting opinions, albeit in a more limited fashion, by referring merely to their sceleton arguments.

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3 A report by the Contracts and Commercial Law Reform Committee. The rule in White and Carter (Councils) Limited v. McGregor. Patterson C. I. (et al.). Wellington, (P.D. Hasselberg, Government Printer) 1983. p. 1. The report was a reaction to the New Zealand Law Society´s criticism of the rule in White and Carter, which suggested that the rule should be considered with a view to reform. However, the Committee came to the conclusion not to introduce any changes in law, since “a reasonable balance exists already in the law as it stands.” (p. 15)

4 (Councils) Limited v. McGregor (1962) A. C. 413.

5 Contractual duties: Performance, Breach, Termination and remedies. Neil Andrews (et al.). London, (Sweet& Maxwell) 2011. p. 150

2.2 The White & Carter (1962) decision

2.2.1 Introductory remarks

As outlined in the introduction above, the judgment in *White & Carter* was a landmark decision in English law. It confirms that the innocent party might have the capacity to keep open the contract and complete his side of the bargain. At the same time, however, it formulates two restrictions upon the innocent party´s opportunity to take advantage of this rule. Before I turn to the analysis of the judgment itself, I will present the facts on which the Court based its decision.

2.2.2 Summary of the facts of the case

In 1954 the parties entered into a contract under which the appellant advertising contractor agreed to display advertisements on local authority litter bins for the respondent´s garage for a three-year period. The contract was renewed for a further three-year period in 1957. On the day that the renewal contract was concluded the respondent wrote to the appellants, seeking to cancel the contract on the ground that his sales manager, who concluded the contract on the respondent´s behalf, had no specific authority to make the contract. The appellants refused to accept the respondent´s cancellation and continued with performance of the contract. The respondent refused to pay for the advertisements. The appellants sued in accordance with the clause 8 of the contract, for the full sum due under the contract for the period of three years.

The respondent, however, maintained that he was not liable to pay the sum alleged to be due on the ground that he had repudiated the contract before anything had been done under it so that the appellants were not entitled to continue with performance and sue for the price.

The case was of great importance, although the claim was for a comparatively small sum. If the appellants were right, it would have consequences in any case in which, under a repudiated contract, services are to be performed for the earning of the contract price. Such situa-

tion would also comprise also repudiations by charterers in cases of purported early re-deliveries of vessels. In the following, I will address the decision of the Court.

2.2.3 The decision of the House of Lords

The House of Lords held by a majority 3 to 2 that the appellants were entitled to recover the contract price on the ground that the respondent´s unaccepted repudiation of the contract had not operated to terminate the contract between the parties. The appellants were therefore entitled to continue with performance of the contract and recover the contract price. The House of Lords held that, on an anticipatory repudiation of a contract, the innocent party has an election. He may, if he wishes, terminate the contract forthwith and sue for damages without having to wait for the other side to make actual default. Alternatively, he may opt to hold the contract open. If he chooses the latter course, and is able to complete his own performance, he can sue for the contract price on the due date as a debt owing to him. The pursuer in that case, having elected to keep the contract on foot, and having satisfied the terms of the contract entitling him to payment, was entitled to judgment for the contract price as a debt owing to him.

After the confirmation of the general rule, Lord Reid went on to formulate two conditions[6], which must be fulfilled in order for the innocent party to be able to claim the contract price. As a first rule, the innocent party must be able to complete the contract in order to earn the contract price. In the further text, I will refer to the restriction by using the convenient term: ”the cooperation qualification”. The second limitation, following from the *White & Carter* decision, is only implicated if the contract in question can be performed without the cooperation of the party in default. In accordance with this restriction, the innocent party cannot succeed in claiming the contract price, where the repudiating party is able to prove a lack of legitimate interest in affirming the

6 In *Hounslow London Borough* council v. Twickenham Garden Developments, (1971) 1 Ch. 233 the Court described both limitations as important.

contract. In the further text, I will refer to this fetter as ”the legitimate interest qualification”.

The cooperation qualification

In most cases the circumstances are such that an innocent party is unable to complete the contract without the cooperation of the other party. The peculiarity of the *White & Carter* case was that the appellants were able to completely fulfill the contract without any co-operation of the respondents. However, it has been noted by Lord Reid, that ”if it had been necessary for the respondent to do or accept anything before the contract could be completed by the appellants, the appellants could not and the court would not have compelled the defender to act, the contract would not have been completed and the pursuers´ only remedy would have been damages.”[7] This is of central importance. Under English law, if the debtor is dependent upon the creditor´s (repudiator´s) cooperation in order to fulfill the contract, he will not have the right to affirm the contract because: a) the contract price is not earned without the cooperation and b) other solution would in reality involve a decision on specific performance against the creditor (repudiator), something the English law does not allow in principle.

There is a potential room for argument in the passage from the Lord Reid speech: ” (…) if it had been necessary for the respondent to do or *accept* anything before the contract could be completed (…)” (emphasis addedd). In the context of a charterparty relationship, one might say, that a charterer as part of his obligations *accepts* the services provided by the owner. However, the question following from the above passage is rather whether such acceptance of services is a pre-condition for the completion of the contract. With this regard an important clarification was made by Lord Reid. It was stated that non-acceptance of services in circumstances similar to those in *White & Carter,* i.e. where the innocent party is able to complete the subject-matter of the contract, does

7 *White & Carter*

not mean that the contract had not been completely carried out. [8] This part of the ruling has some important implications in the context of a charterparty relationship, which will be elaborated further in the thesis[9]. In this connection the following questions will be examined: What is the subject-matter of the charterparty relationship and whether it can be completed without the co-operation of the charterer. The questions will be examined in connection with both time charterparties and demise charterparties. As will be noted, the issue may entail complications depending on the specific terms of the contract.[10]

The legitimate interest qualification

The other condition, noted by Lord Reid, in order for the innocent party to be able to claim the contract price, was the existence of a legitimate interest in completing the contract. It is important to note here, that the Court in *White & Carter* formulated the option of the innocent party to affirm the contract as a *right* in common law. Nevertheless, the Court admitted the possibility of limitation of such rights under the general equitable jurisdiction of the court based on "general equitable principle or element of public policy". It was noted that:

> "*It may well be that, if it can be shown that a person has no legitimate interest, financial or otherwise, in performing the contract rather than claiming damages, he ought not to be allowed to saddle the other party with an additional burden with no benefit to himself. (…) And, just as a party is not allowed to enforce a penalty, so he ought not to be allowed to penalize the other party by taking one course when another is equally advantageous to him.*"

Two groups of legitimate interests were mentioned in the cited passage: financial and other, non-financial. Nevertheless, I consider it sufficient for the purposes of this thesis to examine only the owners´ financial

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8 *White & Carter*, Lord Reid referring to Langford & Co. Ltd. v. Dutch.

9 See subheadings 3.2.3.1; 3.3.3.1.1; and 3.4.3.1

10 See subheading 3.2

interests, since this is most practical in the charteparty context.[11].

The Court has further used the term *substantial interest* as a synonym to *legitimate interest*. However, in this respect, Lord Reid expressed his opinion that "the de minimis principle[12] would apply in determining whether his interest was substantial." In other words, it need go only beyond the merely trifling. What is to be considered a substantial/legitimate interest, had not been further elaborated by the court. But it was ruled by the court that a decision on the lack of legitimate interest should be limited to "*extreme cases*".

It was at the same time stated, that the evaluation should not be based on the comparison of the benefits and losses of the parties upon affirmation of the contract and claim of contract price as opposed to the acceptation of the repudiation and claim in damages. As Lord Reid stated: "It is, in my judgment, impossible to say that the appellants should be deprived of their right to claim the contract price merely because the benefit to them, as against claiming damages and re-letting their advertising space, might be small in comparison with the loss to the respondent…". The suggested test in *White & Carter* focuses rather on asking whether the wastefulness of a party´s continuing performance outweights its interest in performance and earning the contract price.

Further, it follows from the decision, that the legitimate interest limitation will only be applied in *extreme cases* and that it is the repudiating party who bears the burden of proving that the other party had no legitimate interest in completing the contract.

2.2.4 The dissenting opinions

I found it of importance to provide an account of the dissenting opinions in *White & Carter*, albeit not an exhaustive one. The findings of the two of their Lordships in minority, when compared with the majority view, are a good indication as to what are the conflicting principles

11 See subheading 2.2.5

12 Since then, the Supreme Court of Canada appears to have treated the "substantial" requirement as going well beyond the "*de minimis*" rule. Asamera Oil Corpn. v. Sea Oil & General Corpn. (1979) 89 D. L. R. (3d) 1

present in connection with the right of affirmation. Therefore this part will serve as a convenient bridge to the next subheading[13] "The conflicting principles and policy considerations".

Both judges in minority, Lord Morton and Lord Keith, thought that the company should have mitigated its loss by not taking action on the contract and by claiming damages instead. Lord Keith of Avonholm in his speech referred to the case of *Langford & Co. Ltd v. Dutch*[14] where the circumstances were practically indistinguishable from those in *White & Carter.* He quoted the judge in the case, Lord President, who said that the law of Scotland did not afford to a person in the position of the pursuers the remedy thought, i.e. the recovery of the contract price. Lord President further added that the only *reasonable* and *practical* course, which the pursuers should have adopted, would have been to treat the defenders as having repudiated the contract and as being on that account liable in damages. The decision is however lacking an explicit reference to the principles which Lord President had in mind. Nevertheless, the words "only *reasonable* and *practical* course" seem to point to the direction of economic wastefulness argument, which will be examined under the next subheading.

However, the reference to "the only *reasonable* and *practical* cause" was not accepted by the majority in *White & Carter* as a basis for a refusal of the innocent party´s right to affirm the contract. Lord Reid for the majority view said: "It might be, but it never has been, the law that a person is only entitled to enforce his contractual rights in a reasonable way, and that a court will not support an attempt to enforce them in an unreasonable way." He argued that it "would create too much uncertainty to require the court to decide whether it is reasonable or equitable to allow a party to enforce his full rights under a contract." The other judge in majority Lord Hodson agreed. He was of the opinion that if a party was not to be held to his contract unless the court in a given instance thought it reasonable so to do would introduce uncertainty into the field of contract. It would make an action for debt a claim for a discretionary remedy.

13 Subheading 2.2.5

14 [1 952] SC 15

Both majority views, seem to refer to the principle of legal certainty[15] in English law, without explicitly mentioning it. Lord Reid´s concern was ”that it would create too much *uncertainty* to require the court to decide whether it is reasonable or equitable to allow a party to enforce his full rights under the contract”, while Lord Hodson held that the same ”would introduce an *uncertainty* into the field of contract (…)” (emphasis added). Ultimately, the majority in their judgment gave preference to that principle above any other considerations.

Secondly, the two of the dissenting judges suggested that in all cases of repudiation there is, on the innocent party, a duty to minimize the liability of the party repudiating. The majority however held that the rule about mitigation of loss is a rule of the law as to damages and not to the actions for the contract price. There is no common law principle analogous to mitigation which would compel a contractor to reduce his contract price by the amount of any savings he is able to make in the course of his performance. Nor, for that matter, were the Lords aware of any principle of law, which entitles a court to interfere with a contract simply on the grounds that it is wasteful. The role of the mitigation rule was believed not to be the elimination of waste but as an aid to the quantification of damages recoverable in respect of the wrongdoer´s breach of contract. Thus, if the innocent party does not claim damages, there is no common law duty upon him to mitigate loss.

I find the example used by the majority about a contractor apposite. Admittedly, it might be broadly said, that the *White & Carter* legitimate interest qualification and the duty to mitigate share the same goal of waste avoidance. However, the difference is that the *White & Carter* legitimate interest qualification addresses the innocent party´s ability to earn the contract price by continuing performance, rather than its ability to recover for certain avoidable loss.

15 See subheading 2.2.5.1

2.2.5 The conflicting principles and policy considerations

The decision has been subject to active criticism[16] over the years and considered to be a controversial one. It has been criticized in a leading textbook[17] and it has been said to give a "grotesque"[18] result. It was contested that the right of affirmation contravenes the policy of mitigation rules as it allows the innocent party to disregard the repudiation and continue his performance of the contract so as to recover the contractual price[19]. The decision therefore seems to encourage economic waste, since the innocent party was entitled to complete his performance and recover the price, even though the defaulter no longer wanted the performance in question. It was further criticized, that the House of Lords afforded the benefit of the right of affirmation to an innocent party even though the defaulter had repudiated before the innocent party even had begun his performance.

In the light of the above criticism, one may wonder why an aggrieved party should wish to go on and incur expense in performing the contract instead of accepting repudiation and recovering damages from the party in default. For several reasons, it is preferable from the innocent party´s point of view to pursue an action for an agreed sum rather than claiming damages. In the following, I will examine the conflicting interest of the parties.

The owner´s interest

First of all, the determination itself whether an action of a charterer constitutes repudiation might involve risk of misinterpretation. Also actions, which a lay person regards as a very clear repudiation of the

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16 A report by the Contracts and Commercial Law Reform Committee. The rule in White and Carter (Councils) Limited v. McGregor. Patterson C. I. (et al.). Wellington, (P.D. Hasselberg, Government Printer) 1983. p. 2.

17 Furmston, M.P.: Cheshire, Fifoot and Furmston's Law of Contract. 15th edition. New York, (Oxford University Press) 2007. p. 782

18 *ibid*

19 Chitty, J.: Chitty on Contracts. 24th edition. London, (Sweet & Maxwell) 1983. para 1601; see also Ewan McKendrick: Contract law. 4th edition. Oxford, (Oxford University Press) 2010. p. 812

contract may not be so regarded by the courts.[20] Admittedly, in a number of instances, the repudiatory act is so unambiguous that the risk of misinterpretation will not arise. However, the number of decisions in England and other common law countries[21], dealing with the question of whether a particular action constitutes repudiation, is a vivid proof that the issue is practical. The determination of courts is in principle discretionary. As said by Earl of Selborne LC in the House of Lords in *Mersey Steel and Iron Co (Limited) f Naylor, Benzon & Co (1884):* ”(…) you must look at the actual circumstances of the case in order to see whether the one party to the contract is relieved from its future performance by the conduct of the other; (…) whether it amounts to a renunciation, to an absolute refusal to perform the contract…”. Consequently the discretionary character of the evaluation has the potential of introducing an element of uncertainty into the innocent party´s decision making process. There is an obvious risk associated with it. An innocent party who makes wrong judgment and under the impression of an existing repudiation ceases to perform the contract puts himself in an essential breach of contract by evincing an intention that he himself will not perform.

Secondly, the procedure for recovering an agreed sum is simpler than the ordinary action for damages. It is a claim for a sum certain where proof is simple and quantification raises no problem. By contrast, a damages claim raises more complicated problems of liability, remote-

[20] In Woodar Investment Development Ltd. v. Wimpey Construction (U.K.) Ltd. (1980) 1 All E. R. 571, the claimant seller had agreed to sell land to the defendant purchaser. Completion was to occur after planning persmission had been granted. The defendant purported to resile from the deal before completion. It mistakenly invoked a purported contractual right of withdrawal. That possible “exit” was contained in an obscure clause. In fact, that clause conferred no such right. The majority of the House of Lord held that defendant had not absolutely refused to perform. Instead, the parties had understood that, if the defendant´s reliance on this clause proved to be unfounded, the defendant would abide the contract.

[21] E.g. Vaswani v Italian Motors (Sales & Services) Ltd (1996) 1 W.L.R. 270, PC; Alfred C Toepfer v Peter Cremer GmbH & Co (1975) 1 Lloyd´s Rep. 118, CA; Starlight Enterprises Ltd. v. Lapco Enterprises Ltd.(1979) 2 N. Z. L. R. 744; DTRNominees Pty Ltd v Mona Homes Pty Ltd (1978) 138 CLR 423

ness and quantification[22].

In practice, the charterers often question the extent of damages claimed by the owners. The parties may submit conflicting expert reports on the state of the market in order to substantiate their claim[23]. Consequently, it may take months for the decision on the extent of damages recoverable. As additional consequence, even though in theory the compensation in damages should correspond with what the owner would earn under the contract, in reality, due to the difficulties in the evidentiary part of the assessment of damages, it is not necessarily always the case. A claim for hire, on the other hand, is much more straightforward and difficult evidentiary issues normally do not arise. Thus within the main reasons to keep contract alive are substantial difficulties in fair assessment of damages, especially when some part of loss is hardly recoverable because it is too remote.

Thirdly, in case of claim for the agreed sum, the innocent party is spared from the burden of the duty to mitigate which would arise in case of a claim for damages. Although commonly referred to as a "duty to mitigate", it is acknowledged not to be a duty but a principle adopted in the measure of loss[24]. Nevertheless, the shipowner will very much feel it as a duty, an additional burden of deciding on and employing measures to avert or minimize loss. With a measure of oversimplification it may be said that the obligation to find employment for the ship transfers, by means of the duty to mitigate, from the charterer to the shipowner. It is therefore preferable from the view of the shipowner to insist on the performance of the original charterparty and avoid additional burden in putting the ship back on the market in order to mitigate damages.

Another reason for the preference of the contract affirmation, as opposed to the acceptance of repudiation and claim for damages, is the

22 The difficulty of the assessment of damages was also addressed by Kerr J in *Gator Shipping Corporation v. Trans-Asiatic Oild Ltd SA and Occidental Shipping Establishment* [1978] 2 Lloyd's Rep 357 ("*The Odenfeld*"). For discussion see 3.3

23 *See* Isabella Shipowner SA v Shagang Shipping Co Ltd (2012) EWHC 1077 ("*The Aquafaith*"). The decision is analysed under subheading 3.4

24 *The Soholt* [1983] 1 Lloyd's Rep 605 CA

commitments, which innocent party may have with third parties, which he must honour as a matter of business. It is common when obtaining ship financing, that the banks require assignment of charter hire as security for their loan. Thus, any element of uncertainty as to the existence of the charterparty, introduces at the same time an undesired uncertainty into the relationship between the shipowners and bankers. Moreover, the innocent party (shipowner) may have other side benefits from affirming the contract. He may for instance want to keep his work force together instead of laying the crew off in circumstances where there is no available market for the employment of the vessel.

The charterer´s interest

I have considered at some length the reasons for preference of action for contract price as opposed to claim in damages from the shipowner´s point of view. I will turn now the attention to the charterer´s interests. This is much more simple, obvious and do not deserve much discussion. The charterer who repudiates a long-term contract will be interested in reduction of his economic exposure by way of compensation of the innocent party in damages instead of payment of the sum agreed.

Admittedly, the charterer's interests, will be slightly different in situation where the charterer has a right to sublet the vessel under the charterparty. In such circumstances it is equally open for the charterer as to the owner to employ the ship on the market. Therefore, at least theoretically, it should lead to the same financial result for the charterer, whether the charterparty is kept alive or is repudiated. I write theoretically, because due to the uncertainties in the process of assessment of damages, the financial result for the charterer tends to be more favorable when it is the owner who trades the vessel as part of his mitigation of damages. At the same time, under circumstances where there is only limited time left from the charterparty period, e.g. 10 days, it might be problematic for the charterer to find an employment for the vessel for the residual contract period. In such situation it is more accessible for the owner to employ the vessel, since he might enter into charterparties with longer duration than 10 days.

The reconciliation of the conflicting interests

The starting point seems to be that it is fundamentally wrong to encourage parties to believe that, if they find their contracts not to their liking, then they may escape from those contracts, even though they remain liable in damages. This is in line with the rationale behind the old maxim "equity mends no man´s bad bargain". The right of affirmation has usually been justified on the basis that it would be wrong to allow a defaulting party to take advantage of his own default. The charterer cannot impose a termination on the other party simply on the grounds of his own actual or intended default. Therefore, at the first glance, it seems to be wrong to allow the charterer to get out of the contract on a speculative basis, when the markets are not developing in accordance with the forecast. However, this is to a certain extent an oversimplified reasoning. The commercial risk will not transfer from the charterer to the shipowner by way of charterer´s repudiation, since the charterer will be in any case liable in damages for the difference between the charterparty rate and the applicable market rate. What transfers to the shipowner, is the burden of obtaining employment for the ship.

In many instances, the reason why a shipowner employs a vessel on a long-term charter-party is because he only has a limited organization which is not suited for employing the vessel on the spot market. Therefore it is in his interest to leave this part of the commercial operations to a charterer with a specialized competence. At the first sight, it seems to be fundamentally unrighteous to allow the shift of the activities connected to the commercial employment of the vessel from the charterer to the shipowner by way of the charterer´s wanton conduct. That is at least the practical consequence of the rule relating to mitigation of losses in connection with a claim for damages. The shift of the burden of finding employment for the vessel seems to be unfair also when we take into consideration that it is equally open to the charterer to trade the vessel under the running charterparty[25].

On the other hand, the approach in *White & Carter* may lead to

[25] Provided that there is a sub-letting clause in the contract, which is common.

undesirable waste of physical and human resources. If the shipowner keeps the vessel fully crewed and ready to perform transport services despite a clear repudiation of the charterparty by the charterer, it may lead to an economic waste. It was claimed by the respondent in the *White & Carter* appeal that it is against public interest to allow the innocent party to complete the contract under such circumstances.

Another argument against the outcome in *White & Carter* is that, from the economic point of view, contracts are entered into with a view to gain profit. It makes no difference, whether the profit is collected through the fulfillment of the contract or by way of payment of damages. A contracting party, who is paid compensation representing the profit of the transaction receives from economic point of view all what he expected to receive and no further sanctions are needed.[26]

It follows from the above illustrated conflict between the individual interests, that what is to be balanced is, on one hand the right of the innocent party to rely on his contract against the defaulter, i.e. the principle of certainty in commercial contracts, and on the other hand, the interest of a defaulter to reduce the cost of his default and the interest of the society to eliminate economic waste. The question in this connection is whether the current state of law allows to strike an optimal balance between the competing principles. I will return to this question in the last chapter of the thesis[27]. At this junction, I consider it appropriate to set out the evolution of the case law, which forms the basis for the current state of law.

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26 Atiyah, P.S.: An introduction to the law of contract. 5th Edition. Oxford, (Clarendon Press) 1995. p. 417

27 Under heading 4. Conlusion.

3 Right of affirmation in the charterparty context – selected decisions

3.1 Introduction

The right of affirmation within the charterparty relationship has been addressed by the courts on several occasions. It was first and foremost the limitations of the right of affirmation set out in *White & Carter* that the decisions evolved around, i.e. 1) the cooperation qualification and 2) the legitimate interest qualification. The questions arising in this connection were relatively simple: 1) Is a charterparty a contract which requires cooperation from the charterer in order to be performed and 2) had the shipowner in particular circumstances a legitimate interest in affirming the charter, as opposed to accepting the charterers repudiation and claiming damages. The focus of this chapter will be on the courts′ application of the above limitations in particular circumstances. Ideally, this should provide us with some guidance as to the interpretation of the vague terms introduced by the majority in *White & Carter,* particularly in connection with the legitimate interest qualification.

As outlined in the introduction, I will limit the analysis under this heading only to the selected decisions. Neither the scope of the thesis does allow for including a full account of all related case law, nor is it necessary for the purposes of this thesis. I have chosen the decisions with the view to include the most influential ones, which formed a point of reference in the subsequent judgments and which brought some clarification into the issue of right of affirmation/or possible fetters on it. I will particularly address the contribution of each decision in connection with the two *White & Carter* qualifications described above.[28]

[28] See subheadings 2.2.3.1 and 2.2.3.2

3.2 The Puerto Buitrago (1976) – The "adequacy of damages" test

3.2.1 Introductory remarks

The *Attica Sea Carriers Corporation v. Ferrostaal Poseidon Bulk Reederei GmbH ("The Puerto Buitrago")*[29] was one of the first judgments after the delivery of the decision in *White & Carter,* where the Court of Appeal had to decide on the question of repudiation within a charterparty relationship. The application of the principles in *White & Carter*, which in itself would not be a simple exercise, was even more complicated by the facts of the case. It is natural to provide first an account of the facts of the case.

3.2.2 Summary of the facts of the case

In *The Puerto Buitrago* the charterers chartered a vessel from shipowners for seventeen months. The vessel was on a bareboat time charter by demise, under which the vessel was manned and maintained by the charterers. After six months the vessel required substantial repairs. In accordance with the charter it was the charterers who were obliged to repair the ship and return it in good repair at the end of the charter. However, the charterers prematurely returned the ship without repair as the cost of repairing the ship would have exceeded its value. The cost of repairs was some $2 million, while the vessel was worth, in the second-hand market, only $1 million, even in fully repaired state. The scrap value of the vessel was about $12 million. The charterers admitted liability for $400,000 for the repairs, but they disputed the rest.

Seeing the huge claim by the shipowners, the charterers consulted their solicitors. They advised the charterers that it was open to them to redeliver the vessel to the owners in its unrepaired state – thus terminating the charter hire, but being liable in damages. On Sept. 22, 1975, the charterers telexed the owners´ agents, saying that they intended to rede-

29 *Attica Sea Carriers Corporation v. Ferrostaal Poseidon Bulk Reederei GmbH* (1976) 1 Lloyd´s Rep 250

liver the vessel at 12 noon the next day, Sept. 23. The owners, however, refused to accept redelivery. They had a few men on the vessel and removed them next morning at 10.00. At 12 noon the charterers´men left. The only men left on the vessel were watchmen provided by the repairers.

The shipowners refused to accept the re-delivery of the vessel, contending that the charterers were bound to repair the vessel before redelivery and that the owners were entitled to hire until the charterers repaired the vessel. Consequently, the owners brought an action against the charterers claiming hire at the charter rate of $46,000 a month until the vessel was repaired and redelivered in sound condition. In their submissions they referred to clause 15 of the charter as a basis for their claim that the repair of the ship was a *condition* for the owner´s duty to take redelivery: ”*Conditions on Redelivery* The vessel shall be redelivered to the Owner in the same good order and condition as on delivery (…)” The judge of the first instance court gave a judgment in favour of the shipowners, holding in effect that the charterers were bound to repair the vessel before redelivery, and that the owners were entitled to the hire until the charterers repaired the vessel. The charterers appealed the judgment.

3.2.3 The decision of the Court of Appeal

The Court of Appeal rejected the shipowner´s argument, holding that 1) the obligation to repair the vessel was not a condition precedent to the entitlement of the charterer to redeliver the vessel, 2) on the true construction of the charterparty the redelivery of the vessel was effective notwithstanding that the vessel was not in proper repair, and 3) when the charterers tendered redelivery at the end of the period of the charter the shipowners ought in all reason to have accepted it and sued for damages. It is the last point of the decision which is relevant from the viewpoint of the subject-matter of this thesis. In the following I am going to deal with the reasoning of the parties and the court in this regard.

The shipowners relied on the decision of the House of Lords in

White & Carter. Lord Denning, M. R. accepted that "even though it was a Scots case, it would appear that the House of Lords, as at present constituted, would expect us to follow it in any case that is precisely on all fours with it."[30] However, he expressed his view not to follow the decision in the particular circumstances. The two other judges, Lord Orr and Lord Browne agreed. In the following I will highlight the reasoning of Lord Denning and Lord Orr[31] with respect to the 1) cooperation qualification and 2) the legitimate interest qualification following from *White & Carter.* I will conclude with the evaluation of the decision′s contribution to the clarification of the two *White & Carter* qualifications.

The cooperation qualification

Lord Denning has not explicitly referred to the qualifications following from *White & Carter.* Nevertheless, the arguments he used in his speech can be conveniently divided and linked to these two categories of qualifications. In connection with the first qualification, i.e. whether a charterparty is a contract which can only be performed with the cooperation of the charterer, an example has been developed by Lord Denning. He likened the charterparty relationship to that between a servant and a master. He said: "Take a servant, who has a contract for six months certain, but is dismissed after one month. He cannot sue for his wages for each of the six months by alleging that he was ready and willing to serve. His only remedy is damages."[32] In accordance with this reasoning, a contract between master and servant applies more closely to a time charter than the analogy of a simple debt because the owners supply the vessel and the crew, whilst the charterer supplies fuel oil, pays disbursements and gives orders.

The argument "stems from a debate as to whether a contract of personal service forms an exception to the general rule that an anticipatory breach does not automatically terminate the contract but merely vests

[30] Puerto Buitrago, p. 255

[31] Lord Brown agreed with the speech of Lord Orr, without adding any comments.

[32] Puerto Buitrago, p. 255

in the victim a power to terminate. Two opposing views present themselves in this regard.[33] "One, treats a contract of personal service as no different from other types of contracts. The other, usually excludes such a contract from the general rule."[34] It has been noted that "the legal authorities are divided, but as a matter of precedent it seems to be that the former view has thus far gained the upper hand."[35] The latter view, was also condemned by Templeman LJ as "contrary to principle, unsupported by authority… and undesirable in practice."[36] In the charterparty context the argument of Lord Denning was criticised by Justice Kerr in *The Odenfeld*[37] case. He said in this connection: "I confess that I am not impressed by arguments to the effect that a time or demise charter requires a degree of co-operation between the parties so as to make such charters analogous to contracts for personal services."[38]

In summary, the analogy used by Lord Denning with the contract for personal service is at best uncertain and at worst not applicable to the charterparty relationship. As follows from the argument of Justice Kerr in *The Odenfeld* cited in the previous paragraph, the level of cooperation required between the parties is an important factor when determining whether the analogy is appllicable. In the particular circumstances of *The Puerto Buitrago*, the degree of cooperation required from the charterer was slightly higher due to the requirement of repairs being performed by the charterers. Probably, therefore, the analogy was more accessible to the judge.

Lord Denning also likened the situation to "a finance company which lets a machine or motor-car on hire purchase, but the hirer refuses to accept it. The finance company cannot sue each month for the

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33 These two views were helpfully summarised in *Robert Cort & Son Ltd v Charman* (1981) ICR 816 EAT 819 (Browne-Wilkinson J).

34 Liu, Q.: *The White & Carter Principle: A Restatement.* In: The Modern Law Review. Volume 74 (March 2011), p. 175

35 *ibid*

36 *London Transport Executive v Clarke* (1981) ICR 355 CA 366

37 See subheading 3.3

38 *Gator Shipping Corporation v. Trans-Asiatic Oild Ltd SA and Occidental Shipping Establishment (The Odenfeld) (*1978) 2 Lloyd`s Rep 357, 373-374

installments. Its only remedy is in damages”[39]. In my opinion, it is questionable whether the example is fitting in the circumstances of the case. In *The Puerto Buitrago* the charterer initially accepted the vessel, the case instead regarded the redelivery of the vessel and whether the owner could claim hire for the time until the vessel is redelivered in a repaired state. In subsequent decisions, another analogy was used, analogy to letting of an appartment, which will be examined later in the thesis[40].

Lord Orr, unlike Lord Denning, referred explicitly to the cooperation qualification in *White & Carter* decision. He said: “The present case differs from that case in that here it cannot be said that the owners could fulfill the contract without any co-operation from the charterers (…)”. The differentiation of the two cases was rather brief. It does not follow from the cited passage, what cooperation the judge had in mind. On the other hand, one might say that the issue was addressed by Lord Denning and there was no need for repetition. As such, it was likely the obligation of the charterer to repair the vessel, on which Lord Orr based his conclusion.

The legitimate interest qualification

In connection with the legitimate interest qualification, Lord Denning reasoned that the decision in *White & Carter* “has no application whatever in a case where the plaintiff ought, in all reason, to accept the repudiation and sue for damages – provided that damages would provide an adequate remedy for any loss suffered by him.”[41] The test used by Lord Denning was later referred to by the legal theory as “the adequacy of damages test”[42]. In accordance with this test, the innocent party´s right to affirm the contract will depend on a discretionary determination of whether damages in particular circumstances are adequate and whether the innocent party ”ought, in all reason, to accept the repudia-

[39] Karsales (Harrow) v. Wallis, (1956) 1 W.L.R. 936 (2nd point).

[40] See subheading 3.4.3.1

[41] Puerto Buitrago, p. 255

[42] Liu, Qiao: The White & Carter Principle: A Restatement. The Modern Law Review. Volume 74, (March 2011). p. 184

tion and sue for damages." Lord Denning further went on to develop his argument by saying:

> "The reason is because, by suing for the money, the plaintiff is seeking to enforce specific performance of the contract – and he should not be allowed to do so when damages would be an adequate remedy. (….). They cannot sue for specific performance – either of the promise to pay the charter hire, or of the promise to do the repairs – because damages are an adequate remedy for the breach."[43]

Lord Denning here treated the claim for hire analogous to a claim for specific performance. This was likely due to the requirement of completion of repairs by charterers prior to redelivery. Therefore, it could be said that the claim for hire, in its effect, amounted to an attempt to enforce the charter by a specific performance. However, it has been suggested in legal theory that such analogy drawn in the English context is both lax and dangerous.[44] "Once the victim fulfils all conditions precedent to the payment of the contract price, that price is payable ´as a matter of right´and a claim in debt is not subject to the court´s discretion. (…) Admittedly, Lord Reid´s legitimate interest qualification confers on the courts an equitable jurisdiction to constrain the accrual of that entitlement."[45] However, the issue in *White & Carter* was not whether the victim, having fulfilled all the conditions precedent, should be awarded the contract price, but whether it should be allowed to fulfil those conditions in the first place.[46] The doctrine of specific performance, on the other hand, regards the unavailability of certain remedies. Therefore, in my opinion, the issue should have been correctly approached through the legitimate interest qualification and not

43 Puerto Buitrago, p. 255

44 Liu, Qiao: The White & Carter Principle: A Restatement. The Modern Law Review. Volume 74, (March 2011). p. 179

45 *ibid*

46 There are several other grounds distinguishing the legitimate interest qualification from the doctrine of specific performance, such as their focus and scope. See Liu, Qiao: The White & Carter Principle: A Restatement. The Modern Law Review. Volume 74, (March 2011). p. 179

through the doctrine of specific performance, albeit the solution would not vary.

Lord Denning further pointed out the commercial absurdity of other solution. He said:

> "What is the alternative which the shipowners present to the charterers? Either the charterers must pay the charter hire for years to come, whilst the vessel lies idle and useless for want of repair. Or the charterers must do repairs, which would cost twice as much as the ship would be worth when repaired-after which the shipowners might sell it as scrap, making the repairs a useless waste of money."

Clearly, what was Lord Denning emphasizing was the commercial nonsense which would be a consequence of the affirmation of the contract as opposed to the redelivery and claim for damages. In the particular circumstances the court´s decision must be seen as the only rational option. It would be unlikely for any commercially aware judge to reach other conclusion.

Lord Orr, the other judge in the case, concluded that the particular case differed from *White & Carter* because the charterers had set out to prove that the owners had no legitimate interest in claiming hire rather than claiming damages. Again, he had not referred to any specific circumstance which evinced the lack of owner's legitimate interest in performing the charter. Nevertheless, as discussed in the previous paragraph, the facts of the case were so extreme that it would stretch beyond mere unreasonableness to affirm the contract.

3.2.4 Conclusion

In my opinion, the *Puerto Buitrago* decision brought some, if only a limited, light on the issue of charterers repudiation and the right of the owner to elect to affirm the contract. It seems, at least form the speech of Lord Denning, that what prompted the referred solution in the case was the commercial absurdity of other solution. And from this point the judges took different approaches in justification of it. Lord Orr ex-

plicitly referred to the fetters on the innocent party´s right to affirm the contract following from *White & Carter.* It was equally open for Lord Denning to do the same. The vagueness of the terms used in *White & Carter* would allow reaching the same conclusion through the interpretation of those terms. Instead, Lord Denning, took a more "adventurous" road through analogy between the claim for hire and doctrine of specific performance. Apparently, it was the facts of the case, particularly the obligation of the charterer to repair the vessel prior to redelivery, which made it convenient to use such line of argumentation. However, I have doubts about the appropriateness of drawing such analogy for reasons set out above[47].

Nevertheless, Lord Denning contributed to the clarification of the vague *White & Carter* legitimate interest qualification with the formulation of the "adequacy of damages test". As will be seen further, the test was accepted in subsequent decisions, albeit in a supplemented form. Admittedly, the decision does not present a clear demarcation of situations where the owner is entitled to affirm the contract. However, this could hardly be expected in the light of the complexity of the issue.

Furthermore, it was clearly stated by Lord Orr, that a demise charterparty of a kind as in *The Puerto Buitrago,* i.e. where the charterer is obliged to repair the vessel prior redelivery, is not a contract which can be performed without any cooperation from the charterers. Whether the same could be said about time charterparties and demise charterparties, without the charterer's obligation to perform repairs, remained unanswered. I consider this part of the decision to be of most practical value, since it follows from the *White & Carter* decision, that if any of the two qualifications is not met, the charterer may not bring an action for the contract price/hire. It follows, that in such situations an owner, will not be entitled to claim hire even if he has a legitimate interest in claiming it, due to the inability to perform the charter. The strict application of the *Puerto Buitrago* decision would therefore mean that in case of demise charterparties, of the same kind as in the case, the shipowner would only have a claim in damages in case of charterer´s repudiation.

[47] See subheading 3.2.3.2

3.3 The Odenfeld (1978) – The "wholly unreasonable" test

3.3.1 Introductory remarks

In *The Odenfeld* a less restrictive approach to the scope of *White & Carter* was adopted as compared to *The Puerto Buitrago*. Justice Kerr provided a detailed description of the facts of the case and a thorough discussion of the questions of law. He referred to *The Puerto Buitrago* discussed under the previous subheading, however, as will be noted, he did not accept all the propositions presented in the case. I will continue with the same structure of the discussion, i.e. I will start with the presentation of the facts of the case, then address the two qualification rules from *White & Carter* and conclude with a short summary. Since the facts are very complex, I only propose to summarise them so far as practicable for the purposes of this thesis.

3.3.2 Summary of the facts of the case

The charterer and the shipowner entered in 1973 into charter for a basic period of ten years in respect of the vessel Odenfeld. After the first two years the charter hire rate was to be assessed by the London Tanker Broker Panel, subject to a minimum. A side letter from the owners to the charterers contained a 'funding arrangement' under which, if the hire fixed by the Panel was less than the minimum hire specified in the charter, the owners would pay the difference. The charterers knew the documents were written to help the owner raise a loan and that it was at least highly likely that the owner would not disclose to the lender the side letter. After the charter had been made, the owner approached the Gator Shipping Corporation for a loan, disclosing only the charter and not the side letter. The owners were granted a loan of $6,660,000 on the security of an assignment of the money due under the charter.

After some time, the freight market collapsed, and the Panel fixed a rate below the minimum level in the charter. The owner continued for some months to make the funding payments to the charterers as requi-

red in the side letter. By September 1975, however, they ceased to do so and claimed to justify the non-payments on the ground that they were entitled to a set-off against the charterers for hire due under other charters and contended that the charterers had made wrongful deductions from hire under them. The charterers disputed both contentions but continued to pay the full hire from September to December, 1975. However, on or about 6th January 1976, the charterers refused to continue to do so and said that they treated the charterparty as at an end due to the owners´ wrongful repudiation of it. In May and June the vessel performed two voyage charters for the charterers on a without prejudice basis and on July 2, 1976, after the completion of these voyages she was laid up. On September 22, 1976, the title in the vessel was transferred to the financing company and they conceded that the charter-party then came to an end.

The finance company Gator Shipping Corporation brought an action against the charterers claiming outstanding hire for the period January, 1976 to September 1976. The charterers denied liability and counterclaimed declarations to the effect that the charter came to an end in January, 1976.

3.3.3 The decision of the Commercial Court

There were several preliminary questions to be decided by the Commercial Court, but the one relevant for the purposes of this thesis is the question no. 3: "Whether on the assumption that the charterers repudiated the charter, the charterers´ plea that the owners ought to have accepted the repudiation and that thereafter the only liability of the charterers was in respect of damages was correct: and if so when the repudiation ought to have been accepted."[48]

Another potentially interesting question is the one under no. 6, whether the charter came to an end when the vessel was laid up or only at the time of the transfer of the title to the vessel to the financing company. The answer to this question provides some light on the issue

[48] Odenfeld, p. 359

of what actions constitute an acceptation of charterers´ repudiation.

Preliminary question no. 3 – The right of affirmation

The charterers contended that the owners were under the duty to accept the repudiation of the charterers on or about Jan. 6, 1976, and to treat the charter as at an end. They contended that this was the only reasonable course for owners to take in the circumstances.[49] Nevertheless, Justice Kerr ruled, that "the charterers´ plea was incorrect since the owners were not obliged to accept the charterers´ repudiation and treat the charter at an end."[50] In the following I will examine the reasoning of the Court in relation to the two *White & Carter* qualifications.

The cooperation qualification

In connection with the cooperation qualification, Justice Kerr saw it as a crucial factor that the charterers had the vessel at their disposal and that there was nothing to prevent or hinder them from giving orders to her and employing her normally under the charter. This was even more so, since the charterers in fact employed the vessel, even though on a without prejudice basis, on two voyages in May and June. He considered also of a considerable importance, that the charterers had an express right to sublet the vessel or to lay her up at a reduced rate of hire. Justice Kerr concluded that charterers "were under no obligation to employ the vessel; their only irreducible obligation was to make whatever were the payments due under the charter at any particular time (…)"[51]

I agree with the reasoning of Justice Kerr. It is true, that the performance of voyages under the charterparty requires active participation from the part of charterers in form of orders, but the question expressed in *White & Carter* was rather whether charterer´s cooperation is needed for the accrual of hire. In this connection I find it decisive that under a time chartperaty an owner fulfills his obligations by keeping the vessel

[49] Odenfeld, p. 372
[50] Odenfeld, p. 359
[51] Odenfeld, p. 374

ready to receive orders against the payment of hire by charterers. This forms the subject-matter of a time charter-party. The shipowner earns hire o the basis of the time during which the vessel is at the disposal of charterers and not on the basis of the performed voyages. Therefore, I am of the opinion that a time-charterparty is not a contract which could only be performed with the cooperation of the charterer. The *White & Carter* right of affirmation is therefore applicable, albeit subject to the fulfillment of the second qualification, which will be examined next.

The legitimate interest qualification

When examining the second *White & Carter* qualification, i.e. the owner´s legitimate interest in performing the contract, Justice Kerr considered the decision in *The Puerto Buitrago*[52]. But, he did not regard the case as any authority for a general proposition to the effect that whenever the charterer repudiates a time or demise charter for whatever reason and in whatever circumstance, the owners are always bound to take the vessel back, because a refusal to do so would be equivalent to seeking an order for specific performance. He added: "Consequences of such a proposition would be extremely serious in many cases, and no trace of such a doctrine is to be found in our shipping laws." I have discussed the deficiencies of the specific performance analogy above[53] and here I only refer to it.

On balance, Justice Kerr considered the conclusion in *The Puerto Buitrago* to be based on the extreme facts of the case. Then he went on to formulate or further precise the legitimate interest qualification set out in *White & Carter*. He said: "It follows that any fetter on the innocent party's right of election whether or not to accept a repudiation will only be applied in *extreme cases*, viz. where damages would be an adequate remedy and where an election to keep the contract alive would be *wholly unreasonable*."[54] (emphasis added). The cited passage can be

52 See subheading 3.2.3.2

53 *ibid*

54 Odenfeld, p. 373

seen as a prominent attempt to formulate a test for the applicability of the principle in *White & Carter.* Some described Kerr J in *The Odenfeld,* "as putting gloss"[55] on the limitation expressed by Lord Reid in *White & Carter.* However, when Lord Reid´s speech is read in its entirety, it is clear that the innocent party´s right is not qualified by the need to act reasonably. It requires something beyond that before the courts will interfere and prevent the innocent party insisting on performance of the contract.[56]

The first part of the test formulated in *The Odenfeld* decision is a re-statement of the "adequacy of damages test"[57] adopted by Lord Denning in *The Puerto Buitrago.* However I find the test suggested in *The Odenfeld* to be more in line with the intended balance between the competing interests expressed in *White & Carter* due to the added "wholly unreasonable" qualification. The application of the test formulated in *The Odenfeld* makes it assumably more difficult to confine the owner's right to a claim for damages. I write assumably, because the test allows for a substantial discretion by courts in connection with the interpretation of the vague term "wholly unreasonable".

The Odenfeld test was also commented on in the subsequent decision by Simon, J. in *The Dynamic.*[58] He said: "Although, the use of the qualifying word *wholly unreasonable* in *The Odenfeld* properly emphasizes that the rule is general and the exception only applies in extreme cases, it adds nothing to the test (…)."[59]All the courts which have considered the matter since have taken the view that Lord Reid´s test[60] has merely been expressed in other language in the later succession of authorities.[61]

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[55] Charterers´submissions in *The Aquafaith* accepted by the arbitrator. However, the Commercial Court on the appeal said that the arbitrator was wrong to regard the comments of Kerr J as a "gloss" on Lord Reid´s dictum in *White & Carter.*

[56] See subheading 2.2.3.2

[57] See subheading 3.2.3.2

[58] Ocean Marine Navigation Limited v. Koch Carbon Inc. (2003) EWHC 1936

[59] Dynamic, p. 698

[60] *White & Carter*

[61] In Stocznia Gdanska SA v Latvian Shipping Co. [1998] 1 WLR 574, Clarke J after referring to previous authorities said that he did not think there was any real difference between those differing ways of putting the principle.

Nevertheless, the judgment has in my opinion an indispensable effect as it lifts the requirement for the courts justification of the denial of the shipowner´s right to claim hire in individual cases This is even more so since the judgment limits the fetter on the innocent party´s right of election whether or not to accept a repudiation to "*extreme cases*".

On the basis of the particular circumstances the court held that the shipowners were not obliged to accept the defendant´s repudiation and treat the charter as at an end. Justice Kerr did not use the language of "legitimate interest". But he must be taken to have found that the charterers had failed to prove absence of legitimate interest on the part of the owners in claiming hire. One of the grounds on which Justice Kerr so found was the difficulty in calculating damages.

Further, it will be interesting to note what factors have been considered relevant in the case. On the facts of the case, Kerr, J, did not consider that damages were an adequate remedy because it would be difficult to assess damages for a prospective six and a half-year period following repudiation, as compared with a claim for hire[62]. He also attributed significance to the fact that the plaintiffs were assignees of the owners (being lenders) and an acceptance of the repudiation as terminating the charter would have put the owners in breach of their covenants with them. Moreover, he considered of significance the charterers´ liberty to sublet, and to lay up the vessel, which meant that they had options as to the disposal of the vessel. Hence, it was equally open to owners or charterers to employ the vessel on the market or reduce the loss by laying-up the vessel.

It was however added, that this must not be seen as implying that the shipowners could necessary have maintained the same position for a further six years. It was said that, "the passage of time might in itself

[62] In contrast, in *The Alaskan Trader* (Clea Shipping Corporation Bulk Oil International Ltd [1984] 1 AII ER 129) the Commercial Court refused to interfere with the decision of the arbitrator who found that the owner had no legitimate interest in keeping the contract alive in situation when the charterer repudiated the contract 8 months prior to the expiry of the time charterparty. The reason for charterer´s repudiation was the lack of employment for the vessel due to a market downturn. It was not accepted that the assessment of damages, on the facts of the case, presented any special difficulty.

alter the legal position of the parties, because an insistence to treat the contract as still in being might in time become quite unrealistic, unreasonable and untenable".[63] This passage implies that the time factor has a bearing on the right of the shipowner to keep the contract alive. In the particular case, the court acknowledged the shipowner´s right to keep the charterparty alive from the moment of charterer´s repudiation in January to the laying up of the vessel in September, i.e. for a period of approximately eight months. Predictably, the judgment does not define a precise moment from which the charterparty could not longer be kept in effect. It is left for the courts to determine in individual circumstances, from which moment in time the keeping of the contract alive becomes "quite unrealistic, unreasonable and untenable". This allows for a degree of flexibility in the decision-making process, albeit for the price of a degree of uncertainty. As a practical implication of this part of the judgment, it is important that the shipowners evaluate their legal position continuously, not only at the time of charterer´s repudiation.

Preliminary question no. 6 – Acceptance of repudiation

In answer to question no. 6, whether the charter came to an end when the vessel was laid up or only when the title to the vessel was transfered to the financing company, the Court decided, that "by laying up the vessel, the plaintiffs and owners should be regarded as having brought the charter to an end"[64]. The Court considered the submissions of both parties. The charterers submitted that if the other side was purporting to keep the charter alive, the vessel had at all times to be ready and at the disposal of the defendants. They submitted that laying her up was a breach of the charter if the charter was then still alive. The Court, however ruled otherwise by holding that the laying up of the vessel did not constitute a breach; at any rate not a breach on which the defendants can rely when they were themselves in repudation of the charter and treating it as having come to an end.

[63] Odenfeld, p. 375

[64] Odenfeld, p. 378

The Court then went on to consider the alternative submission of the charterers that by laying up of the vessel the shipowners impliedly accepted the repudiation and treated the charter as at an end. Justice Kerr had considerable hesitation over this point.[65] In one sense there was clearly no acceptance of the repudiation, since the shipowners at all times continued to maintain that the charterers remained bound by the charter. Justice Kerr, nevertheless came to the conclusion, that by laying up the vessel the shipowners should be regarded as having brought the charter to an end. He further reasoned:

> "It is true that the innocent party is dispensed[66] from being ready, willing and able to perform a contract in all respects, at any rate at short notice, when the other party has repudiated it. (…) But the extent to which the innocent party is dispensed from continuing adherence to the terms of the contract must be subject to some reasonable limitation. For instance, if the innocent party has put it out of its power to perform or cannot for some other reason continue to perform, then he clearly cannot achieve anything by maintaining that the contract is nevertheless still alive. Similarly, if he maintains that the contract is still alive, but does something which is inconsistent with its continuing survival, then he must be treated as having acquiesced in its termination."

However, the present case was not as clear-cut as the examples mentioned in the speech of Justice Kerr. It was accepted that the vessel could at any time have been brought back into service at short notice if the charterers had been willing to resile from their attitude. Nevertheless, Justice Kerr held on balance that laying up a vessel was so inconsistent

[65] Odenfeld, p. 379

[66] It might seem at the first impression, that the Court here denied the first qualification following from *White & Carter,* i.e. that the owner must perform the contract in order to earn the hire. However, the context here is slightly different. Here the Court did not deal with the question of whether the owner accrued the hire, but rather whether it is open for the charterer to claim that the owner by way of his actions (laying up of the vessel) impliedly accepted the repudiation. Admittedly, the borderline between the two aspects of the case is narrow. Since, if the owner cannot earn the hire, then in turn he cannot claim the hire and in such situation it is irrelevant whether the owner accepted the repudiation or not.

with the continuing existence of a time charter that the shipowners could not be heard to say in the same breath that the charter was still on foot.[67] He further reasoned: "To hold otherwise would lead to unrealistic and unfair consequences. The owners would not have to bear the expense of manning the vessel or the other normal costs of keeping the vessel in service, but would nevertheless be entitled to recover the full hire (…)."[68]

The legal effect of the laying up of the vessel was further addressed by the Court. It was mentioned that it was only consistent with action taken to mitigate loss resulting from the charterers´ repudiation of the charter and that it therefore operated as an implied acceptance of the repudiation, with the effect that from then onwards the plaintiffs only had a claim for damages.

The court interpreted the laying up of the vessel as an indication of the shipowners´ resignation as to the existence of the charter-party. The action clearly expressed a lack of hope for receiving of any future orders from the charterers. Also, the readiness of the shipowners to perform services required was impaired by the laying up of the vessel. The decision on this point is well justified. Even though the decision was not reached without hesitation, there is every ground to expect it to be followed in parallel situation.

Furthermore, there are some general rules, which follow from the decision. It was held, that when there is inconsistency between the verbal non-acceptation of repudiation and shipowner´s actions, the latter is given priority. The difficult part is to decide whether a particular action of a shipowner is incompatible with keeping the charter alive. In this connection, the decision reveals series of factors, which are of importance: 1) what the actions reveal about the shipowners´ perception of the situation, does he still consider the charterer to be alive, or does he now accept that it is at an end 2) is the purpose of his actions to mitigate damages, 3) would it be *unrealistic* or *unfair* to consider the charter-party to be still alive in the light of the shipowners´ actions.

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[67] Odenfeld, p. 379

[68] Odenfeld, p. 379

There is yet another point to be made in connection with this part of the decision. The Court decided in the particular case that the laying-up of the vessel was inconsistent with keeping the charter alive. There are however two forms for lay-up known in practice, for a short term or long term period – the so called "hot" lay-up and "cold" lay-up alternatives. A "hot" lay up means leaving skeleton crew in place to keep all systems running on minimum power. A "cold" lay-up means shutting down the ship almost completely for an extended period, in practice at least two months. This leads to greater cost savings, but the ship usually needs dry-docking before coming back into service. It takes normally some months for the ship to be again ready to perform voyages.

The decision does not explicitly mention whether the form for lay-up was "hot" or "cold", but since there was no crew present on board, it indicates a "cold" lay-up. The practical question, which arises, is whether the court would consider a "hot" lay-up as equally giving rise to inconsistency between shipowners´ actions and their verbal affirmation of contract. At first blush, there is much to say for a negative answer. One argument is that under "hot" lay-up the minimum requirements for the crewing of the vessel are met and the vessel can be ready to set out on a voyage usually within a week. In my opinion, such action would not indicate a resignation on the part of the shipowners as to the continuation of the charter-party, since "hot" lay-up is commonly used also during low employment periods of charter-parties, which were not repudiated. At the same time, it cannot be said that the vessel is not at the disposal of the charterer due to the presence of the crew and running of the vessel´s systems, even though at the minimum level. Although, the purpose of this form of laying- up is to reduce the running costs, the extent of it does not reach the same scope as in the case of a "cold" lay-up. On the other hand, it is an indication, even though on a smaler scale of an action to mitigate loss. The answer is therefore not unambiguous.

3.3.4 Conclusion

The contribution of *The Odenfeld* can be seen in the formulation of the

”wholly unreasonable test” in connection with the legitimate interest qualification. The decision acknowledges that there is a point at which court will cease, on general equitable principles, to allow the innocent party to affirm and perform the contract. The definition of such point is of course subject of some difficulty as it requires drawing a line between conduct, which is merely unreasonable and conduct which is *wholly* unreasonable.[69] Moreover, it was held, that the limitation of the owner´s right to affirm the contract will apply only in ”extreme cases”.

The decision, at the same time, shed light on the issue of the cooperation qualification. The court held that the owner may perform the time charterparty without any need for cooperation from the charterer.

The last discussed part of *The Odenfeld* decision[70], brought some clarification on the issue of what actions of the owner will amount to an acceptance of charterer´s repudiation. The Court specifically ruled, in this connection, that laying up of the vessel is an example of such action.

3.4 The Aquafaith (2012) – The “perverse” test

3.4.1 Introductory remarks

In recent case of Isabella Shipowner SA v Shagang Shipping Co Ltd (“*The Aquafaith*”)[71], the Commercial Court considered application of the rule in *White & Carter* in circumstances when charterers repudiated time charterparty but owners decided to maintain the charter and claim hire instead of mitigating loss and claiming the balance in damages. The decision stirred a lot of interest since it brought some degree of clarity into the issue of owner´s right of affirmation, albeit it has not eliminated the existing obscurity completely.

The state of law prior to *The Aquafaith* was marked by a degree of uncertainty as to the interpretation and application of the *White &*

69 Alaskan Trader, p. 651

70 Subheading 3.3.3.2

71 (2012) EWHC 1077

Carter limitations on the innocent party´s right to affirm the contract, i.e. 1) the cooperation qualification and 2) the legitimate interest qualification. In accordance with the decision in *White & Carter* the qualifications were to be applicable only in extreme cases. Nevertheless, there were examples of decisions where the court/arbitrator rejected the right of the innocent party to affirm the contract in circumstances where it could be disputed whether they were extreme.[72]

The shifting of the opinions as to the application of limitations on the right of affirmation can be illustrated by the amendments introduced in the most recent edition of "Time charters"[73]. The authors in the latest edition after refering to the authorities draw a conclusion that the exception from the innocent party´s right to affirm the contract applies in circumstances where damages are an adequate remedy and it would be "wholly unreasonable" and state that the exception is applicable only in very clear cases[74]. In contrast, in the previous five editions[75] we find the conclusion: "it seems that once it becomes clear that there is no room for a change of mind by the charterers, the courts are likely to insist that the owners accept the re-delivery and sue for damages – assuming that damages will be an adequate remedy"[76]. In summary, what was meant to be an exception, as per speech of Lord Reid in *White & Carter*, was presented in the older versions of "Time charters" as a general rule. That opinion, in turn, due to its persuasive authority, had a potential to influence the legal and arbitration practice for many years.

In this context *The Aquafaith* decision was important since it reinforced the reliability of owners on their right of affirmation following from *White & Carter.* In the following I will examine the contribution of the decision to the clarification of 1) the cooperation qualification and 2) the legitimate interest qualification following from *White & Carter.* I start with a summary of the facts on which the court based its decision.

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72 *The Alaskan Trader*

73 Time Charters. Terence Coghlin…(et al.). London (Informa Law) 2008

74 *ibid,* para 4.35

75 1978 - 2003

76 Time Charters. Terence Coghlin…(et al.). London (Informa Law) 2003, para 4.41

3.4.2 Summary of the facts of the case

The vessel Aquafaith was chartered on an amended NYPE form which included a warranty that the vessel would not be redelivered before the minimum period of 59 months, which, in the event, was 10 November 2011. On 6 July 2011, however, the charterers stated that they would redeliver the vessel on dropping the last outward sea pilot after discharge in China under the then current voyage, which was in the event on 9 August 2011. It was common ground that that constituted an anticipatory repudiatory breach. The owners did not accept the repudiation and sought to affirm the charterparty.

On 25 July 2011 the owners commenced arbitration proceedings seeking a partial final award declaring that they were entitled to refuse the redelivery and to affirm the charterparty, as they had done, and that the charterers were liable for hire for the balance of the minimum period (94 days).

The charterers, on the other hand contended that the owners were not entitled to affirm the charterparty. "They said that the case fell outside the rule in *White & Carter* because the owners could not complete the charter without the cooperation of the charterers. Moreover, the owners had no legitimate interest in performing the contract rather than claiming damages."[77]

The arbitrator accepted both of the charterers´ arguments. He held that a time charter was not a contract that could be performed without the charterers needing to do or accept anything. He held that cooperation in that limited sense was necessary for the running of a time charter, stating by way of example the obligation of the charterers to provide fuel for the vessel to enable it to conduct its required operations. This, he held, took the present case outside the ratio of the House of Lords decision. He also expressly found that the owners had no legitimate interest in insisting that the charter remained alive. Accordingly, the owners were required to take redelivery of the vessel, trade her on

[77] Aquafaith, p. 61

the spot market by way of mitigation and claim damages.[78]

The owners appealed to the Commercial Court, submitted that "the arbitrator was wrong in law both to hold that time charters fell outside the scope of the rule in *White & Carter* and to hold that the owners had no legitimate interest in refusing early redelivery (…)"[79]

3.4.3 The Decision of the Commercial Court

Cooke, J considered the previous authorities and concluded on the facts of the case that there was "a clear error of law on the part of the arbitrator in finding that the *White & Carter* principle was of no application to the time charter in issue."[80] In his judgment he addressed the two qualification rules following from *White & Carter.*

The cooperation qualification

Time charterparty

The cooperation qualification has been discussed several times in this thesis. It follows from the decision in *White & Carter* that the innocent party will not be entitled to a claim for hire if he is not able to perform the contract without the cooperation of the charterer. It was argued that the relevant question to be asked in this connection is whether the charterer´s cooperation is necessary in order for the owner to be able to earn the hire. The Commercial Court in *The Aquafaith* adopted the same view. It was held by the Court:

> "The question, to my mind, is very simple. Could the owners claim hire from the charterers under this time charter without the need for the charterers to do anything under the charter? The answer is yes. If the charterers failed to give any orders, the vessel would simply stay where it was, awaiting orders but earning hire. (…) Although the charterers are obliged under the terms of the charter

78 Aquafaith, *p.* 61, 62

79 Aquafaith, *p.* 63

80 Aquafaith, *p.* 69

> to provide and pay for fuel, should the bunkers run out whilst awaiting orders, it is open to the owners to stem the vessel and to charge that to the charterers' account. In order to complete their side of the bargain, the owners do not need the charterers to do anything in order for them to earn the hire in question."[81]

The Court´s ruling on the cooperation qualification is important as it brings the disparity of opinions on this issue to an end[82]. The courts expressed conflicting opinions on the question of whether charter is a type of a contract, which can be performed without the cooperation of the charterer. In *The Puerto Buitrago*[83] Lord Orr stated that it could not be said that the owners could fulfill the particular demise charter, without any cooperation from the charterers. This was obiter and contained no explanation for that conclusion. In *The Odenfeld*[84] Kerr J, concluded that the owner is able to perform the time charter and claim hire without any cooperation from the charterer. On the other hand, Lloyd J, in *The Alaskan Trader*[85] was, at first blush (obiter) of the opinion that a time charter required the degree of cooperation referred to by Lord Reid which would make the application of the *White & Carter* general rule impossible. In *The Dynamic*[86] the applicability of the *White & Carter* right of affirmation to a time charterparty was accepted on all sides without argument. Equally, the standard textbooks, *Time Charters*[87] and *Scrutton on Charterparties*[88] have always accepted the applicability of the principle. On balance, there were more voices for bringing time charters under the principles of *White & Carter* than against. The decision in *The Aquafaith* can be considered as the "final nail in the coffin".

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[81] Aquafaith, 68

[82] at least in connection with time charterparties

[83] Subheading 3.2.3.1

[84] Subheading 3.3.3.1.1

[85] not analyzed in the thesis

[86] not analyzed in the thesis

[87] Time Charters. Terence Coghlin…(et al.). London (Informa Law) 2003. p. 138 -139

[88] Scrutton on Charterparties. Stewart C. Boyd… (et al.). London (Sweet & Maxwell) 2008. p. 351-352

Demise charterparty

The Aquafaith decision did not concern a demise charterparty. Hence, the court has not provided a definite answer as to the question of the application of the cooperation qualification on the demise charterparty. Cooke J nevertheless dwelled upon the issue. He pointed out that there is a material difference between a demise charter and a time charter, as in the case of a demise charter, the charterer takes possession of the vessel, provides the crew and typically pays all outgoings on the vessel. The question is whether this material difference makes the *White & Carter* principle inapplicable. The relevant question to be asked as formulated by Cooke J in *The Aquafaith* is: Could the owners claim hire from the charterers under the demise charter without the need for the charterers to do anything under the charter? The subsequent question is then: What is the basis for the owners earning of the hire? Under a demise charter the owner transfers the possession of the ship to the charterer and earns hire on the basis of the time during which the owner parts with the whole possession and control of the ship[89]. It is irrelevant for the accrual of the hire whether the demise charterer in fact operates the ship or not. However, if the charterer abandons the vessel as it was the case in *The Puerto Buitrago*[90] where only a ship repairer´s watchman were left on board, a question arises whether the owner still continues to earn the hire. In this connection it was held by the Court in *The Aquafaith*, that the owner is not entitled to claim hire after regaining the posssession of the ship.

The question left open is however, what would be the outcome if the owner had not regained possession of the ship. Would he be entitled to the hire under the demise charterparty? In *The Aquafaith* decision Cooke J drew analogy between a demise charterparty and a renting of a flat. He referred to the decision of the Court of Appeal in *Reichman v Beveridge*[91]. This concerned a claim by landlords for rent arrears where

89 Scrutton on Charterparties. Stewart C. Boyd… (et al.). London (Sweet & Maxwell) 2008. p. 55-56

90 See subheading 3.2.2

91 (2007) Bus LR 412

the tenant had quit the premises, having no further use for them, and maintained that the landlord had a duty to mitigate its loss rather than hold the tenant to the terms of the lease and require payment of rent. The tenant´s submission failed. An analogical conclusion in the context of a demise charter would mean that the owner is entitled to the hire even though the charterer is no longer in possession of the vessel, provided that the owner has not regained the possession. I must admit, however, that the situation is not very practical since in most circumstances the owner of the vessel will be, compelled to regain the possession of the vessel due to the existence of substantial risk of damage/loss of the vessel along with a potential insolvency of the charterer.

The legitimate interest qualification

In connection with the second *White & Carter* qualification, Cooke J, on proper analysis of all preceding case law, held that "The effect of the authorities is that an innocent party will have no legitimate interest in maintaining the contract if damages are an adequate remedy[92] and his insistence on maintaining the contract can be described as "wholly unreasonable"[93], "extremely unreasonable" or, perhaps, in my words, "perverse"."[94] Cooke J highlighted the exceptional character of the fetter on the right of the innocent party to affirm the contract by referring to the terms used by previous authorities, while he could not resist adding an additional adjective of his preference – "perverse".

Some considered the use of the term "perverse" to amount to an overreaching[95] from the part of the judge. In my opinion, however, it is clear from the above words of Cooke J, that he intended to use the word "perverse" as a synonym to the previously formulated tests and it does not present any change as to the test set out in *White & Carter*. Hence, I

[92] See subheading 3.2.3.2

[93] See subheading 3.3.3.1.2

[94] Aquafaith, p. 69

[95] See Leung, A.: Keeping Repudiated Contracts Alive: *Isabella Shipowner SA v Shagang Shipping Co Ltd, "Aquafaith"* [2012] EWHC 1077. 2012 http://www.stonechambers.com/news-pages/08.05.12--article--keeping-repudiated-contracts-alive---aquafaith----andrew-leung.asp. [Visited 30th October 2012]

doubt that the term used by Cooke J has the potential of increasing the burden on the contract breaker seeking to extricate himself from a contract.[96] Neither I agree with the view, that if Cooke J´s test gains precedence over its predecessors, it is possible that the scope of the *White & Carter* principle will be widened[97]. Such consequence could only follow from ignorance of the context of the use of the term ”perverse” and the ignorance of the previous authorities to which Cooke J referred to in his decision.

It will be of practical importance to note what factors Cooke J took into consideration when deciding on the legitimate interest qualification. As will be noted, the Court paid attention to several of owners interests.

First, the cash-flow implications of a claim in damages as opposed to the claim of hire were pointed out. Under the charter the charterers were under the obligation to pay hire up front, semi-monthly in advance. Thus, at the time of the repudiation there were moneys “sitting” in the owners account. If the owners decided to accept the repudiation, they could be compelled to repay the amounts corresponding to the hire not earned and wait for the outcome of the assessment of damages in arbitration. The assessment of damages itself was not simple on the facts of the case. The parties presented conflicting expert reports on the state of the market, giving rise to a potential significant argument as to proper mitigation of loss and the extent of damages recoverable. Under such circumstances the payment of any liability could be postponed until the conclusion of arbitration, months away, by which time the charterers could conceivably have become insolvent.

The Court accepted in the judgment that the difficult financial situation of the charterers was a relevant factor when examining the question whether the owners had legitimate interest in affirming the contract. In the actual circumstance, the owners had a clear financial interest in claiming hire, in a simple and fast procedure, rather than damages of uncertain quantum in a lengthier procedure with a accompanying risk

[96] *ibid*

[97] *ibid*

of the charterer becoming insolvent. The litigation tactic was therefore, in my opinion, correctly chosen in the light of the facts of the case.

Secondly, Cooke J dealt with the "legitimate interest" argument that "the contract breaker was seeking to foist upon the innocent party the burden of seeking to trade in a difficult spot market, where a substitute time charter was impossible, with all the management issues involved".[98] In this connection, the Court considered the option of the charterer to sublet to be "a matter of relevance".[99] It was held by the Court that in the view of the existence of the charterer's right to sub-let, the charterers had the same opportunities to use the vessel as the owners. The repudiation by the charterer was therefore seen as an attempt to be shot of the difficulties in trading the vessel by imposing that burden on the innocent party.[100]

Thirdly, the Court considered as relevant factors that 1) there were only 94 days left of a five-year time charter, 2) the market conditions were difficult, 3) a substitute time charter was impossible and 4) trading on the spot market very difficult. In the light of these facts, Cooke J held that: "(…) it would be impossible to characterize the owners´ stance in wishing to maintain the charter and a right to hire as unreasonable, let alone beyond all reason, wholly unreasonable or perverse."[101]

One must bear in mind however, that it was the combination of the above facts of the case which lead to the court´s conclusion that the owners had legitimate interest in affirming the contract. It does not follow from the judgment whether any of the above factors weighted more than other. It is therefore an open question whether the Court would have reached the same conclusion if circumstances were different, for example where the charterer was not in financial difficulties, or the assessment of damages was a simple matter, or where the time left of the charterparty was more than 94 days.

[98] Aquafaith, p. 70
[99] *ibid*
[100] *ibid*
[101] *ibid*

3.4.4 Conclusion

The decision was regarded as to provide some clarity in connection with the application of the *White & Carter* rule and to potentially strengthen the position of owners with vessels on time charter facing an early redelivery.[102] It was said to be a "welcome news for owners faced with early redelivery in an adverse market.[103] It is unlikely that the charterers were similarly enthused.

The decision was important from several aspects. First of all, the decision expressly states that time charter is a contract, which can be performed by the owner without need for any cooperation from the part of the charterer. Consequently, the effect of the decision is that it eliminates the previous uncertainty existing in connection with the *White & Carter* cooperation qualification. In accordance with the decision, the owners will be able to continue to accrue hire by keeping the vessel at the charterers disposal even when facing charterers repudiation, subject only to the requirement of legitimate interest in affirming and performing the charter. As a consequence, *The Aquafaith* decision affords the owner a more favorable negotiation position by strengthening his reliance on the *White & Carter* right of affirmation.

Moreover, in connection with the second *White & Carter* qualification, the legitimate interest qualification, the decision provides some more clarity as to what factors support the conclusion in favor of the existence of legitimate interest on the part of the owner. It also confirms the previous authorities in maintaining that a fetter on the innocent party's right to affirm the contract only applies in "exceptional cases". At the same time, however, the Court accepted, that the innocent party´s right to affirm the contract is not unfettered. It was in the light of the specific facts of the case that the Court concluded that the owners

102 Young, P: The owner´s right to reject the early re-delivery of a vessel on a time charter. A review of the "Aquafaith" decision in the English Commercial Court. In Nordisk Medlemsblad, September 2012. p. 6259

103 Herring, P: Shour R and Zen-McDonald, L: United Kingdom: Commercial Court Confirms Principle In White And Carter Applies To A Time Charterparty. (London) 2012. http://incelaw.com/documents/pdf/strands/shipping/shipping-e-brief/shipping-e-brief-july-2012.pdf [Visited 31st October 2012]

had legitimate interest in affirming the contract. By using the expression preferred by Cooke J, the affirmation of the contract was not "perverse" on the facts of the case. The owners are therefore encouraged to exercise caution when determining whether the conclusions in *The Aquafaith* are applicable in concrete circumstances[104].

3.5 Practical scenarios in the light of The Aquafaith

Since the delivery of the decision, it was hotly disputed whether and what the decision´s impact will be on the owners' decisions facing charterers´ repudiation. It was noted by the legal practice, that "following recent judgments on damages for breach of time charter where difficulties have arisen in quantifying damages due to the lack of an available market, it is likely, that arguments of a right to affirm will be raised more often by owners in similar situations as in *The Aquafaith*"[105]. In the following I will discuss the impact of the decision in connection with several possible scenarios.

In situations where the repudiating charterer is clearly insolvent, *The Aquafaith* decision will not lead to any fundamental changes as to what constitutes a rational decision of the owner. In circumstances where it is obvious that the charterer will not be able to honour his obligations, it would be futile to bring a claim for the contractual hire. The owners will therefore wish to take the only rational step, accept the redelivery of the vessel and try to trade it. Thus, in this connection *The Aquafaith* decision will be of no assistance.

Similarly, in situations where there is an available market, and the owners are able to find a comparable employment for the vessel, the owners may wish to accept the redelivery of the vessel and claim damages, if there will be any. The reason for this suggestion, lies in the

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[104] Young, P: The owner´s right to reject the early re-delivery of a vessel on a time charter. A review of the "Aquafaith" decision in the English Commercial Court. In Nordisk Medlemsblad, September 2012. p. 6259

[105] without referring to any concrete judgment. In: Macfarlane, Ben. *Isabella Shipowner – v – Shagang Shiping "THE AQUAFAITH". (*London) 2012. http://www.bjm-co.com/reports/Report_047_IsabellaShipowner_120517_201k.pdf. [Visited 31st October 2012]

uncertainties in connection with the owner´s right to affirm the contract which remained, albeit on a reduced scale, even after *The Aquafaith* decision. Therefore the most sound solution in such circumstances will be the securing of a certain income through accepting and trading the vessel as opposed to an uncertain outcome of a claim for hire, even in cases where the charterer is ”good for money”.

However, in circumstances where there is no or only limited available market, the solution will not be as clear-cut and will depend on the evaluation of the particular circumstances of the case. What is to be weighed in such circumstances are the advantages of the claim for hire as opposed to the acceptance of the repudiation and claim in damages on one hand and the level of uncertainty as to the owner´s right to affirm the contract. In connection with the latter a series of factors will be of relevance. Hence, the owners will want to make sure, prior to affirming the contract and ‘’submitting a claim for hire, that the matter is clearly within the rule in *White & Carter* by analyzing the particular circumstances of the case in the light of the relevant case law. Since *The Aquafaith* decision eliminated the uncertainties in connection with the “cooperation qualification”[106], the owners will be focusing on finding whether they have “legitimate interest” in affirming and performing the charter.

[106] In connection with time charters.

4 Conclusion

It was as early as in 1962 when the main rule applicable to the right of affirmation in English law was formulated as part of the *White & Carter* decision. In accordance with the decision, an innocent party has, as a starting point, right to affirm the contract in case of a repudiation of the other party to the contract. The right is however not unlimited. It is subject to two qualifications, which formed one of the main subject of discussion of the thesis, i.e. 1) the cooperation qualification and 2) the legitimate interest qualification.

The thesis further discussed the competing interests behind the main rule and its limitations. The court in *White & Carter* was presented with a daunting task of determining which of the two equally important values, such as certainty in commercial contracts or economic efficiency should prevail in the event of a clash. The court´s decision was a prominent attempt to devise a formula applicable to future cases. In general, the principle of certainty was given priority, but not unconditionally. The court intended to capture cases of extreme economic wastefulness and avoid the application of the right of affirmation in such circumstances through the notion of legitimate interest qualification. That brought an element of balance between the two competing interests but also an element of uncertainty, due to the essential equitable nature of the legitimate interest qualification. At the same time, the lack of express notion of the underlying clash of values exposed the later courts to the danger of striking an improper balance between the competing interests.

Following the decision in *White & Carter,* there have been several attempts to articulate a test for determining the lack/presence of legitimate interest in affirming and performing the repudiated contract. In the third chapter of the thesis the following tests were discussed: 1) the ”adequacy of damages” test (*The Puerto Buitrago*), 2) the ”wholly unreasonable” test (*The Odenfeld*) and 3) the ”perverse” test (*The Aquafaith*). In accordance with the ”adequacy of damages” test, the innocent party

will not have a legitimate interest in affirming the contract when damages would provide an adequate remedy for any loss suffered by him. The second, ”wholly unreasonable” test, added a further qualification to the ”adequacy of damages” test. In accordance with this test, the innocent party will not have legitimate interest in affirming the contract where damages would be an adequte remedy and where an election to keep the contract alive would be *wholly unreasonable*. The last test, as was argued in the thesis, is only a restatement of the previous tests where the judge in *The Aquafaith* used an adjective of his preference – ”perverse” – as a synonym to the words ”wholly unreasonable”. Thus, in accordance with this test, the innocent party, will not have legitimate interest in affirming the contract if his insistence on maintaining the contract can be described as ”perverse”.

Admittedly, the tests set out in the previous paragraph, have been expressed in vague terms requiring further interpretation and thus presenting an element of uncertainty from the shipowners´ point of view. The reason for their vagueness is that they refer to the legitimate interest qualification, which is in its nature equitable and requires use of discretion by courts. The equitable character is meant to allow for striking balanced decisions in future cases, where the certainty in commercial contracts and the economic efficiency are present as competing values. The effect of the authorities referred to in this thesis is that the economic efficiency value shall prevail only in extreme cases, where it would be ”wholly unreasonable” or ”perverse” to keep the contract alive.

In the light of the discretionary evaluation of the facts of the case by courts, it will be of interest to summarize the factors which the courts considered relevant when deciding on whether the owner had legitimate interest in affirming the contract. In the two decisions discussed in the thesis where the court held that the owner had legitimate interest in affirming the contract – *The Odenfeld107* and *The Aquafaith108* – the following factors were considered relevant and supporting the conclu-

[107] See subheading 3.3.3.1.2

[108] See subheading 3.4.3.2

sion on the existence of legitimate interest: 1) the difficulty in calculating damages, 2) interests of third parties which could be affected by the termination of the charterparty (e.g. lenders), 3) charterers right to sub-let the vessel, 4) charterers right to lay-up the vessel, 5) cash-flow implications of a claim in damages as opposed to the claim of hire, 6) the contract breaker in effect seeking to be shot of the difficulties in trading the vessel by imposing that burden on the innocent party, 7) the amount of time left from the charterparty period (the less the more likely that owner has legitimate interest), 8) difficult market conditions (substitute time charter is impossible, trading on the spot market very difficult). It must be stressed however, that the courts have not granted more weight to any of the factors mentioned. The decisions were rather based on a complex evaluation of all relevant factors.

In contrast to the legitimate interest qualification, the current state of law in connection with the cooperation qualification is marked with more clarity. The court in *The Aquafaith* decision stated expressly that the owners are in the position to earn hire under a time charter, by keeping the vessel for the charterer´s disposal, without the need for the charterers to do anything under the charter. Nevertheless, there is still a degree of uncertainty in respect of the application of the cooperation qualification to demise charterparties. In *The Puerto Buitrago* the court held that the demise charterparty under which, the charterer has a duty to repair the vessel prior to redelivery, is not a contract which could be fulfilled by the owner without any cooperation from the charterers. In *The Aqufaith* decision, the court held that under a demise charterparty the owner will not be entitled to claim hire from the moment he retakes the possession of the vessel. On the basis of the decisions analyzed in the thesis it is, however difficult to make any more general remarks in connection with demise charterparties.

On balance, the current state of law does not allow to provide a standard answer to the question whether owner is entitled to affirm the contract, applicable to every case of charterer´s repudiation. The thesis rather outlines the different legal tests and factors relevant for the determination of the availability of the right to affirm the contract in parti-

cular circumstances. The uncertainty existing in this respect allows for striking the proper balance in future decisions, provided that the courts are aware of the competing interests at stake and the balance intended by the Court in *White & Carter.* Moreover, an absolute certainty in contracts can hardly be attained anyway. There are other examples of legal rules, which may import a degree of uncertainty into commercial contracts, such as the doctrine of frustration.

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A New Standard in Contracts for Private Security Providers on Ships

A Critical Review of BIMCO's GUARDCON

Erik Tuvey

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1 Introduction

1.1 "A contract for the employment of security guards on vessels"

GUARDCON is a standardised contract designed for use between shipowners and private maritime security providers, published in March 2012 by BIMCO, a non-governmental organisation made up of members from various participants in the shipping industry. The contract was created by a working group consisting of "experts from shipowners, underwriters, P&I clubs and lawyers with first-hand experience of working with contracts for security services."[1] The impetus for the project was the increasingly costly and deadly threat of piracy off the coast of Somalia in the preceding half decade, and the growing trend of shipowners choosing to protect their vessels and crew with armed guards. The development of a maritime security industry was not without its growing pains, with many complex legal and financial challenges presented to shipowners, masters, crew, insurers, security providers, guards and others. BIMCO sought to relieve some of these problems through the creation of a standardised contract that would provide industry norms and greater legal certainty, and GUARDCON was the result.

This paper will review various aspects of GUARDCON, including the context in which it was created, its most significant provisions, and its potential impact on the industry and use moving forward. Already in its short life GUARDCON has taken a lead in redefining a fledgling industry, granting better legitimacy to security providers while delivering greater legal confidence and efficiency for shipowners and their insurers. However, even its creators hope that its lifespan will be limited, preferring other long term solutions to the threat of piracy that do not

[1] Hunter, Grant. qtd. in BIMCO. BIMCO publishes much anticipated GUARDCON Contract (2012)

involve placing armed personnel on ships.[2] Furthermore, GUARDCON's usefulness in its current form may be tied to the future of the Somali state and the potential for its effectiveness in other environments. Whatever its impact, GUARDCON provides an interesting study on the ability of an industry to adapt quickly to changing demands and challenges.

1.2 Structure and Scope

This paper will first examine the context in which GUARDCON was created and identify the challenges it was designed to overcome. It will then move to a discussion of specific clauses of GUARDCON, evaluating the attempted solutions for the challenges identified and highlighting certain areas that might be of concern to shipowners or security providers intending to use the contract. Only the most significant clauses relevant to the general objectives of GUARDCON or of other particular interest will be addressed. The paper will conclude with speculation on the changes GUARDCON could effect within the maritime security industry, and its future for use in Somalia and other areas affected by piracy.

It is beyond the scope of this paper to examine all aspects and concerns of piracy and the placement of armed personnel aboard ships. Certain general concerns about arming vessels are included only insofar as they provide context for the demand for a contract such as GUARDCON. Flag state law, coastal and port state law, international guidance, shipowner policy, insurance availability, financial resources, moral beliefs and other considerations are all relevant to the issue of whether to place armed guards on board a particular ship, but are better left to be considered elsewhere. This paper will for the most part assume that the decision to employ armed personnel on board a ship has already been made by the shipowner, and will therefore evaluate the utility of GUARDCON and its terms to the shipowner, security provider, insurers and other relevant parties in that context.

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2 BIMCO. *BIMCO publishes much anticipated GUARDCON Contract* (2012)

Furthermore, this paper will not evaluate any particular operations or procedures of security providers except to the extent they are included within GUARDCON and the Explanatory Notes. It will therefore avoid aspects such as which Rules for the Use of Force ("RUF") or Standard Operating Procedures ("SOP") should be adopted, or any substantive evaluation of Best Management Practices ("BMP") as issued by the International Maritime Organization ("IMO") or other ship hardening measures.

This paper will not assume the selection of any particular governing law under Clause 24 (Dispute Resolution), allowing points of background law from various jurisdictions to be highlighted in relation to certain clauses. However, choice of law under Clause 24 itself is addressed in Section 3.7.5. Furthermore, for the most significant issues addressed in GUARDCON, such as duties imposed on the master and liability to third parties, international treaty law and guidance, flag state law and coastal state and port state law will be most relevant. The instances in which GUARDCON is subject to such law has been indicated as far as practicable, but it is far beyond the scope of this paper to analyse the provisions under every permutation of legal jurisdictions that could become applicable.

1.3 Legal Sources

The main sources for this paper are the GUARDCON contract itself and the accompanying Explanatory Notes, both published by BIMCO. Grant Hunter, BIMCO's Chief Officer Legal and Contractual Affairs, was extremely helpful in answering questions related to the drafting process and the impact GUARDCON is having on the industry, and his comments are liberally included. Other sources include guidance published by the IMO, treaties, cases, academic writings, articles from independent trade publications and in-house updates from industry participants ranging from P&I clubs to maritime security industry consultants. For a full list of sources, see the Table of Reference.

1.4 Terminology

GUARDCON uses the term "owners" for the shipowner, but for the sake of general understanding this paper will use the term "shipowner" unless quoting directly from the contract. Similarly, GUARDCON uses the term "contractors" to refer to the security provider, meaning the company that will be signing the contract with the shipowner, but this paper will use the term "security provider" in most contexts. Quotes from other sources may use other terms, such as "private maritime security contractor" ("PMSC"), and these have been left as is. The guards themselves can be referred to by numerous terms, including "Security Personnel" in GUARDCON as well as generally in this paper, but also as "guards", "armed guards" or "privately contracted armed security personnel" ("PCASP").

In contrast to most of GUARDCON, the liability and indemnities provisions of Clause 15 (Liabilities and Indemnities) apply rights and obligations to the "Owners' Group" and "Contractors' Group", which is broader than merely the shipowner and security provider who are entering into the agreement. These definitions also include certain companies and individuals related to these entities, including subsidiaries, employees, insurers, crew, supernumeraries, and the security personnel. Save where the expanded definition is particularly relevant, the discussion of liabilities and indemnities in Section 3.3 will retain the "shipowner" and "security provider" nomenclature used in the rest of the paper.

All references to "$" are to U.S. dollars.

2 Context for GUARDCON

2.1 The revival of an age-old threat

It would take extraordinary circumstances for a contract such as GUARDCON to ever come into existence. However, such conditions arose

in early 2008 as shipowners began to consider employing armed guards on board their ships as a response to the development of piracy[3] off the coast of Somalia. Previously, at least in the era of modern shipping, incidents of piracy were confined to small scale operations scattered in various parts of the world. Attacks consisted mainly of "pirates boarding ships and robbing them of cash and supplies, and occasionally…a rusty freighter [would be] pirated, then renamed and reflagged for profit."[4] In 2000, the "South China Sea [was] considered the most dangerous for piracy in the world"[5], and worldwide, "[a]ttacks on cargo ships cost insurers about $100m a year."[6] However, the methods and scale of piracy changed as the practice began to develop in Somalia, which at the time had not had a functioning government for over a decade.[7] Increasing numbers of pirates were able to take advantage of the lawless state to create safe havens for themselves protected and financed by tribal warlords, from which they could attack ships without fear of retribution from a domestic police threat. "[B]y mid-2008, Somalia was number one [as a hotspot for piracy], and on a scale not seen since the nineteenth century."[8] The *modus operandi* of the Somali pirate was different from his Asian brethren; the Somali pirates attacked ships using larger numbers and deadly force, with the intent to capture a ship for ransom, not plunder. In 2008, "Somali pirates attacked at least 111 vessels, captured 42, held 242 mariners hostage, and according to some estimates, exacted as much as $150 million in ransoms, a small

3 The generally accepted definition of piracy is found in UNCLOS Article 101, which states: 'Piracy consists of [...] any illegal acts of violence or detention, or any act of depredation, committed for private ends by the crew or the passengers of a private ship or a private aircraft, and directed: (i) on the high seas, against another ship or aircraft, or against persons or property on board such ship or aircraft; (ii) against a ship, aircraft, persons or property in a place outside the jurisdiction of any State." Thus the definition leaves out attacks within the territorial jurisdiction of a state. For this reason, GUARDCON and other documents add violent robbery or similar terms to encompass acts that fall outside of the UNCLOS definition.

4 Little (2010) p.269

5 BBC News (2000)

6 BBC News (2000)

7 *See* CIA (2012)

8 Little (2010) p.269

part of the estimated $16 billion in annual losses due to piracy."[9] As one P&I club noted, "Such levels of maritime crime are unprecedented in modern times and have had a significant impact on the shipping and insurance industries. The human cost of these incidents has also been appalling with reports of abuse and torture being used by the pirates as a means of trying to extract greater ransoms out of shipowners."[10]

One obvious solution, arming the ships themselves, was largely disregarded at first. One expert on piracy summed up the attitude of many in the industry: "Arming commercial ships is a recipe for making a bad situation worse, not better."[11] "Weapons will only escalate the problem," said one insurer. "[I]nsurers would be very wary of insuring any vessel that carried arms or armed guards on board. A potential liability claim for shooting a pirate—or causing a crew member's death—could be very costly, as could the resulting damage to the hull."[12] Reasons commonly cited for not using armed guards for protection were "the cost of maintaining security teams; the difficulty of getting around restrictions on armed personnel in the territorial waters of most nations…[and] the potential for legal claims and criminal charges in the case of the death or injury of 'an innocent party.'"[13]

Such reluctance would have been unthinkable during the romantic age of pirates: "Merchant owners captains, and crews of past centuries would have looked incredulously upon this state of affairs, unable to comprehend the unwillingness of owners and governments to arm

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9 Little (2010) p.12

10 The Britannia (2012)

11 Chalk (2009)

12 Allianz (2009) p.17

13 Little (2010) p.280. Such concerns were realised in the February 2012 incident involving innocent Indian fisherman were shot by Italian marines: "[T]he Italian marines aboard reported that they fired warning shots at the unknown vessel before firing ball ammunition on target. The unknown vessel is then said to have moved off, but it was later reported to the Indian authorities that two fishermen were shot and killed. The facts are still sketchy as to the event itself; however *Enrica Lexie* was ordered to berth in India for investigation and when she docked two of the Italian marines were arrested for murder and the vessel was detained … this raises issues of liability that may arise as a result of the employment of armed guards." Caldwell (2012)

shipping—and to use those arms when threatened by pirates."[14] Eventually, as the number of attacks and value of ransoms continued to grow, more shipowners took on the view of their forebearers that arming their vessels made moral and financial sense. From a moral standpoint, the risks presented by carrying armed personnel on board a vessel, such as the potential for injuring or killing pirates (or with less likelihood, but with greater moral consequence, innocent third parties), were outweighed by the obligation of the shipowner to safeguard its crew.[15] Financially, the decision to employ security began to make sense as ransom demands increased and insurance costs for transiting Somali waters reached hitherto unforeseen levels, with insurance premiums for a single transit through the Gulf of Aden climbing from $500 to as much as $20,000.[16] The high cost of the security personnel, $10,000-15,000 per day per team, by some estimates[17] could be partly offset by savings on insurance,[18] but more importantly was justified as the cost of security team acted as loss prevention measure against the risk of having to pay ransoms, endure loss of income from freight or loss of hire, and suffer the deterioration of a vessel laying at anchor under pirate control. One statistic trumpeted by security providers and their supporters seemed to drown out any concerns: no ship protected by armed personnel had been successfully captured by Somali pirates.[19] Largely as a result of these factors, "the use of security teams aboard

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14 Little (2010) p.271

15 The shipowner may have more than a moral obligation. Lawsuits have already been filed against a shipowner by crewmembers whose U.S. flagged ship was hijacked by pirates: "Eight crewmembers who were onboard during the attack are suing Maersk for damages under both the Jones Act and for unseaworthiness. The crewmembers allege that Maersk was negligent and took inadequate steps to provide appropriate levels of security." Friedman (2011)

16 Kraska (2008) p.43

17 Little (2010) p.281

18 *Piracy and private security: Laws and guns* (2012)

19 There is one exception to this statistic. "[I]n January 2011, [there was a]…capture by pirates of an un-manned barge being towed by a tug carrying armed guards – the barge was cut loose in order to escape from the pirates." The Britannia (2012). Otherwise, the statement continues to be true as of 2012. Caldwell (2012)

commercial shipping increased significantly in 2009 and into 2010."[20]

A significant hurdle was passed for some shipowners as restrictions from national governments were loosened. The ability to place armed guards on ships is regulated for the most part by the law of the vessel's flag state. This is the general position under maritime law in relation to all activities on board a ship sailing on the high seas, in accordance with the United Nations Convention on the Law of the Sea ("UNCLOS")[21] and IMO guidance.[22] However, as Koji Sekimizu, IMO Secretary General explains, "the carriage of firearms on board merchant ships is a complex legal issue with member states taking diverse positions. The MSC [the Maritime Safety Committee of the IMO] has concluded that the carriage of armed personnel is a matter for flag states to authorise, however, it has also accepted that their carriage has legal implications for coastal and port states, particularly with respect to the carriage, embarkation and disembarkations of firearms and security equipment in areas under the jurisdiction of such port or coastal states."[23] Other interested states will be any port states a vessel visits, especially the embarkation and disembarkation points of the security personnel if this takes place in port rather than out at sea. Furthermore, coastal states may have an interest insofar as the vessels seek to make use of the territorial sea of such states in reliance on the innocent passage provisions of UNCLOS.[24]

Previously, international organisations including the International Maritime Bureau of the International Chamber of Commerce ("IMB"), the IMO and even BIMCO tended to discourage shipowners from arming their ships, especially with private security teams.[25] Attitudes

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[20] Little (2010) p.280

[21] UNCLOS art 92, 94. This also generally accepted in countries in which UNCLOS has not been ratified, such as the United States, as a part of customary international law. *Challenges to Maritime Interception Operations in the War on Terror: Bridging the Gap* (2007) p.591

[22] IMO MSC.1/Circ.1443 (2012) sec 1.2

[23] Qtd. in Booth (2012)

[24] *See* UNCLOS art 17, 19

[25] Spearin (2010) p.557

mellowed, however, as the success of the increasing presence of armed personnel became evident. Guidance from the IMO changed from recommending against employing armed guards,[26] to providing guidance if and when flag states, coastal states and port states decided to adopt measures permitting their use.[27] Many countries, such as the United Kingdom and Norway responded by either adopting or relaxing their arms laws to allow for armed guards to sail on their flagged vessels.[28] Thus the new industry[29] of private maritime security had been granted a certain degree of reluctant acceptance by national and international bodies.

2.2 A boom industry created, with problems to match

As the maritime security industry gained the recognition of authorities and the popularity of utilising the services of maritime security providers increased, so did the proliferation of such companies looking to cash in on an increasingly lucrative business opportunity. The maritime security industry was, and still is, marked by a great number of security providers—more than 200 as of 2012[30]—with a wide range of backgrounds and experience all seeking to provide their services in the profitable field of defending against piracy off the Horn of Africa:

Private security contractors have been in existence for many years,

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[26] IMO MSC.1/Circ.1335 (2009) annex II, recommended best management practices, sec 2(b)(vii)

[27] *See* IMO MSC.1/Circ.1406/Rev.1 (2011) and IMO MSC.1/Circ.1408 (2011)

[28] *See* United Kingdom, Department for Transport, Interim Guidance to UK Flagged Shipping (2011) and Norway, Amendments to Regulation 972/2004 and 904/2009 (2011)

[29] It might be more correct to say that employing armed personnel aboard ships is a "renewed" industry: "Until the mid-nineteenth century AD, merchants, ship owners, and merchant crews accepted as the cost of doing business that their vessels must be armed in peacetime against pirates…This was well understood in antiquity, and perhaps the only real question was whether or not to spend the money to arm a vessel, and, if the decision were made to arm the vessel, how much to spend. From at least the seventh century BC onward, some merchant ships…carried armed men for protection." Little (2010) pp.60-1

[30] Dobbs (2012)

often providing land-based security services in the world's trouble spots – but, in recent years, they have expanded their services to deal with security threats at sea. Now known universally as PMSCs (Private Maritime Security Contractors), they have recently been joined by many newcomers to the field. Partly, this has been a case of companies seeing a business opportunity, and partly it has been a necessary response to the sudden increase in demand for their services.[31]

With such fragmentation in the industry, shipowners, insurers and other maritime participants struggled to adapt to how best to effectively utilise such services, especially in light of the increasingly demanding requirements placed on them by IMO guidance and national regulations. The major challenges industry participants faced can largely be grouped into two main categories: quality assurance and efficiency.

2.2.1 Quality Assurance

With the rapid expansion of the maritime security industry, it almost seemed as though anyone with a former military background and a gun was trying to find a way into the business. The original fears of hired armed personnel presenting a greater threat to ships than pirates resurfaced as security providers with relatively little experience and financially fragile footing continued to flock to the boom industry. Shipowners and P&I clubs needed a way to distinguish good companies from bad in order to limit the risk of something going wrong.

Maritime security providers broadly fall into one of two categories: (a) start-ups, largely formed by recently discharged military personnel, and (b) traditional land-based security providers looking to expand into the ship-based environment. The start-ups faced large challenges in terms of meeting financial standards, developing proper oversight and management, and addressing other problems that may be common to new participants in any industry, but are more troubling when that industry includes the threat of lethal consequences in the event of a mistake. Traditional land-based providers had an advantage in that

31 The Britannia (2012)

they could offer the closest thing the industry offered in the way of longevity, and were more likely to be on secure financial footing. However, an armed guard cannot merely step from dock to vessel and assume that he is adequately prepared for the risks he faces. One such difference is the multitude of licences and permits for weapons and guards that can be required, given the number of jurisdictions that can be encountered during a sea voyage. Shipowners needed confidence that their vessels would not be detained by authorities of a coastal or port state because their security provider failed to realize the permits and licences that would be required.

Financial stability of security providers was a major concern. Many lacked adequate insurance to protect themselves, their shipowner clients and third parties in the event of a potentially financially ruinous incident.[32] Furthermore, start-ups without significant capital resources could leave a shipowner (or its insurer) without recourse if it were held jointly and severally liable with a security provider after the negligent shooting of a fisherman by an armed guard, for example. Without some assurance that they could recover in the event of loss due to the actions of their hired guns, shipowners and their insurers could be exposed to far greater risk than they could tolerate.

Ensuring proper vetting of security providers and personnel, including meeting financial, management, experience and training standards, was a central issue in the debate about how to best to manage risks introduced by the presence of armed guards on board a vessel. According to IMO guidance, a shipowner must make "a thorough enquiry regarding the prospective PMSC […] particularly in the absence of a robust certification scheme for PMSC,"[33] and "PMSC should demonstrate that they have verifiable, written internal policies and procedures for determining suitability of their employees."[34] Various attempts were made to create a vetting standard or achieve some form of certification requirement, but no industry-wide method for verifying the

32 McMahon (2012)

33 IMO MSC.1/Circ.1405/Rev.2 (2012) sec 4.2

34 IMO MSC.1/Circ.1405/Rev.2 (2012) sec 4.4

competence of security providers could be agreed upon.[35] Shipowners and P&I clubs had been left with the task of creating their own individualised vetting systems that need to be repeated over and over for each security provider, and security providers were likewise forced to undertake such procedures for each proposed client.

2.2.2 Efficiency

Another problem caused by the increasing number of security providers was that the negotiation process became increasingly inefficient. Having more counterparties leads to higher transactions costs from having to continuously negotiate individual provisions in more and more contracts. Employing armed personnel on board ships is a relatively new industry, without a body of trade usage and practice to rely upon. Absent an industry standard, certain problems needed to be resolved anew for each negotiation. These included the relationship between the authority of the master and the team leader of the security personnel, requirements for obtaining permits and licences, allocation of risk and assumption of liability, insurance requirements and the consequences in the event of a successful hijacking by pirates. As stated above, quality assurance checks needed to be undertaken for each new contractor. If there had only a few dominant players on the security provider side, shipowners would have an idea of what to expect and the industry might have gravitated towards a few alternatives of terms demanded by those firms. Absent a trend of consolidation in the industry, shipowners would be left to continuously negotiate bespoke agreements with different terms for a large number of security providers. Furthermore, security providers, especially the start-ups, may have been excellent at shooting weapons and neutralising threats, but might not have experience running a business, ascertaining risks and mitigating liability. These companies could lack a standard business plan or defined risk calculation model, thus even with the help of legal counsel, assessing

[35] *Shipping security firms return fire as UN experts criticise regulation gap* (2012). This may have changed with the December 2012 introduction of the draft ISO 28007. *See* Section 3.6.2.

various provisions in a services contract could become difficult and time consuming.

The fragmentation of the industry also meant increased costs in acquiring and providing insurance. Shipowners and security providers not only had to negotiate the terms of contracts between themselves, but also gain approval from their insurers or acquire any necessary insurance related to the services governed by each of those contracts. Each individually negotiated contract will carry with it its own set of risks and allocations of liability, thereby demanding a new assessment of risks necessary to be covered by the insurers of each side. Such insurance is required of security providers under IMO guidance, although particular levels are not specified.[36] Negotiating individual insurance products for each security arrangement raises transactions costs for insurers and the insured, and further complicates the ability of insurers to statistically determine their exposure to various risks. Matching liabilities with reinsurance options becomes more difficult, thus making hedging against such risks less efficient and less effective.

2.3 Attempts that never left port

There were a few attempts to create a standard contract to address some of these concerns prior to GUARDCON. One such contract, MARSEC 2011, was created at the request of the Security Association for the Maritime Industry ("SAMI"), a trade organisation of maritime security providers, by Stephen Askins of Ince & Co., one of the members of the GUARDCON working group.[37] However, MARSEC 2011 and other such attempts faced the same problems associated with attempts by land-based providers to use their contracts.[38] They were never widely accepted and were seen as being too friendly towards security providers from the prospective of wary shipowners.[39] As INTERTANKO, an or-

36 IMO MSC.1/Circ.1443 (2012) sec 3.4
37 Ince & Co International LLP
38 Thompson (2012)
39 Hunter (2012)

ganization of independent owners and operators of oil and chemical tankers, commented, "[P]rivate armed guard contracts vary in content and standard, with some being unclear and/or unfavourable to owners. In some, legal rights and obligations of the parties are ill-defined."[40] Grant Hunter of BIMCO was not surprised that MARSEC 2011 and others had failed: "It is very difficult to get any form of standard contract agreed and used in the industry without the backing of some large "standards" body with contractual experience, such as BIMCO."[41] Without the support of shipowners or an industry giant to champion them, the security provider-based contracts such as MARSEC 2011 never found enough success to fuel their own use as an industry standard. Thus, at the request of the shipping industry,[42] BIMCO stepped in to play that role that was missing from previous attempts.

2.4 BIMCO to the rescue?

BIMCO sought to alleviate some of the concerns of efficiency and quality assurance by introducing a single standard contract for the employment of security personnel aboard ships. An industry-wide standard contract would provide much needed stability and could thereby reduce transactions costs. According to BIMCO,

> In response to ship owners' increasing demand for security services, an ever growing number of private maritime security companies have entered the market to meet that demand. In the absence of a standard contract for these services, ship owners and their P&I Clubs are currently faced with the difficult and time consuming task of assessing large numbers of contracts from these security companies, all with varying terms and conditions. GUARDCON's objective is to create a contractual benchmark for the employment of security services so that minimum levels of insurance cover for PMSCs are established and that adequate safeguards are put in place to ensure that liabilities and responsibilities are properly

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40 BIMCO. *INTERTANKO endorses BIMCO's GUARDCON* (2012)

41 Hunter (2012)

42 Hunter (2012)

> addressed and that all necessary permits and licenses are obtained.[43]

For BIMCO to undertake such a task was not unusual. One of BIMCO's main remits is to create standard documentation for use by its members, which include shipowners, charterers, insurers, legal advisors and other participants in the shipping industry. Many of BIMCO's standard form agreements and clauses have become industry norms, albeit modified to suit the needs of individual parties and specific uses.

Besides the subject matter, what makes GUARDCON so unique in BIMCO's library of standard documentation is how quickly it was created. As Grant Hunter states, "We were under immense time pressure to get GUARDCON drafted and published."[44] The entire process was completed in a matter of months, rather than the longer time frames typically needed to formulate numerous drafts of a document, review industry practice, compile feedback from various interested parties and create a final agreement.[45] The working group for GUARDCON included participants from shipowners, P&I clubs, insurance underwriters and law firms, and security providers contributed to the process as well by providing comments on the various drafts. P&I clubs and insurance underwriters played an especially important role, as getting their approval was key if GUARDCON was going to be able to see widespread use in the industry.[46] To process the needs of such a diverse group in such a short time span is indeed a remarkable achievement, and indicates the motivation and necessity of such an agreement within the context of the threat of Somali-based piracy.

The significant provisions of GUARDCON will be discussed in Section 3. Among them are BIMCO's solutions for problems related to the master's authority and chain of command, permits and licences, allocation of liability, insurance requirements and the consequences of

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[43] Hunter, Grant. qtd. in BIMCO. *BIMCO publishes much anticipated GUARDCON Contract* (2012)

[44] Hunter (2012)

[45] Hunter (2012)

[46] Hunter (2012)

hijackings. GUARDCON's indirect means of addressing aspects of quality assurance are dealt with as well.

3 Content of GUARDCON

3.1 Master's authority

One of the most controversial and hotly debated topics regarding the placement of a security team on board a ship relates to the master's authority and the chain of command of the security personnel. As with other matters on board the ship, the authority of the master is a matter of flag state law, although flag states that are parties to SOLAS will share a common requirement under that convention. The ISPS Code, incorporated into SOLAS, provides: "The master shall not be constrained […] from taking or executing any decision which, in the professional judgement of the master, is necessary to maintain the safety and security of the ship."[47] However, the security personnel, especially the team leader, will likely be the most experienced in gauging threats to the ship and make the proper decisions accordingly. Outside of GUARDCON, security providers typically seek to maintain the most control possible

[47] SOLAS, (as amended to 2012) ch XI-2, reg 8. The ISPS Code came into effect in 2004, as did an amendment to the general protection found in SOLAS, ch V, reg 34-1, that nothing shall "prevent or restrict the master of the ship from taking or executing any decision which, in the master's professional judgement, is necessary for safety of life at sea and protection of the marine environment." Prior to 2004, the requirement was that nothing the master's discretion "necessary for *safe navigation* and protection of the marine environment," (emphasis added) SOLAS (as amended until 2004) ch V reg 34 para 3,which may not have been sufficient to present a direct conflict with shared authority with a security team leader. However, the necessity of the supreme authority of the master has been long recognised in other sources. *See* The Steamship Styria v Morgan, 186 U.S. 1, 9 (1902) ("The master of a ship is the person who is intrusted with the care and management of it.") and United States Coast Guard v Merchant Mariner's Document No. Z217567381, Decision of Commandant, No. 1098 (Mar. 18, 1977) (holding that the shipmaster is the individual "primarily charged with the care and safety of the vessel and crew") cited in *Challenges to Maritime Interception Operations in the War on Terror: Bridging the Gap* (2007) p.601

over the ability to choose when and how weapons are used.[48] The team leader often will prefer to be required to consult with the master only "if there is time."[49] Thus, in the event of an attack, there is a question of who can tell the personnel to begin firing their weapons, or stop firing them, or make tactical decisions in relation to the ship, crew, security personnel and the use of weapons. Furthermore, there is a question of who will be held responsible if something goes wrong.

Clause 8 (Master's Authority and Division of Responsibilities) seeks to resolve these dilemmas by creating a hybrid command structure in which the security team leader has the ability to invoke RUF[50] and direct the security personnel if the vessel is perceived to be under threat, but clarifies that the master retains overall authority over the vessel even during an attack. Thus the security team will generally be responsible for actions during an attack, but the ISPS Code and SOLAS requirements are preserved. This fact is highlighted in Clause 8(d): "Nothing in this Contract shall be construed as a derogation of the Master's authority under SOLAS." This is doubly important for the shipowner because "any breach of SOLAS or the ISPS Code could prejudice P&I cover."[51]

Consider the following progression of events: The guards and crew are under normal watch procedures when a suspicious vessel is observed. At this point, according to Clause 8(b) the team leader will need to advise the master or the officer of the watch that he intends to invoke the RUF. Thus, while the team leader might prefer to commit to action immediately, he must take this intermediate step first. According the RUF Guidance, "It is recognised that consultation with the Master may not always be possible, but there is always a responsible officer on the bridge of the vessel with whom the [Team Leader] should be able to communicate."[52] After notification, the team leader can mobilise the

48 Askins. *Piracy – Issues arising from the use of armed guards* (2012) p.2
49 Askins. *Piracy – Issues arising from the use of armed guards* (2012) p.2
50 *See* Section 3.6.3.
51 Swedish Club (2012) p.2
52 RUF Guidance, p.3

security team, ready weapons, etc. in accordance with the RUF. Should an attack commence, according to the RUF Guidance the team leader is "responsible for all decisions on the use of force, save that the Master maintains the right to order a ceasefire." However, should the situation get out of hand, even if the master orders a ceasefire Clause 8(d) acknowledges the right of the security personnel to exercise their rights of self-defence in accordance with applicable law.[53] Sub-clause (c) of Clause 3 (Security Services) and the waiver of Annex D attempts to prevent overreaching on this basis as the personnel undertake to act upon the lawful instructions of the master.

By structuring the relationship between the master and the security team leader as a division of responsibilities, GUARDCON hopes to prevent such assumptions on the ability and responsibility of the master with respect to security-related decisions. The intent is to avoid the risk of "joint enterprise" in which the master could be considered individually responsible for the actions of the security personnel.[54] GUARDCON goes a step further in Clause 8(c), providing that "Each of the Security Personnel shall always have the sole responsibility for any decision taken by him for the use of any force, including targeting and weapon discharge." Such a division of responsibilities may seem to solve the problem of liability on paper as between the master and security personnel, but whether such a division will be accepted by courts and arbitration panels is another matter. Giving the master the overall authority to be able to order a ceasefire could open up the possibility of civil or criminal liability for the master on the basis of negligent supervision or other theories of direct responsibility for oversight of the security

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53 In addition to flag state and coastal state law, there may also be a general customary international law right to self-defense against piracy: "Forcible self-defense against pirate attacks is universally permitted under conventional international law" Editor's comment to the U.N. Security Council Resolution 1846 in 6D Benedict on Admiralty Doc. No. 13-14A (Frank L. Wiswall, Jr. ed., LexisNexis 2008) cited in Martin (2010) p.1372

54 Explanatory Notes p.6

team.[55] Third parties and criminal prosecutors will be less interested in to whom responsibilities have been allocated under a contractual arrangement than what occurs in practice. Liability considerations are further addressed in Section 3.3.

3.2 Permits and Licences

Clause 10 (Permits and Licences) is another of the central pillars of GUARDCON. The complications of obtaining permits for the various jurisdictions in which a maritime-based, armed, mobile security team will be regulated is one of the distinguishing traits separating the practice from land-based, single-jurisdiction security services.[56] Clause 10 provides for a bifurcation of responsibilities for obtaining necessary permits and licences for weapons and personnel. The responsibility for permits required of the vessel is placed on the shipowner, while responsibility for any necessary permits for the personnel themselves rests on the security provider. Clause 10(d) further provides a cross-indemnity for any costs or penalties levied on behalf of one of the parties caused the other party failing to obtain the necessary permits. However, if a security provider fails to obtain necessary permits and the result is a detainment of the vessel, damages owed under the indemnity may not fully cover the full economic consequences due to the limitation of liability provisions in Clause 15(d) and prohibitions of loss of profit or consequential loss in Clause 15(e).[57] Shipowners and their insurers should ensure that their vetting procedures are robust enough to ensure that the security provider has or can obtain the necessary permits and

55 "A person conducting an activity through servants or other agents is subject to liability for harm resulting from his conduct if he is negligent or reckless: (a) in giving improper or ambiguous orders or in failing to make proper regulations; or (b) in the employment of improper persons or instrumentalities in work involving risk of harm to others: (c) in the supervision of the activity; or (d) in permitting, or failing to prevent, negligent or other tortious conduct by persons, whether or not his servants or agents, upon premises or with instrumentalities under his control." Restatement (Second) of Agency § 213 (1958)

56 Gibbins *It's good to talk* (2012)

57 Caldwell (2012)

licences, thus lowering the risk of unrecoverable losses.

Currently, many security providers and shipowners rely on so-called "floating armories" to avoid permit and licencing requirements of coastal states.[58] Under such an arrangement, the vessel and security team can pick up or drop off their weapons from another vessel stationed outside of the territorial waters of states on either end of a transit or both. This saves on importing and exporting costs for the security providers, and limits the need for permits and licences to flag state and security provider home state jurisdictions. There is as of yet no regulation or precedent for the legality of these floating armories (some of which have land-locked Mongolia as a flag state),[59] and thus could expose shipowners and security providers to undesirable uncertainty of liability of the kind the GUARDCON was meant to overcome.

3.3 Liability and indemnification[60]

BIMCO touts the liability provisions of Clause 15 (Liabilities and Indemnities), to be among those "at the very heart of GUARDCON."[61] They are important not only because they finally provide a standardised allocation of risk across the industry with the approval of P&I clubs, but also because they will indirectly affect the availability and cost of insurance to security providers. Since the clause is so fundamental to GUARDCON for these reasons, there will be little scope for amendment.[62]

3.3.1 Between the contracting parties – "knock for knock"

In allocating tort liability between the contracting parties, Clause 15(b) of GUARDCON applies the mutual risk assumption of the "knock for knock" principle. Under knock for knock, each party (or its insurer)

58 Houreld (2012)

59 Houreld (2012)

60 *See* Section 1.4 for a description of the terminology used in this Section and Clause 15.

61 Explanatory Notes p.10

62 McCormick (2012)

assumes responsibility for any losses or damage it sustains to its own property or personnel (as well as others within its "group," as defined in Clause 15(a)) and will not seek to recover from the other party (or group) no matter who was at fault in causing the loss or damage. Furthermore, under Clause 15(b) each party agrees to indemnify the other party in respect of the losses and damage for which it has assumed liability under knock for knock. Other than the carve-out for accidental or negligent discharge of firearms that injures the crew in Clause 15(c)(iii), GUARDCON's version makes no general exceptions for losses caused by gross negligence, ordinary negligence, or otherwise that are found in some types of knock for knock clauses. Thus, even if a mate negligently opens a cargo hatch door and a security guard is injured falling into the hold, or a guard intentionally blows a hole in the ship with explosives, neither party will be liable to the other.

Clause 15(c)(iii) provides an exception from the knock for knock principle for incidents of injury or loss suffered by the crew due to accidental or negligent discharge of firearms by the security personnel. In the event of such incidents, the security provider must indemnify the owners. The effect of this exception is that it alters the knock for knock standard of letting the loss fall where it lies in the very instance where the security provider is at the greatest risk of causing extensive damage. The shipowner takes on no corresponding additional liability where it is particularly likely to be the cause of risk.

The advantage of the pure knock for knock system is that it simplifies dispute resolution by forcing each party to seek recovery from its own insurer only, rather than the other party in an expensive arbitration or court case. The system also allows each party to seek insurance to cover only its own risks, avoiding double coverage. Furthermore, risk assessments and damage evaluations are made more efficient as the party only needs to assess risks within its own risk zone. However, the disadvantage of knock for knock is that the party who is not at fault in causing a loss can often be the one end up bearing the burden (or its insurer could, thus potentially raising premiums). Furthermore, there can be less incentive to take precautionary measures to reduce risk for losses

that might fall on the other party. If the benefits of administrative ease of knock for knock outweigh the potential for injustice, and the insurance providers are able to average out the potential for the likelihood of loss over time (without needing to factor in fault) and set premiums accordingly, knock for knock can be mutually beneficial. However, if one side is always less likely to be at fault, or is likely to suffer greater loss more often due the fault of the other party than it is likely to inflict, its insurance premiums will likely be higher than they would have been absent the knock for knock provision. Knock for knock clauses have been demanded by maritime security companies in contracts outside of GUARDCON, likely because of the severity of the consequences if a mistake is made by their personnel,[63] but shipowners have been encouraged to use them as well.[64] However, given the carve-out in Clause 15(c)(iii) that excludes some of the highest potential for liability on the part of the security company, time will be needed before one can determine which side will benefit the most from GUARDCON's version of knock for knock. Furthermore, the administrative advantages of knock for knock are absent in instances covered by the carve-out.

Knock for knock is common in some types of maritime agreements, such as offshore charterparties and towing contracts.[65] These types of agreements involve multiple vessels, crews and contractor personnel, usually between two large sophisticated parties with insurance policies to match and years of evidence to assist in evaluating risk. The provision of maritime security services, however, is much different. It is very new industry with a unique set of risks, with the shipowner and security provider subject to different hazards and potential causes for liability. The two parties may have significantly different bargaining power, especially if shipowners and P&I clubs demand the use of a standard form with certain clauses unavailable for amendment. Even though knock for knock provisions have generally been upheld by English courts in

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63 *See* Swedish Club (2012) p.5

64 Killengreen (2012) p.14

65 *See, e.g.*, SUPPLYTIME 2005 cl 14, TOWCON 2008 cl 25

offshore contracts,[66] they have not been widely tested in other situations. Other jurisdictions' courts have rarely examined knock for knock provisions, but in some cases it has been argued that they could be held invalid due to public policy reasons.[67] Although the knock for knock provision is somewhat one-sided due to the carve-out, one could argue that the carve-out preserves the incentive for security providers and personnel to take proper care to prevent accidental or negligent discharge of their weapons, thus removing some potential public policy concerns. Whether GUARDCON's knock for knock provision would be upheld in an English court or arbitration or otherwise remains to be seen.

3.3.2 Third parties - indemnification

No agreement between shipowners and security providers can restrict the ability of a third party to recover from either of them, such as in the case of a fisherman accidently shot by a security guard. However, the parties may allocate the extent to which they are able to avail themselves of recourse as between themselves for liabilities owed to third parties. Under Clause 15(c), the parties agree to indemnify each other for liabilities to third parties caused by their own unlawful or negligent act or omission (although an indemnified party will not be able to recover any portion losses related to contributory negligence). The indemnity

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[66] *See, e.g.,* Smit v Mobius [2001] CLC 1545 and A Turtle [2009] Lloyd's Rep 9

[67] Murugason (2007) p.1-4. Under general U.S. federal maritime law, knock for knock clauses of a maritime nature are generally enforceable (Murugason (2007) p.2), but one-sided exculpatory clauses have been held invalid in certain towing contracts. Bisso v Inland Waterways Corporation, 349 U.S. 85 (1955). However, "US companies may find that some such provisions, such as 'knock for knock' indemnities…clauses run afoul of US state legislation." Chalmers (2012)

should also apply if the shipowner is held to be vicariously liable[68] for the negligent actions of the security personnel. Clause 15(c)(iii) is worthy of special note because it extends third party liability indemnification from security provider to shipowner for acts related to discharge of firearms by security personnel to accidental causes, not just negligence.

One complication of Clause 8 (Master's Authority and Division of Responsibilities), is that by placing ultimate authority over the vessel and security team with the master, it could open the master or shipowner to liability on the basis of negligent supervision. Under the doctrine of negligent supervision, a person supervising others can be held negligent for giving improper or ambiguous orders, or for failing to prevent negligent or other tortuous conduct by persons whether or not his servants or agents, upon premises under his control.[69] A master (or shipowner vicariously for the master) could be liable to an innocent third party shot by security personnel because he had the opportunity to order the guards to cease firing, but failed to do so. Such liability might not be covered by the third party liability indemnification, because the act of negligence would actually be that of the master or

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[68] For example, under §151 of the Norwegian Maritime Code. The shipowner "shall be liable to compensate damage *caused in the service* by fault or neglect of the master, crew, pilot, tug or *others performing work in the service of the ship*." (emphasis added). It is likely that contracted security personnel would be considered to be "others performing work in the service of the ship," so the matter would depend on whether the damages was "caused in the service." This can be difficult to determine on the facts, but would almost certainly be the case if the security personnel shot fisherman by mistake in attempting to protect the vessel. Whether §151 would apply in the case of an accidental discharge is unclear. In one case, a master was hunting birds with a shotgun from the bridge and accidently shot one of the persons on board. The court decided that the act fell within the scope of the statue and the shipowner (the State) was held vicariously liable. ND 1973.343 NSC TRYGG. However, in several cases involving accidental discharge of weapons on board ships, the shipowner was not held liable. *See* ND 1914,159 NCC SARDINIA (A rocket fired from the bridge sets fire to a building. The shipowner was held not liable because the rocket within the scope of employment) NJA 1938.575 SSC (A loaded and unsecured rifle in the seating area accidently discharges injuring an apprentice pilot being transported from a ship. The shipowner (the State) was held not liable because no error was committed within the scope of employment) cited in Falkanger (2011) pp.180-181

[69] Restatement (Second) of Agency § 213 (1958)

shipowner in lack of proper oversight, not mere vicarious liability for the actions of the security personnel. Furthermore, even if the attempt at separating the master from responsibility through the RUF invocation procedure could be effective under the governing law of the contract, it may not be so under the law of the jurisdiction where the third party brings the claim. Thus the master and shipowner could still be held to unlimited liability by a third party, with limited or no recourse against the security provider.

3.3.3 Limitation of liability and insurance

Clause 15(d) limits liability owed by one party to the other to $5,000,000. This corresponds to the insurance security providers are required to obtain under Clause 12(b).[70] In addition, shipowners maintain their ability to limit their liability under national law and international conventions, such as the Convention on Limitation of Liability for Maritime Claims, which limits liability of shipowners at an amount linked to the tonnage of the vessel.[71] If the parties negotiate for a different insurance policy limit for the security provider in Box 12 of Part I, the limit of liability between the parties will be matched accordingly pursuant to Clause 15(d). However, there may be a practical limit on how much risk and insurance a security provider is willing or able to take on.

Because the knock for knock liability system will generally exclude fault claims between the parties, the limitation of liability provision will be most relevant only in cases of indemnification for third party claims and the Clause 15(c)(iii) carve-out. Any indemnification actually owed by the security provider to the shipowner should be completely covered by mandatory insurance, but since the indemnification is subject to the limitation of liability provision and the shipowner's rights of limitation under the LLMC, each party could still be subject to large losses if the claim exceeds the limit.

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70 *See* Section 3.4.

71 *See* LLMC Convention art 6

3.3.4 Security personnel

The individual security personnel enjoy an exclusion of liability to the owners under the Clause 16 (Security Personnel Liability) "Himalaya" provision. Clause 28 (Third Party Rights), while excluding the rights of any third party to rely on the contract such as would arise under the Contracts (Rights of Third Parties) Act 1999 under English law, confirms that the security personnel may enforce rights granted to them under Clauses 15 and 16.

GUARDCON includes a form of waiver of liability that is to be signed by individual security personnel for the benefit of the shipowner in accordance with Clause 17 (Security Personnel – Waiver). Generally, GUARDCON sets out the terms of the horizontal relationship between the shipowner and the security provider company. The security provider will have a vertical contractual relationship (either express or implied) with its security personnel, either as employees or as independent contractors. The waiver is worthy of note because it seeks to create a direct, cross-contractual relationship between the shipowner and individual security guards.

The waiver covers a wide range of topics, such as acknowledging the supremacy of the authority of the master and agreeing to follow the RUF, a general waiver of liability on the part of the shipowner including for damage sustain as a result of the shipowner's negligence, representations and warranties relating to acquiring insurance, necessary permits, etc. and an indemnification on behalf of the shipowner. The authority of the master and RUF clauses seem appropriate, given the unusual circumstances of having two lines of chain of command on board the ship and the need for shipowners to be assured that proper procedure is followed for quality assurance purposes. The liability waiver and indemnification terms, on the other hand, seem onerous when viewed from the prospective of individual guards, who are in no position to negotiate the terms after the general contract and form of waiver have been agreed by their employer. In effect, the combination of the waiver and the Himalaya provision of Clause 16 create a sort of

knock for knock relationship between the shipowner and guard. The Explanatory Notes explain that "(a) number of security companies have reviewed the text of the waiver and seem satisfied that it fits the bill as currently worded,"[72] however, it is the individual guards who are giving up their rights by signing the waiver. Once a guard has accepted employment, signed the waiver and is deployed, it is too late to complain, for example, if upon arrival he discovers the condition of the ship is not acceptable. Presumably the intention of the waiver is to ensure that any potential liability follows the knock for knock principle and that individual guards should seek redress for any injuries or losses sustained from their employers (or their insurance).

The default choice of law for the waiver is English law, which is printed onto the form and does not allow for another selection without altering the text. This could cause issues if the contract itself selects another background law, potentially leading to mismatches in liabilities and obligations between the main contract and the waiver. Furthermore, the waiver selects English courts as the forum to hear any dispute, rather than the default of arbitration as under GUARDCON. The intention behind these selections is difficult to justify, other than to make the waiver difficult and potentially expensive for an individual guard to challenge.

3.3.5 Criminal liability

GUARDCON itself cannot allocate or limit criminal liability—such matters are left to the flag state, coastal and port states, and other potentially interested jurisdictions such as the home state of the security provider. However, the contract does attempt to allocate certain obligations among the shipowner, security provider, master, team leader and individual security personnel with an eye to how criminal law might interpret responsibility. For example, Clause 8 (Master's Authority) attempts to avoid assigning direct responsibility to the master to give a "fire" order to the security personnel, instead assigning to the team

[72] Explanatory Notes p.11

leader the responsibility of informing the master that he is invoking the RUF. The intention is to "protect the master from criminal liability through 'joint enterprise,'"[73] which the UK Crown Prosecution Service indicated could open the master to criminal liability by being "tainted by the actions of the security personnel."[74] However, given that the master retains overall authority of the vessel and those on board, including the ability to issue a "cease fire" command, such an attempt may not be entirely successful if a coastal state's fishermen have been shot and the local population is howling for blood. Even if the attempt to avoid "joint enterprise" is effective under English law or another law selected in Clause 24 (Dispute Resolution), it might not be so under the law of the jurisdiction seeking to apply criminal liability.

3.4 Insurance

Another of the major achievements of GUARDCON is the establishment of a standard regime for insurance related to security personnel on board ships. The insurance requirements for both security providers and shipowners are found in Clause 12 (Insurance Policies). Security providers are required to obtain insurance covering particular risks at specified levels. Previously, insurance policies have been unnecessarily costly due to their bespoke nature and the transaction costs that follow. Providing a single insurance product that can be marketed to an industry of security providers facilitates the grouping of similar risk profiles and therefore in theory lowers costs for insurers.[75] Insurance products for security providers specifically tailored to the requirements of GUARDCON were introduced almost concurrently with the publication of GUARDCON,[76] and could come to represent a standard for the industry. The implications of insurance requirements on security providers are further considered in Section 3.6.1.

[73] McCormick (2012)

[74] Explanatory Notes p.6

[75] McMahon (2012)

[76] *See, e.g.*, Chesterfield Group (2012)

One of the concerns of carrying weapons, ammunition and non-crew members on a vessel is that particular risks related to such items and personnel would be introduced or increased. Even if the presence of armed guards on board reduced the overall level of risk to a vessel, because different risks are borne by different entities, each of those entities needs to be satisfied that it is not individually exposed to greater risk due to the presence of the armed guards. For example, consider a car carrier with high freeboard traveling at high speed and implementing BMP4,[77] thus at low risk of a successful hijacking. If the risk of loss due to piracy, however remote, is to be borne by a war risk insurance provider, that entity would still benefit from having armed guards on board since its risk is lowered even further without any greater exposure due to the presence of the guards. However, a P&I club could end up bearing some risk in the event of an accidental shooting but with less concern about an unlikely pirate attack. To this end, BIMCO worked with P&I clubs in developing GUARDCON to ensure that armed security personnel under its auspices would not invalidate a shipowners P&I insurance cover.[78]

Kidnap and ransom (K&R) insurance is mentioned in Clause 12(d) to highlight that while K&R insurance policies obtained by a shipowner will generally cover all persons on board the vessel, including the security personnel, such policies will not cover security personnel if they are removed from the vessel.[79] Security providers may therefore want to obtain their own K&R insurance, or if possible, amend the contract so that the shipowner is obliged to extend its policy to cover the security personnel.

3.5 Hijacking

Clause 9 (Hijacking) makes it clear that the security provider does not provide a guarantee against a hijacking. Thus the security provider

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77 *See* Section 3.6.2.

78 Hunter (2012)

79 Explanatory Notes p.9

should not be liable under the contract if it fails to successfully protect the ship. There is always some risk that a pirate attack will be successful, no matter what precautions are taken to secure against it. Thus, the shipowner will still need to maintain insurance for such a possibility, although perhaps at a reduced cost.[80] Under sub-clause (k) of Clause 13 (Fees and Expenses), however, the security provider could still be at financial risk in the event of a successful hijacking. Assuming that the parties use the fee structure as contemplated under GUARDCON's Clause 13, daily payments due under the contract during deployment will cease in the event of a hijacking while the hijackers have control of the vessel. On its face this arrangement certainly seems fair—the entire point of paying for a security team is to prevent such a hijacking. However, the cost of the guards' salaries is still an expense to be considered from the security provider's point of view, one that can grow to extremely large levels upon an extended period of detainment. In some cases, detainments have lasted for over 2 years and the average length is now 8 months,[81] creating a large deficit for a security provider no longer receiving income from the shipowner. Furthermore, it is the shipowner who will be responsible for negotiating the release of the ship and therefore the one indirectly in control of ending the security provider's obligations to its personnel.

Notwithstanding the fact that no ship with armed personnel has yet to be captured, the prudent security provider should take steps to lessen the risk of having to pay the salaries of detained personnel. One option would be for the security provider to ensure that under the employment contracts it has entered into with the individual guards, payments to the guards also cease in the event of a hijacking. A second option would be to obtain insurance to cover the mounting salary expenses. Such a risk could be folded into the insurance offered to security providers to satisfy the requirements of Clause 12 (Insurance Policies), or a separate arrangement could be made. A third option would be to amend Clause 13 to provide for continued payments to the security provider even in

[80] *Piracy and private security: Laws and guns* (2012)

[81] Freeman (2012)

the event of a hijacking, perhaps at a lower rate which would cover the expenses directly related to the detained guards. This option has the advantage of placing the risk of increasing costs on the party most able to end the detainment.

3.6 Quality assurance

While GUARDCON should not be the only method used to guarantee the quality of a security provider, it does offer some means of protection against one of the major question marks of the industry. GUARDCON has several provisions which directly or indirectly seek to provide some comfort to shipowners as a second layer of assurance after pre-contractual vetting procedures have been completed.

3.6.1 Insurance requirement as a quality control

As noted in Section 3.4, Clause 12 (Insurance Policies) contains specific policies and certain levels of insurance that a security provider must have in place. These include employer's liability insurance and personal accident insurance to cover the security personnel, comprehensive liability insurance to cover third parties and professional indemnity insurance. Other than the personal accident insurance, the policy limits must be at least $5,000,000 (or as otherwise stated in Box 12 of Part I).[82] These minimum insurance requirements have an indirect role in providing a level of quality assurance for shipowners, in that a security provider must be on significant enough financial footing to be able to afford such policies. Such a clause has the potential for significant impact on weeding out some of the less sophisticated security options available,[83] thus showing its value as a surrogate for quality assurance and the importance of retaining the requirement in negotiations with security providers. As one P&I club has advised, "[t]he USD 5,000,000 level is

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[82] *See* Section 3.3.3.

[83] "The insurance requirement [of GUARDCON] alone could exclude smaller companies without sufficient financial resources from being able to offer the contract." Dobbs (2012)

higher than many PMSCs have been regularly offering to date. While PMSCs may try to negotiate a reduced minimum cover (and a corresponding reduced cap on liability), we caution against any amendment to Clause 12."[84]

3.6.2 Security providers' representations

GUARDCON contains several representations by the security provider for the quality of its company and personnel in Clause 6 (Contractors' Obligations and Responsibilities). These attestations of quality and fitness include that the security personnel are "suitably qualified, trained and experienced," are physically and mentally fit, have relevant training, are without a criminal record and have military or law enforcement service, among other representations. Furthermore, the team leader must have "prior experience of performing services equivalent to the Security Services on board a merchant vessel" and one of the team must be trained in first aid. However, simply obtaining a confirmation from the security provider does not relieve the shipowner of its duty to perform its own due diligence to satisfy itself that its contractor is as reputable as it claims it is when signing the contract.[85] The shipowner will still need to undertake a thorough examination of any security providers it retains to satisfy the IMO guidance, including considering updating and confirming its findings periodically or each time a security team is deployed in the case of a multiple transit framework agreement.

Subsequent to the introduction of GUARDCON in December 2012, the International Standards Organisation ("ISO") published the draft ISO 28007, formulated at the request of the IMO.[86] The publication sets out international standards for companies providing armed personnel on ships, including means of certification. It remains to be seen what effect ISO 28007 will have, but the creation of an internationally accepted set of standards could prove extremely valuable for shipowners and se-

[84] McCormick (2012)

[85] Dobbs (2012)

[86] ISO/PAS 28007:2012

curity providers alike. Should they become widely accepted, shipowners should consider amending Clause 6(b) to include a representation to the effect that the security provider complies with ISO standards, and has obtained and will maintain any related certifications.

Best Management Practices

The IMO has released guidance specifying BMP recommended to be employed by shipowners in the High Risk Area, defined as an area bounded by Suez and the Strait of Hormuz to the North, 10°S and 78°E.[87] The current edition of BMP is BMP4 (Best Management Practices for Protection Against Somalia Based Piracy), which includes procedures and hardening measures that should be undertaken before and during a potential pirate action. To a certain extent, GUARDCON contemplates the parties following BMP as per IMO guidance. For example, in Clauses 6 and 7 of GUARDCON, the security provider and shipowners agree to take certain steps in accordance with BMP4 or more recent equivalent. Security providers must advise and assist with hardening the vessel, and owners must liaise with appropriate authorities as set out in BMP. However, GUARDCON in its standard form stops short of creating a general enforceable duty from either the security provider or the shipowner to the other to comply with BMP. To ensure compliance with IMO guidance, shipowners should seek to impose such a duty from the security provider by including explicit references to BMP in the Annex B (Rules for the Use of Force) or Annex F (Standard Operating Procedures), or other best management practices as appropriate given the geographic scope of operation.[88]

Subcontracting by the security provider

Clause 6(d)(i) forbids the security provider from contracting out its obligations without the consent of the shipowner. However Clause 6(d)(ii) and the Explanatory Notes clarify that this restriction does not

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[87] BMP4 sec 2.4

[88] *See* Section 3.7.7

apply to the common practice of security companies of structuring their teams using independent contractors rather than direct employees.[89] Thus a security provider should not be concerned that its typical independent contractor structure would be in breach of Clause 6(d) and does not need to seek permission from the shipowner under such circumstances. According to the Explanatory Notes, the restriction on sub-contracting in Clause 6(d)(i) is for the purpose of ensuring that the vetting process undertaken by the shipowner in compliance with IMO guidance is not undermined by the assignment of security services to an unchecked provider.[90] However, to comply with the 72-hour readiness requirement, it might facilitate the arrangement if the security provider were granted the right of assignment to other contracted providers that had already been vetted and cleared by the shipowner. Thus the security provider would be able to retain some flexibility with its staffing and standby readiness in busy periods, while ensuring that the shipowner would still be in compliance with its due diligence duties.

3.6.3 Security Services

The purpose of GUARDCON is to create a defined relationship between security provider and shipowner for the provision of security services on board ships. This is accomplished through Clause 3 (Security Services), in which the contract sets out in general terms the services to be provided by the security provider to the shipowner.

The general description of services and the reason a shipowner would hire a security provider is found in Clause 3(b). This clause creates an undertaking on the part of the security company and its personnel to "protect and defend the Vessel during Transit against any actual, perceived or threatened acts of piracy and/or violent robbery and/or capture/seizure."[91] The provision notes that the means of such

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89 Explanatory Notes p.5

90 Explanatory Notes p.5

91 Clause 3(b). The Explanatory Notes clarify that the inclusion of violent robbery is to capture the situation in which a vessel is attacked within inshore or territorial waters, and thus not within the usual definition of piracy. *See* fn.3.

protection are subject to adherence to national laws, the Rules for the Use of Force and Standard Operating Procedures. The latter two are documents attached to the contract as Annex B (Rules for the Use of Force) and Annex F (Standard Operating Procedures) respectively, and form the basis of determining with more specificity the exact services a shipowner expects to be performed by the security team on board the vessel.

Rules for the Use of Force

The RUF are meant to be a step-by-step procedural strategy of the escalation of responses that are to be invoked upon the threat of an attack. "RUF are invoked in response to an actual, perceived or threatened act of piracy. They are not intended to be invoked without a specific threat."[92] Alongside the publication of GUARDCON, BIMCO provided the RUF Guidance to assist in drafting an evaluating a security provider's RUF.[93] The RUF Guidance does not provide a standard form RUF because, as BIMCO notes in the Explanatory Notes, "It is outside of BIMCO's remit to draft a standard RUF as such because, ultimately, the content of such Rules is a matter of national law."[94] However, the RUF Guidance does contain some general principles on what should be included in a RUF such that it will be in line with IMO guidance, and should be helpful in reviewing individual RUFs.[95]

While true that individual procedures taken in response to the threat of attack are more likely to be directly impacted by various national laws, given that much of the subject of the content of GUARDCON itself and the provision of security services in general is a matter subject to various national laws, it seems odd that BIMCO would hesitate to provide a template RUF solely on such grounds. Grant Hunter states: "It was felt at the time that the drafting of RUF was outside the scope of BIMCO's activities - bringing in […] issues of flag state as well as natio-

92 McCormick (2012)

93 Guidance on the Rules of the Use of Force

94 Explanatory Notes p.2

95 *See* IMO MSC.1/Circ.1405/Rev.2 (2012)

nal laws. […] There were some legal reservations about the idea of an NGO preparing RUF, so we decided to hold back."[96] However, a general template could be created similar to how the RUF Guidance is set out, but in a more usable form, perhaps within the framework of one particular set of national laws. The lack of a form could be more of a result of the sensitive nature of getting into the gory details of what is expected to happen in the course of an attack. Many authorities note the hesitance with which armed personnel are allowed on board ships at all, so avoiding producing a complete RUF relieves BIMCO and the working group of getting their hands too dirty. It also might be an area in which security companies already have their own standard RUF and less likely to swap these for a standard form. Presumably the speed of the consultation process for GUARDCON made constructing, reviewing and gaining consensus on a standard RUF impractical in any case.

Whatever the reason for not adopting a template RUF, the procedures included are likely among the most relevant in terms of potential liability. For example, if a shipowner agrees to a RUF that permits an unreasonable use of force on the part of the security personnel and an innocent third party is injured as a result, the shipowner could be held liable on the basis of its own negligence of permitting such procedures through negligent supervision.[97] The shipowner, as well as insurers for both the shipowner and security provider will need to check the RUF against the RUF Guidance, IMO guidance, national laws and whatever industry practice it can find. As one P&I club has noted, "[f]ailure to incorporate suitable RUF may prejudice P&I cover. It is vital that each PMSC has properly drafted RUF which are agreed by the owner and their insurers."[98] A template RUF could have simplified that vetting process. Luckily, there might be an answer on the horizon. BIMCO acknowledges "we are now in the processing of assisting with the development of what we hope will become a standard RUF published through ISO in collaboration with numerous key stakeholders - not

96 Hunter (2012)

97 *See* fn.55

98 McCormick (2012)

least the PMSCs who have most at stake here."[99]

Standard Operating Procedures

GUARDCON also does not include any specific set of SOP, rather noting in the Explanatory Notes: "Many maritime security companies have their own standard operating procedures covering the provision of security services on board ships. If such procedures exist, they should be attached to this Annex (F)."[100] While RUF need to be invoked and only apply while the vessel is under threat of attack, SOP could be understood to be the general procedures under which a security team operates before, during and after deployment on a vessel, whether or not an attack is threatened. The statement in the Explanatory Notes is indicative of the limited attention GUARDCON gives to the actual operations of the security personnel, outside of the context in which the RUF are engaged. The above statement is the only reference to SOP in the Explanatory Notes, and GUARDCON itself only refers to SOP in Clause 3(b) and the definitions in Clause 1, which merely cross-reference Annex F. BIMCO provides no further guidance on any specific SOP or what should be acceptable to either shipowners or security companies.

BIMCO's justification for GUARDCON's minimal treatment of SOP is that: "[W]e had to appreciate that there are some things that we cannot dictate to the security industry. While the majority of PMSCs have SOPs, not all do."[101] However, despite the lack of emphasis GUARDCON places on SOP, they should not be ignored. As with RUF, SOP represent an opportunity for liability to arise for shipowners, should unreasonable procedures be adopted. According to BIMCO, "We would fully expect the owners to have conducted due diligence on any prospective PMSC to establish what the security company can actually provide and how before they enter into a contract."[102] However, performing due diligence to determine what a security provider's stan-

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[99] Hunter (2012)

[100] Explanatory Notes p.13

[101] Hunter (2012)

[102] Hunter (2012)

dard services entail is far different that providing a contractual basis to rely on them, thus it should be emphasised that the security provider should have a well-developed set of SOP, included in contract and reviewed carefully against industry norms. Furthermore, SOP can include specific services such as pre-voyage consultation, training drills with the crew, hardening procedures, and post operation reviews. Given the general nature of the description of "security services" in Clause 3, SOP provide an opportunity to clarify exactly what a shipowner is getting in return for the fee it pays, and gives security providers the ability to add to their offerings and distinguish themselves from their competitors. Both shipowners and security providers can benefit by setting out detailed SOP in the contract, and the opportunity should not be missed.

Composition of the team

Clause 3 sets the standard security team to be at least four persons, one of which will be designated the team leader. According to the Explanatory Notes, "(f)our is considered to be the minimum number of guards necessary to operate an efficient round-the-clock watch on board a vessel during a transit and providing the required level of protection."[103] However, at least one source indicates that prior to GUARDCON at least, teams have been typically made up of "three to six armed professionals,"[104] suggesting that the four-man team is not completely universal. The Explanatory Notes suggest that certain circumstances, including limited berthing options on board a vessel, could lead to the selection of a smaller team, but that such decision should be considered carefully in each circumstance following a "proper risk analysis."[105] Such a deviation from the fundamental terms of the services to be provided would likely be difficult to achieve, given the implications of such a change for altering risk and adding to the concerns of various insurers.

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[103] Explanatory Notes p.4

[104] Little (2010) p.281

[105] Explanatory Notes p.4

3.7 Other provisions

3.7.1 Shipowners' representations

The representations and obligations of the shipowner are included in Clause 7 (Owners' Obligations and Responsibilities). GUARDCON is designed as a shipowner friendly contract,[106] and shipowners and P&I clubs are more worried about the risks presented by the presence of armed guards, so it is understandable that the representations of the shipowner are not as extensive as those of the security provider. However, there is some room for improvement. Clause 7(c) requires the owner to provide hardening materials for the vessel, but fails to specify what those materials are. Security providers need to be assured which hardening protections are available so that they can prepare the ship as intended. Key to this is the reinforced citadel that serves as a "panic room" in the event of a hijacking. Thus the exact materials required by the security providers or available on the vessel could be included in a list or annex to the contract.

Another possible additional obligation from the shipowner could be relevant crew training. One insurer has stated that "Crewmembers need to know how to interact with the security personnel and what will happen in an emergency. Otherwise, a bad situation could rapidly escalate. There is always an increased risk when weapons are involved."[107] Even without armed guards, as of July 2012, "no vessel with a highly trained crew has ever been hijacked."[108] Security providers should consider adding a representation from the owner crew is sufficiently trained on how to respond in the event of an incident, either before the deployment or when the security team first boards the vessel.

3.7.2 Sick and injured security personnel

Through Clauses 6(a)(x) and 7(i), GUARDCON seeks to place the risk

[106] Hunter (2012)

[107] Gerhard, Sven. qtd. in *New study highlights response to piracy* (2012)

[108] Sjödoff (2012)

and costs of deviating the vessel for the sake of disembarkation of sick or insured security personnel on the shipowners, but the arrangement of transportation of the sick or insured security personnel to and from the vessel and related costs on the security provider. This division of responsibility is an inefficient and unnecessary burden to place on the security provider. The shipowner is likely best placed to know what transportation options are available to and from the ship at any given point along its voyage. It will likely have better experience arranging for such transportation, and coupled with its allocated responsibility for deviation of the ship, is in the best position to make the most efficient combination of ship deviation and transport to care. Furthermore, the shipowner would already need to undertake such arrangements for the sake of the crew. Extending that service to the security team would be more efficient than to ascribe the same function to the security provider in duplicate. Even if such costs are meant to be covered by the security provider's insurer, that does not make the logistics of arranging for the transportation any easier, and is unnecessary in any case.

3.7.3 Non-exclusionary contract

GUARDCON is set up to be used either as a one-off contract for the supply of security personnel for a single voyage, or as a framework agreement for use during multiple voyages. If the contract is to serve as a framework agreement, under sub-clause (c) of Clause 2 (Commencement, Appointment and Duration) the shipowner's appointment of a security provider is non-exclusive. The multiple transit approach allows shipowners to create a list of suitable providers who can be contacted and sent to a meet a voyage on short notice, which can be as little as 72 hours under Clause 4 (Engagement of Security Services). According to the Explanatory Notes, "Owners require a degree of flexibility in providing security guards for their vessels to ensure that services are available when needed. As smaller security companies may not always have the personnel resources available to provide guards as and when needed by the owners, the contract allows the owners to obtain services elsewhere

to meet their vessel scheduling requirements."[109]

A stable of contracted providers may fit within the scheduling requirements of owners, but it could raise issues with respect to vetting and due diligence concerns. Each security provider needs to be vetted if the shipowner intends to follow the IMO guidance.[110] Given the current lack of a universal vetting standard, such a practice could be costly and time consuming if the list of providers is long. Furthermore, security companies asked to comply with due diligence checks and procedures by shipowners could be spending their limited resources of cash and time assisting in these investigations without any assurance of ever receiving an instruction for work. Once the due diligence has been performed, the security company accepted, and the GUARDCON framework signed, the security company will still need to keep its resources at the ready to comply with the 72-hour mobilisation requirement. As part of their fee arrangement, security providers could receive a low standby rate when not deployed that would compensate for the resources devoted to due diligence requests and personnel readiness. Such a fee arrangement might be expensive for a shipowner with a long list of security providers, but it could replace a higher mobilisation fee demanded by some security providers.

While not provided for in GUARDCON, all vetting should be kept current for each appointment. Under Clause 2(b), the multiple transit framework arrangement lasts initially for a one year period but continues in force until one of the parties gives thirty-days' notice. As the circumstances of a security provider, especially a start-up, are at risk for significant change within the potentially long time span contemplated by the framework agreement construction, the vetting process should be renewed at regular intervals or upon appointment to ensure standards are still met. Furthermore, reviews of security provider performance should be undertaken after deployments as part of the continuing due diligence process.

109 Explanatory Notes p.3

110 IMO MSC.1/Circ.1405/Rev.2 (2012) sec 4

3.7.4 Fees and expenses

Clause 13 (Fees and Expenses) is a relatively undeveloped clause, in the sense that merely contains simple arrangements from which the parties can select a fee structure. The Explanatory Notes admit that in spite of the variety of arrangements in practice in the security industry, GUARDCON only contemplates two forms of compensation—a daily rate or a lump sum.[111] Even a simple combination of using the two specified forms would require an amendment to the standard terms.

It is certainly understandable that BIMCO would want to avoid listing all of the various permutations of compensation packages that are possible or even in common practice in the security industry. Clause 13 sets out some simple arrangements, and invites shipowners and security providers to come up with their own solutions if desired. However, a few more options could have been included. As noted in Section 3.7.3, a low standby rate could be advantageous to ensure the readiness of security personnel, and a lower rate in the event of a hijacking could be considered. Perhaps once the industry has had time to digest GUARDCON and seen trends of utilising certain alternative fee arrangements, such possibilities could be added to as additional options in the fees and expenses clause of a revised version of the standard contract.

Indeed, the Explanatory Notes suggest that commercial terms would be among the sections the contract most likely to be subject to amendment.[112] However, this is an opportunity that could eventually die away if industry practice does trend toward one or another type of fee structure. Shipowners that have created a list of contracted and vetted security providers will tend to want similar fee structures among all of their contractors so that they do not need make complicated cost judgments at the time of selecting a team for mobilisation. Even if some providers demand higher fees, the shipowner will have a strong incentive that the structure of each fee arrangement, if not the exact level, is consistent throughout the list. The effect could act as a feedback loop as

[111] Explanatory Notes p.9

[112] Explanatory Notes p.3

the standard spreads throughout the industry, with security providers also seeking to standardise the terms on which their services are offered to various shipowners. Thus, while the Explanatory Notes suggests that Clause 13 could be subject to amendment, it might not always remain that way in practice.

3.7.5 Dispute resolution

In any standard form contract drafted within the shadow of a particular jurisdiction, merely inserting a choice of law clause selecting another jurisdiction is not sufficient to serve the interests of the parties wishing to rely on the background law of that jurisdiction. In the case of GUARDCON, Box 19 of Part I and Clause 24 (Dispute Resolution) allow for the selection of English law, New York law, or the law of another unnamed jurisdiction. However, given that GUARDCON was drafted with English or New York law as a default, the choice of another law should be made with particular care, and appropriate alterations made in consequence. One example could be the enforceability of the knock for knock provision discussed in Section 3.3.1, which is largely untested outside of English law. Special attention should be given in the case of selecting of the law of a non-common law jurisdiction, which could in some cases end up backfiring on the party advocating the selection. For example, civil law jurisdictions tend to imply a requirement of negligence to recover on a breach of contract.[113] GUARDCON was not drafted with this principle as an element of the background law, and representations, duties and liabilities have been assigned accordingly. Selecting the law of a civil law jurisdiction could mean that certain breaches of the contract could be without remedy, even if prior to the dispute both parties had intended otherwise.

3.7.6 Firearms

According the Explanatory Notes, although GUARDCON "is geared towards the employment of private armed guards on board ships, it may

[113] Pejovic (2001) pp.817-841, 824

equally also be used for the employment of unarmed guards."[114] While true that GUARDCON could be used for unarmed personnel, especially in situations such as West Africa where armed personnel may not be allowed in territorial waters, it seems unlikely to be the best form for that purpose without significant alteration. The allocation of liabilities, especially the knock for knock clause, and the insurance requirement assumes there to be risks caused by each party and GUARDCON has assigned liability based on those risks accordingly. However, unarmed personnel surely present a much lower risk to the vessel and therefore the shipowner than armed personnel, but yet are still exposed to the same level of shipowner-controlled risk, such as negligence in ship management, without recourse. While certain provisions of GUARDCON could still be useful if unarmed guards are employed, in its entirety GUARDCON might not be the best form for an unarmed security provider to use without significant alteration to its liability provisions.

Security equipment, including firearms, ammunition and other equipment is to be listed in Annex A (Security Equipment). In the case of a multiple transit agreement, the security provider may want to consider amending the annex to allow for a selection from several predefined packages of equipment based on the transit in question. A security team may find it advantageous to use different equipment based on the capabilities and design of a particular vessel or transit route. Allowing for a simplified selection mechanism based on pre-defined equipment packages could facilitate the mobilisation process.

3.7.7 Geographical scope of operation

If GUARDCON is to be used as a framework agreement for multiple transits, the parties can select a geographical scope of operation in Box 8 of Part I.[115] Clause 4 (Engagement of Security Services) specifies that security providers need only provide services for transits within the

[114] Explanatory Notes p.2

[115] Such a condition would only be applicable if the contract is signed as a framework agreement for multiple transits, as a single transit-use would clearly specify the exact transit for the individual vessel and thus the geographical area would be known.

area included in Box 8, and must do so within 72 hours of receiving an Instruction Notice. Presumably the geographic limitation is in place to ensure that the security provider has the necessary permits for the region specified so that it can prepare a team in adequate time.

The Explanatory Notes contain a curious statement that "the use of the contract is not limited to the current High Risk Area, but can be used within any defined geographical area agreed between the owners and contractors."[116] IMO guidance relating to the use of security providers is limited to their use in transiting the High Risk Area.[117] Given GUARDCON's careful adherence to IMO guidance, it seems strange that the geographical scope is not limited to high risk areas. Shipowners should be wary of attempting to use GUARDCON outside of the context against protecting against Somalia-based piracy. Given the rational for and context within which GUARDCON was formulated, including the unprecedented speed of its adoption, the clear impetus for using armed guards on board a ship and utilising GUARDCON is for operations in the waters off Somalia. Further evidence can be found in the parties' representations in Clauses 6 and 7 related to BMP (the full title of BMP4 is "Best Management Practices for Protection against Somalia Based Piracy") and the sample list of embarkation and disembarkation ports listed in Annex E (Schedule of Charges), all within the geographic scope of the threat of Somalia-based piracy. GUARDCON addresses the BMP issue by making references to BMP apply only "as applicable." However, that solution misses the point that BMP are meant by the IMO and others as the first line of defence against a pirate threat. In effect, GUARDCON's solution is simply to remove the BMP requirement when it used outside the High Risk Area, leaving individually crafted RUF as the only guideline for action before lethal force is used. Other options should be considered for other geographical areas, such as the Round Table of International Shipping Associations' guidance relating to adapting BMP for use in the Gulf of Guinea region.[118]

[116] Explanatory Notes p.4

[117] *See* IMO MSC.1/Circ.1405/Rev.2 (2012) and IMO MSC.1/Circ.1443 (2012)

[118] Round Table of International Shipping Associations (2012)

Since GUARDCON was constructed in response to singular threat, perhaps its scope should have been limited accordingly in the standard form. Of course parties could always adopt a different geographic range by amending the standard contract, but a default against allowing the contract to be used outside of the High Risk Area would highlight the extent to which the contract would deviate from the context in which it was drafted. BIMCO defends its choice by stating: "GUARDCON is already being used for providing security services outside the High Risk Area and it required little in the way of significant amendment for this purpose."[119] Maybe little in the way of significant amendment was added to these contracts because BIMCO left GUARDCON open for that possibility, but that does not mean that more consideration and amendment might have been needed. The potential for use of GUARDCON outside of Somali waters is further addressed in Section 4.2.2.

4 GUARDCON and Beyond

4.1 Achieving its aims

The chief challenges facing shipowners looking to arm their vessels prior to GUARDCON were efficiency and quality assurance due to the fragmentation of the maritime security industry and the influx of new and unregulated companies. Commentators praise GUARDCON's solutions and compromises for the problems related to the master's authority, permits and licences, liability and insurance, hijackings and more, but the real achievement was to create a single, industry-wide document full of provisions that shipowners, P&I clubs, underwriters and security providers could all live with. Thus the success of overcoming the problems that led to inefficiency of repeated negotiations can really only be measured by looking to see how far along it is to become an industry-wide standard. As of this writing, GUARDCON has been in existence

[119] Hunter (2012)

for less than a year, but its effect on the industry can already be felt. Grant Hunter of BIMCO touts, “GUARDCON has been extremely well received. […] P&I Clubs […] are now presented with little else other than GUARDCON.”[120] The praise has been echoed by INTERTANKO, which has “endorsed GUARDCON as a model contract for use by shipowners who engage private armed guards.”[121] Hunter assures that security providers are on board with GUARDCON as well: “[N]ot one has ever suggested that GUARDCON is anything other than a very useful and timely contract for their industry.”[122] Of course, most of this enthusiasm comes by way of anecdotal evidence from BIMCO itself, but there little evidence to suggest there is any major feeling to the contrary. Furthermore, BIMCO has numbers to back up its proclamations: “We have to date seen over 1,000 final concluded GUARDCON contracts published (bearing in mind that most are for multiple transits). It is our fastest ever selling new contract and is already our 4th best-seller.”[123]

GUARDCON’s indirect influence on quality assurance of security providers is tougher to measure, and it will take more time for the industry digest its effects. It has already been shown that GUARDCON’s minimum insurance requirement could weed out security companies with lesser sound financial footing from being acceptable to shipowners using the form.[124] If GUARDCON comes to have a monopoly on the market, that could mark the end of lesser well-established maritime security providers altogether. The effect could be a consolidation of the industry, in which only those providers able to meet the insurance requirements of GUARDCON continue to exist. Of course cost-cutting shipowners willing to accept lower standards could become saviors for less-sound security providers and avoid using GUARDCON, thus allowing them to continue their existence in the bilges of the industry. As one commentator assessed the situation, “Realistically, armed guards

[120] Hunter (2012)
[121] BIMCO. *INTERTANKO endorses BIMCO’s GUARDCON* (2012)
[122] Hunter (2012)
[123] Hunter (2012)
[124] *See* Section 3.6.1.

are simply too expensive […] [T]here are concerns that as owners and operators look to streamline operations wherever possible, increased competition in the PCASP market may lead to a drop in standards."[125] Another states, "[T]here will always be others who will choose not to comply with any standard and offer maritime security at less cost. For a financially beleaguered shipping sector, smaller operators might be tempted by these cheaper and un-regulated security providers in a valiant bid to cut the cost of maritime security on a transit."[126] Thus if GUARDCON has become successful in raising the standards for security providers, the countervailing effect is that not all shipowners will be able to use the contract because they need to lower their standards to achieve cost objectives.

Furthermore, GUARDCON was never intended to be a complete solution for quality assurance of security providers. BIMCO is clear in the Explanatory Notes that shipowners must exercise their own pre-contractual due diligence of security providers.[127] Even better would be a mandatory international certification regime and clearinghouse that would allow shipowners and P&I clubs to quickly select quality security providers. ISO 28007 could be a step in that direction. By pairing a standard contract with a standard certification regime, transactions costs are further lowered and both the goals of quality assurance and efficiency are met.

4.2 Outlook for GUARDCON

4.2.1 Somalia

GUARDCON was created within the context of Somalia-based piracy, so that is the first place to look in evaluating its future prospects. As piracy trends change in the region, so will the functionality and content of GUARDCON also need to be reevaluated. Some fear a continuation

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[125] Sjödoff (2012)

[126] Gibbins. *Lost in translation? The emergence of regulation to the maritime security sector* (2012)

[127] Explanatory Notes p.1

of pirate attacks, thus justifying the view that armed guards and GUARDCON could be mainstays in the industry for years to come. "It is likely to be many years before the threat of Somali piracy is completely eradicated," surmises a P&I club.[128] "It has recently been estimated that up to 40% of all ships transiting the Gulf of Aden and other waters around the Horn of Africa now employ armed guards compared to virtually none just a few years ago. Given the additional cost of taking alternative routes to avoid transiting waters off the Horn of Africa and the Indian Ocean, it is anticipated that the use of armed guards will continue to grow unless there is an unexpected and dramatic reduction in the number of pirate attacks."[129] However, just such a reduction appears to be underway. According to the IMB, 2012 saw a large drop in incidents of piracy in Somalia, with 75 vessels reporting attacks, down from 237 in 2011.[130] Successful hijackings were down as well, from 28 in 2011 to 14 in 2012.[131] Even in light of falling numbers of successful hijackings in the Gulf of Aden and off the coast of Somalia, Koji Sekimizu, IMO secretary general, has stated, "Piracy remains a menace that we need to continue to address. […] We must […] persist with our anti-piracy campaign, in particular, impressing upon the industry the vital importance of ships being pro-active in their own protection."[132] As the chief executive of one security provider warns, "The Somalis will just wait for ship operators to drop their guard."[133]

Still, the goal for the shipping industry is to see GUARDCON become a victim of its own success. The hope is that as more and more shipowners gain comfort in the use of armed guards due to GUARDCON, the trend of successful attacks in Somali waters will continue to decrease as a result. Eventually, the necessity of an armed presence on board would diminish. The difficulty is in ensuring that armed guards

[128] The Britannia (2012)
[129] The Britannia (2012)
[130] ICC International Maritime Bureau (2013) p.24
[131] ICC International Maritime Bureau (2013) p.24
[132] Qtd. in Booth (2012)
[133] Nick Davies qtd. in Berrill (2013)

remain a deterrent longer than the pirates remain a threat, and that the threat does not return once guards are no longer commonplace. Two factors could aid in the transition. First, a continued and more effective naval presence should continue to provide an element of deterrence, especially as naval powers have adopted new strategies for combating the pirate threat. Naval forces now patrol nearer to the coast of Somalia, intercepting threats before they have a chance to reach the larger, more difficult to control open waters of the India Ocean.[134] Second, as Somalia moves towards creating a more stable state, the new government should be able to do more to combat that threat internally. Whether the pirate threat dissipates from the continuance of an armed presence on board ships, a renewed naval deterrent or the emergence of a stronger Somali state, fewer hijackings on the horizon is good news for shipowners and their crew.

4.2.2 Around the world

While Somali piracy may be headed towards decline, the trend is up in other parts of the world, including West Africa.[135] However, as Koji Sekimizu, IMO secretary general, states, "[t]he situation in West Africa is not the same because the Somalia pirates are operating from a failed state. That situation does not apply to the rest of the world."[136] However, it is not just the internal politics of the country that mark a difference in how piracy can be addressed; the methods and motivation for attack play huge roles. Attacks in West Africa and elsewhere are more like those that occurred prior to the outbreak of Somalia-based piracy, albeit on a larger scale. They tend to be closer to shore (often while the ship is at anchor in the territorial waters of a coastal state), and with the goal of stealing cargo rather than holding a ship and crew for ransom.[137] Furthermore, as many coastal states forbid weapons on ships, guards

134 Askins. Presentation (2012)

135 ICC International Maritime Bureau (2013) p.24

136 Qtd. in Booth (2012)

137 Round Table of International Shipping Associations (2012) pp.3-4

are often unarmed.[138] Thus maintaining a security presence on board will present a different set of risks to both shipowners and security providers. Accidental shootings will not happen without firearms on board, but normal maritime perils are reduced if a ship is at anchor. Knock for knock liability may be completely inappropriate, or additional carve-outs may be necessary to realign the balance. If guards are eventually used more frequently in West Africa or other places around the world and GUARDCON is used as a basis for the related contractual arrangements, shipowners and security personnel should be very careful in adopting the solutions designed for the Somali context wholesale to another area. Perhaps different pre-adapted versions of GUARDCON could be made for different regions and for armed or unarmed guards that better reflect the risks involved.

5 Conclusion

In late 2011, the maritime security industry found itself in uncharted waters. Comparisons of security personnel to the gunslingers of the "Wild West" probably took the state of affairs too far, but were not wholly inapt. In the largely lawless waters off the coast of Somalia, these hired guns could provide protection against the increasingly costly threat of the outlaws of the sea with great effectiveness. Liability for potential legal claims could be allocated by contract and insured against, but in such a new and high-risk industry, no satisfactory standard existed. Additionally, as one maritime services consultant stated, "with arms on board and a lack of clarity on the legal accountability for the use of force, there is plenty of scope for errors by armed guards that could escalate the threat to crews and vessels, rather than mitigating it." A better contractual-based solution was needed to create a more streamlined, efficient negotiating process that would be accepted by all interested parties. That required input from shipowners, P&I clubs,

[138] Round Table of International Shipping Associations (2012) p. 6

underwriters, security providers and the endorsement of an industry supported body. BIMCO rose to the challenge, and provided a form that also has the effect of raising the standards required of security providers. The agreement has room for amendment, and certain issues remain unsettled, particularly in the cases of liability for the master's authority and the enforceability of the knock for knock provision. An additional certification process and requirement of security providers would be a welcome supplement for quality assurance, but some standards have been set by GUARDCON. Bimco's deputy secretary general, Søren Larsen, following positive feedback he has received from users stated, "There is no doubt that GUARDCON has hit the spot."[139] It may be too early to determine what the final effect of GUARDCON will be, but there is no doubt that it will play a major role in shaping shipping and the maritime security industry in the years to come.

[139] Qtd. in BIMCO. *London seminar strikes vibrant chord with GUARDCON users* (2012)

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Ice clauses in charterparties and insurance cover for damage caused by ice

Legal review in the context of Arctic shipping

Laura Anamaria Borz

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1 Introduction

1.1 The aim of the thesis

The aim of this thesis is to examine legal issues arising from ice-related risks to vessels. Such risks will often materialize in the form of long delays, deviations and serious hull damage. In this respect, it is essential to identify the legal issues involved and how liability is allocated between the shipowner and the charterer. We also need to consider what other parties are directly affected by such risks and their rights, as well as problems relating to insurance cover and the legal relationships between the shipowners/charterers and their respective insurers.

The parties with interests in the operation of a ship are typically the shipowner, the charterer and the cargo owners. Vessels that operate in cold climates face a number of special risks. Most obviously there is the risk of ice-related hull damage: in the worst-case scenario, a large piece of sub-surface ice may tear the hull, causing the ship to sink, scattering the cargo and possibly causing an oil spill. There is also a risk of propulsion failure due to drifting aground or stranding in ice. Moreover, ships that are using the same channel or that are part of the same convoy may collide. Another typical cause of problems in winter is port access. At some ports, dramatic variations in ice conditions may force vessels to wait or cause them to become trapped for days at a time. The resulting unwanted delays may cause significant financial losses to the parties involved.

This thesis analyses examples of disputes between contractual parties and/or between other parties where the operation of a ship is disrupted by ice. The parties' claims may be based on breach of the underlying contract, statutory provisions or, depending on the circumstances, tort. With regard to contractual relationships, the discussion in this thesis will be restricted to voyage and time charters. Other types of contract of affreightment, namely charterparties for consecutive

voyages, quantity contracts or bareboat charterparties, are not discussed here. While charterparties for consecutive voyages and quantity contracts are not discussed here because they are both very closely related to voyage charters, bareboat charters are not discussed because the legal issues discussed in this thesis are not relevant (because under a bareboat charterparty the charterer undertakes all the typical responsibilities of the owner).

Following the presentation of the various potential claims and legal issues in chapters 3, 4, 5 and 6, chapters 7, 8, 9 and 10 of the thesis examine what insurance cover is available in respect of parties' potential liability and the allocation of risk between insurers and the contractual parties.

The problems discussed in this thesis take on greater significance when seen in the context of a more open Arctic Ocean with its considerable potential for increased shipping in and throughout the region.[1] However, the opening of the Northern Sea Route (NSR) and the changing Arctic environment, besides bringing tremendous opportunities, also pose immense challenges. Extremely cold environments are perhaps the most demanding and challenging operating environments for both crews and vessels. Consequently, most transArctic voyages take place at present in summer along the Northwest Passage, with the NSR being used mostly for scientific and tourism-related purposes. However, the Northern Sea Route has the advantage of offering the shortest route between Europe and East Asia. Transportation time is reduced by nearly 40 per cent compared to the route via the Suez Canal. Besides, unlike the Gulf of Aden, no piracy cases have been registered in the Arctic and the surrounding regions. This makes the NSR very attractive for navigation. [2] The main obstacle for ships is ice. Modern ice-breaking equipment, however, offers a solution to this problem and there is now considerable interest in using these routes for commercial shipping.

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1 *High north: high stakes* (2008) p. 7

2 Felix H. Tschudi, *New frontiers: The Northern Sea Route,* http://www.cefor.no/archive/Documents/Felix%20Tschudi.pdf

1.2 Legal sources

The legal sources for this thesis will be presented in its individual subchapters. The main legal system discussed is that of Norway. Norway is a civil law country and its law has much in common with other Scandinavian civil law systems. Accordingly the main source of law is statute. Support can, however, be drawn from court judgments, academic opinions and customary law.

In the Norwegian context, the Maritime Code (Act no. 39 of June 1994 as amended by Act no. 10 of 26 March 2010) (the "NMC") is the most important source of maritime law. The NMC covers a wide range of topics including the relationships between the charterer and the shipowner and between the shipper, the carrier and the consignee respectively.

As regards contract law, the parties may decide among themselves the nature of their relationship. Statutory provisions only apply where the contract is silent and are therefore subsidiary. A significant number of standard charterparty forms and clauses have been developed by different players in the trade. For example, BIMCO[3] is the principal organisation worldwide responsible for the development of standard contract forms and free-standing clauses for the shipping industry.[4] BIMCO has drafted charterparty clauses covering a wide range of issues. These include ice clauses that govern the obligations of the parties in the event that the voyage is affected by ice. Such clauses may be modified by the mutual agreement of the parties according to their specific needs. In the case of a dispute, the solution should be sought first in the contractual provisions through the application of customary principles of interpretation.

Another factor is the influence of English law on Norwegian statutory provisions and legal approaches.[5] This means that English case law may be relevant to disputes governed by Norwegian law. Accordingly,

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3 The Baltic and International Maritime Conference

4 *Legal issues relating to time charterparties* (2008) p. 1

5 Falkanger (2011) p. 366

in addition to the Norwegian legal system, this thesis discusses relevant English case law. Where appropriate, we consider the position under both legal systems.

2 Some features of voyage and time charters

There are many standard voyage and time-charters forms, e.g., GENCON, BALTIME, NYPE and SHELVOY. The shipowner and the charterer may modify the standard texts by adding rider clauses. Under a voyage charter, the shipowner will bear the risk of delay arising from causes beyond the control of the parties, e.g., delay caused by a large ice floe. The voyage will usually be carried out between such ports as are specified in the charterparty and nominated by the charterer. This means that the voyage charterer determines which loading place or berth will be used. This fact is relevant to liability for damage to the ship. If the charterer nominates a port of loading and the vessel is damaged in connection with its call at that port, e.g., because the port is icebound, the damage will be attributable to the charterer's nomination of that port. This will be sufficient for the charterer to be held liable.

Under a time charter, the vessel is usually fixed for a specific period within a specified geographical area. Unlike the position under a voyage charter, there is a clear division of operational responsibility between the shipowner and charterer, with the charterer exercising significantly greater control over the vessel.[6] The charterer's control extends over the master of the vessel, who is obliged to perform voyages in accordance with the charterer's wishes. Various time-charter forms establish the geographical limits within which the charterer may utilise the ship. The ship may be at greater risk of damage in icy waters, with off hire being the usual result. The shipowner retains liability for risks connected with the operation of the ship. Consequently, a delay caused by a mechanical breakdown will automatically cause the contract to be suspended and

[6] Braden, Vandevender, 49 Tul.L. Rev. p. 806 1974-1975, p. 806

no hire will be payable for such a period. Under a time charter, however, the risk of delay caused by factors such as bad weather conditions, ice or port congestion, falls on the charterer, who has to pay a flat rate for the time for which he has hired the vessel.

3 Claims by the owner for damage to the ship caused by ice

3.1 Legal basis for the claim

In the event of a breach of contract, usually the only remedy available to the injured party is to claim damages.[7]

More specifically, the shipowner is entitled to be compensated for damage to the ship if he can prove that the damage was caused by the charterer's breach of specific provisions in the contract. Accordingly the shipowner's claim will have its legal basis in the contract.

Under Norwegian law, the traditional approach is that liability for damage is triggered by negligence.[8] Consequently, the shipowner will have to demonstrate that the damage was caused by the charterer's failure to perform the contract properly.

Examples of circumstances where the shipowner will be likely to succeed in a claim for ice damage will be where the charterer has nominated an unsafe port or exceeded the trading limits specified in a time charter. Clearly the breach of such contractual provisions may result in damage to the ship. However, in order to have a valid claim, the shipowner will have to prove the liability of the charterer. Losses incurred by the owner as the result of damage to the ship normally consist of repair costs and loss of income because the ship is unavailable for service.[9]

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7 *Voyage Charters* (2007) p. 578

8 Falkanger (2011) p. 173

9 *Voyage Charters* (2007) p. 611

Most charterparties provide that the shipowner is responsible for effecting and paying for the insurance of his ship. This means that if the ship is damaged, the shipowner will claim compensation from his insurers. In practice it is also usual for the charterer to be named as the co-insured on the policy. The charterer will therefore benefit from the shipowner's insurance cover. Thus, in the event of damage, both the shipowner and the charterer will have the right to sue the insurer. In some circumstances the charterer may be obliged under the charterparty to pay the cost of insuring the ship. In neither of the latter situations, however, is the shipowner prevented from claiming directly against the charterer or his servants.[10]

Legal issues that may arise between the shipowner and the charterer will be analysed in detail in the following subchapter.

3.1.1 Responsibility for navigational control of the ship and charterer's orders

Provisions regarding the navigational control or employment of ships are typically set forth in charterparty forms or standard agreements and are agreed mutually by the parties. If the parties disagree about how to interpret a clause, the rule under Norwegian law is that the courts will look firstly at the intention of the parties at the time the contract was concluded. This means that the courts will interpret the contract using the ordinary rules of interpretation and taking into account any relevant supplementary law. For example, *Baltime* clause 9 states: "*The Master to prosecute all voyages with the utmost despatch and to render customary assistance with the Vessel's Crew. The Master to be under the orders of the Charterers as regards employment, agency, or other arrangements.*" This clause has a statutory parallel in Section 378 of the NMC and gives the charterer wide-ranging authority over the ship. Although this authority apparently includes both navigational and commercial authority, the meaning of "navigational authority" must be interpreted restrictively.[11] If the charterer has navigational

[10] *Aira Force v. Christie* (1892) 9 T.L.R. 104 (C.A.)

[11] Falkanger (2011) p. 431

control over the ship, the charterparty is a bareboat charter.

In addition, when interpreting contractual provisions, the Norwegian courts will often follow the decisions of higher courts in previous similar cases. Given the importance of English law in the field of chartering and the considerable number of English judgments in this area, it is also not unusual for the Norwegian courts to take into consideration the decisions of English judges in relevant cases. In the Norwegian case ND 1983.309 *NA Arica*, a vessel chartered by Norwegian parties suffered an engine breakdown on a voyage from the US East Coast to Japan. The question was whether hire was payable for the period the ship was under tow across the Pacific. The majority of judges concluded that the charterparty's off-hire clause must be read literally and interpreted in accordance with English law. As a result, the charterer did not have to pay hire for the period the ship was out of service.[12]

In time and voyage charters, navigational instructions are typically under the shipowner's control, while the vessel's employment is put under the charterer's orders. There are, however, important differences between voyage and time charters as regarding the employment of the ship. Under a voyage charter, the shipowner agrees to present his vessel at a port nominated by the charterer and to deliver the cargo at the destination nominated by the charterer in exchange for freight. This means that the shipowner has exclusive control over the performance of the voyage and accordingly bears the risks and costs. Under a time charter, however, the charterer exercises significantly more control over the vessel.

A time charterer has the right to employ the vessel in any way he wishes, subject only to any limitations imposed by the charter in question. In addition, he may order the master of the vessel – who in principle operates the ship on behalf of the shipowner – to perform the voyage in accordance with his wishes. Such a division of operational responsibilities has consequences for the allocation of risk between the parties. In practice, most time charters, e.g., the New York Produce Exchange (NYPE) standard form, allocate responsibility for navigational duties to

[12] Falkanger (2011) p. 445

the master, who must obey the charterer's orders but who at the same time is the shipowner's representative: *"…The Captain (although appointed by the Owners), shall be under the orders and directions of the Charterers as regards employment and agency;…"*.

According to Lord Wright, in *Larringa S.S. Co. v. The King*,[13] "Employment means employment of the ship to carry out the purposes for which the charterers wish to use her." This definition excludes, however, the navigational execution of the charterer's instructions.[14] The navigational management of the vessel will always remain the owner's responsibility, exercised through the master.

Generally, a master who encounters bad weather may decide to deviate from his originally intended course in order to avoid it. This is an example of a navigational decision. This could also imply that the master has the power to alter course even before encountering bad weather. According to the House of Lord,[15] however, decisions regarding the route are not matters of navigation and a deviation from the route ordered by the charterer may only be justified on safety grounds. Thus the master must obey orders given by the charterer concerning the choice of route. However, some contractual provisions, such as those concerning unsafe ports and trading limits, which are also highly relevant to situations where ice is impeding the vessel, may restrict the master's duty to obey. A particular situation in which the master will in fact be obliged to reject the charterer's orders is where the ship or her cargo is endangered. As Lord Hobhouse said in *The Hill Harmony*,[16] *"The master remains responsible for the safety of the vessel, her crew and cargo"*.

Another situation where the master is not obliged to obey the charterer's orders concerns the charter's trading limits. The provisions on trading limits restrict the charterer's freedom to employ the vessel outside the agreed limits. The parties may however agree to exceed the

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13 *Larringa S.S. Co. v. The King* [1945] A.C. p. 246 (H.L.)

14 http://www.yankodesign.com/2013/01/17/squishy-monster-fishy/, p. 260

15 *The Whistler International v. Kawasaki Kisen Kaisha* [2001] A.C. p. 657-659

16 *The Whistler International v. Kawasaki Kisen Kaisha* [2001] 1 Lloyd's Rep. 147, p. 160

agreed limits. In such circumstances, the shipowner's agreement will usually be conditional on the payment by the charterer of the additional insurance premium required by the vessel's underwriters.[17]

In the context of ice risks, and in addition to the above charterparty regimes, which are designed to restrict the vessel's trading activity to safe ports and within Institute Warranty Limits, some standard charterparty forms contain variously worded clauses that have the effect of restricting a charterer's right to order a vessel to proceed to (or remain in) icebound ports or areas or otherwise to force ice. These clauses also give the shipowner the right to order his vessel to leave a port on account of the presence of ice. In *The Inishboffin,*[18] Scrutton LJ stated that this type of clause:

> "enables the master to refuse to go to an ice-bound port, and to refuse to face ice met on his voyage, without being guilty of any breach of charter, and without prejudicing his owners' right to hire when he is waiting for proper orders, or for a sea free of ice. She is also allowed to leave a port which is likely to become icebound, but is not obliged to do so; that is my view, it cannot be said that the owners lose their right to hire, because the master elects to stay when he might have escaped".

This type of clause would also be valid under Norwegian law. However, it is important to note that in the Norwegian marine insurance market, a vessel's trading limits are regulated by the Section 3-15 of the Norwegian Marine Insurance Plan (NMIP). Under Section 3-15, three types of trading limits apply: ordinary trading limits, excluded trading limits, and conditional trading limits. A detailed geographical description of the three categories has been incorporated into the NMIP by way of a separate Appendix.

Furthermore, the shipowner or the master may choose to

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17 *Temple S.S. Co. V. V/O Sovfracht*, [1944] 77 Lloyd's Rep. p. 257, 267

18 *Limerick Steamship Co. Ltd. v. W.H. Stott & Co. Ltd* [1921] 7 LIL Rep 69 (CA), p. 71

follow the charterer's orders.[19] This was the case in *The Kanchenjunga,*[20] where a vessel was chartered on the *Exxonvoy* form. Clause 21 of this form, regarding safe ports, stipulated that *"if owing to any war, hostilities, … entry to any such ports of loading… or discharging… of cargo at any such port be considered by the master or owners in his or their discretion dangerous… the charterers shall have the right to order the cargo… to be loaded at any other safe port…"*. In this case, the charterer ordered the vessel to Kharg and the owner, despite knowing this port to be unsafe, complied with the order. The court emphasised that the shipowner, by obeying the order, had waived his right to refuse to go to the nominated (unsafe) port. He had not, however, waived his right to recover damages from the charterer if the ship was damaged as a result.[21] This implies that an owner who complies with a charterer's illegitimate order does not waive his right under the charterparty to claim damages.

In other words, even though navigational responsibility lies mainly with the shipowner and his master, under a time charter, the charterer typically has the right to order the vessel to take any route he wishes. The shipowner has the option of disobeying the charterer's orders. But even where the shipowner does not do so, and where the facts about the route were unknown to him, he may still have a claim against the charterer should any damage occur on such a voyage.

3.1.2 Nomination of safe ports and berths

As mentioned above, vessels may often risk encountering ice in ports. Standard charterparty forms provide the parties with the freedom to choose the location of the ports or areas for loading or discharging. No binding fixture can exist before these choices are made. Such provisions are most typically found in voyage charters, but provisions regarding safe ports and berths can also be found in time-charter forms. *Produce 1993* and *Baltime 1939* each contain an ice clause (clauses 33 and 15 (b),

19 See footnote 28, *The Helen Miller*

20 *Motor Oil Hellas Refineries S.A. v. Shipping Corp. of India* [1990] 1 Lloyd's Rep. pp. 391, 397 (H.L.1989)

21 *Time charters* (2008) p. 214

respectively). The clauses are similar, although the drafting of the *Baltime* clause is somewhat more detailed. Both clauses provide that the vessel shall not be obliged to enter either an icebound port or a port where passage is considered dangerous because of ice.[22]

In principle, the obligation to nominate the port or berth lies with the charterer. Most charterparties state that ports and berths nominated by the charterer must be safe. Factors that may make a port or berth unsafe include high winds, inadequate quays, quays that are in bad condition[23] and, at some times of the year, ice. A definition of safety that has been accepted in subsequent cases[24] and that applies to both time and voyage charters was given by Sellers L.J. in *The Eastern City*, where he stated:

> "A port will not be safe unless, in the relevant period of time, the particular ship can reach it, use it and return from it without, in the absence of some abnormal occurrence, being exposed to danger which cannot be avoided by navigation and seamanship".25

Under English and American law there is an express warranty of safety by the charterer regarding the nomination of the port (or berth).[26] This imposes a heavier burden on the charterer, making him liable in situations where the port is considered unsafe. Under Norwegian law, however, the charterer is not subject to any strict guarantee-based liability. In general, where the charterparty is silent with regard to liability for damage to the ship in connection with a call at a port, the charterer or his representatives will only be liable for such damage if they have been negligent, cf. Section 328 of the NMC: *"If the voyage charterer has ordered the ship to an unsafe port, the voyage charterer is liable (…), unless the damage is not caused by the personal fault or neglect of the voyage charterer(…)"*. Section 385 of the NMC provides similarly regar-

22 Michelet (1997) p. 84

23 Gorton (1999) p. 223

24 *Voyage charter (2007)* p. 119

25 *Voyage charters* (2007) p. 119

26 See, e.g., clause 9 of Asbatankvoy

ding time charters. However, the charterer may undertake liability by including an express clause to this effect. Norwegian legal commentators[27] have found arbitration tribunals to be inconsistent regarding the application of strict guarantee-based liability and have referred to a number of cases such as ND 1959.242 *Hilde Torm* and ND 1988.308 *NA*, where the relevant clauses could be construed to give rise to guarantee-based liability. In the first case, the vessel *The Hilde Torm* had suffered damage when she ran aground in connection with a discharge of coal in Trondheim. The court found that the *Baltcon* provision concerning "safely always afloat" represented a guarantee. Accordingly the charterer was found liable for the damage. In the latter case, the crane vessel *The Uglen* suffered damage while performing lifting tasks at a shipyard. The arbitrators found that the wording of the contract rendered the charterer liable under a special guarantee in respect of damage to the ship: "*Section 3.0. Place of operation: The place of operation must be safe, with sufficient water debts and always guaranteeing the crane to be afloat with no risk for damage to the craft and its propellers (…) Section 20.1. The CHARTERERS shall be responsible for loss or damage caused by the CRAFT or to UGLAND: 20.1.1. by any improper or negligent act or omission on their part or that of their servants or agents.(…)*". On the other hand, in ND 1962.143 *NV Vigrid,* the charterparty included a provision that the vessel should lie "safely, always afloat". The shipowner argued that this represented a guarantee against damage caused by grounding. In this case, however, the arbitrators concluded that it was unnecessary to determine the warranty issue, because if the place of discharge was suitable according to the provision, the clause did not represent a guarantee that the ship would not be damaged during the discharge.

Thus the charterer's nomination of an unsafe port or berth may lead to damage to the ship, sometimes accompanied by delay and loss of profit under the charterparty.[28] As already mentioned in subchapter 3.1 above, if a risk materialises and the ship is damaged, the shipowner will be able to claim against the charterer for breach of the safe port war-

[27] Gram (1977) p. 57

[28] *Voyage charters* (2007) p. 616

ranty in the charterparty. The answer to the question whether, in the absence of an express warranty, any warranty should be implied, was summed up by Morris L.J. in *The Stork*[29] when he stated a warranty of safety is implied automatically.[30]

The shipowner, however, cannot refrain from investigating the safety of the port and may make a reservation concerning the charterer's nomination of a port. Arguably, therefore, where the shipowner obtains knowledge of the condition of the port following the charterer's nomination, any damage is a consequence of the owner's failure (through the master) to act prudently. In *The Inishboffin,*[31] the ship encountered thick ice when about 200 miles from her destination port of Abo. The master decided to force the ice instead of waiting for the assistance of an icebreaker. Consequently, the ship became stuck and sustained damage. The court found that the ship could have reached Abo safely had the master waited for the icebreaker. However, if a vessel's port of destination cannot be reached safely because of ice en route, the charterer may be liable for any damage sustained by the ship because the port is unsafe.[32]

Another case[33] that confirms the charterer's liability for ice damage if the port or the approach to the port where the damage occurred is found to have been unsafe by reason of ice is *The MV Sussex Oak*. In this case, the vessel, when approaching Hamburg was stopped by a large ice floe and could neither turn, go astern nor anchor safely. The master decided to force the ice and the vessel sustained damage as a result. Devlin, J. held: "*The charterer does not guarantee that the most direct route or any particular route is safe, but the voyage he orders must be one which an ordinary prudent and skilful master can find a way of making in safety*". Accordingly the charterer was held liable on the ground that Hamburg was an unsafe port.

29 *Compania naviera Maropan v. Bowaters Lloyd* (1955) Q.B. 68, p. 105

30 *Voyage charters* (2007) p.112

31 *Limerick Steamship Co. Ltd. v. W.H. Stott & Co. Ltd* [1921] 2 K.B. 613, 15 Asp. M.C. 323

32 *Time charters* (2008) p. 665

33 *G. W. Grace & Co v. General Steam Navigation Co.* [1949-50], 83 L1.L. Rep. 297

3.1.3 The charterer's liability under trading-limits provisions

The charterer will be in breach of contract if he directs the employment of the ship outside the trading limits established by the specific agreement. It is important to note that this only applies to time charters. A voyage charter will define the geographical employment of the ship. Under a time charter, the charterer is free to order the ship to proceed in any navigable waters worldwide within the specified trading limits.

The seasonally excluded areas that cannot be navigated during winter are typically the St. Lawrence Seaway, the Northwest coast of North America, Northwestern Russia and the Baltic. The reason for these exclusions is ice, as even ships that are equipped to navigate in such hazardous waters may sustain severe damage. These areas are considered to lie outside the trading limits. A shipowner/vessel entering such areas and outside the specified trading limits as agreed in the insurance contract, will need to get permission from his underwriters (Insurance company) or pay extra insurance premiums.

It is important to note that 'intra-Arctic' shipping currently comprises summer operations in the Canadian Arctic and around Greenland, and year-round operations along the ports of the NSR.[34] In these areas, however, the presence of ice and icebergs cannot be excluded even during the summer. Some of these areas are currently outside the trading limits established by the English Hull Conditions (ITC), the Institute Warranty Limits and the NMIP (cf. Section 3-15).

The general provisions of the NMC regarding the charterer's disposal of the ship (cf. Section 378) give the owner the option to make decisions about the performance of the voyage in special cases:

> "The time carrier shall, however, not be obliged to perform a voyage which exposes the ship, persons on board or the cargo to danger in consequence of war, warlike conditions, ice or other danger or significant inconvenience which the time carrier could not reasonably

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[34] *Legal aspects of Arctic shipping*, 2010, p. 5 http://ec.europa.eu/maritimeaffairs/pdf/legal_aspects_arctic_shipping_summary_en.pdf

have foreseen at the time when the contract was concluded.”

Similar provisions may be found in specific charterparties. For example, Clause 2 of *Gentime* refers to “Trading areas” whereby:

> “The Vessel shall not be required to enter or remain in any ice bound port or area, nor any port or area where lights, lightships, markers or buoys have been or are about to be withdrawn by reason of ice, nor where on account of ice there is risk that, in the ordinary course of events, the Vessel will not be able safely to enter and remain in the port or area or to depart after completion of loading or discharging. The Vessel shall not be obliged to force ice but subject to the Owner’s prior approval, may follow ice-breakers when reasonably required, with due regard to her size, construction and class. If, on account of ice, the Master considers it dangerous to remain at the port or place of loading or discharging for fear of the Vessel being frozen in and/or damaged he shall be at liberty to sail to any convenient place and there await the Charterers’ new instructions.”

A time charterer may often wish to direct the vessel to ports or places outside the charterparty trading limits. If the vessel is so directed without the owner’s consent and the vessel is damaged as a result, the shipowner may hold the charterer liable for damages for breach of contract. Alternatively the charterer may seek to obtain in advance the shipowner’s agreement to proceed outside the trading limits. In this situation, however, the owner will be free to impose whatever conditions he likes. For example, he may require the charterer to accept liability for all damage to the ship occurring while the ship is outside the trading limits agreed in the charterparty.

What happens if a shipowner, acting through his master, fails to object to a charterer’s order to proceed outside the trading limits? The owner will not necessarily be liable as a result. In *Temple Steamship v. Sovfracht*[35], the vessel *The Temple Moat* had been chartered on an amended *Baltime* (1920) form. In this case, the master’s compliance

[35] *Temple Steamship Co. Ltd. v. V/O Sovfracht* [1945] 79, L1.LRep. 1

with the charterer's orders did not prejudice the owner's claim for damages, as the master was (pursuant to Clause 8), under the orders of the charterer as regards employment. In other words, waiver of the right to refuse to comply with an order does not inevitably imply a waiver of the right to damages if losses should occur.[36]

The shipowner may consent to the charterer's orders to employ the vessel outside the trading limits. This will be possible in return for the payment of an additional insurance premium by the charterer on the basis of a special clause in the charterparty. One example of such a clause can be found in the *NYPE* charter used in *The Helen Miller.*[37] This charter defined the trading limits as being *"between safe ports within Institute Warranty Limits including St. Lawrence up to and including Montreal, but excluding Cuba (…), and all safe, unsafe ports, but Charterers have the liberty of breaking limits, they paying extra insurance, if any (….)"*. In this case, the charterer ordered the vessel to ports outside the Institute Warranty Limits and she suffered ice damage on voyages to ports that were found to have been unsafe at the relevant time. Consequently, the charterer was found to have been in breach of contract by sending the vessel to unsafe ports. In *The Helen Miller*, Mustil, J. held that *"by paying the premium the charterer does obtain a benefit – the benefit of being able to send the ship on a voyage which the owner would not otherwise allow her to perform. But this is not at all the same as saying that the charterer thereby obtains the right to send her on such a voyage risk-free"*.

It is important to note that even though ice damage is addressed by provisions such as safe ports and trading limits clauses, this does not mean that these clauses contradict the ice clause. In one arbitration award,[38] it was held that the owner's acknowledgment that a port was safe and suitable for the vessel did not deprive the master or the owner of their rights under the ice clause in the event that a port became inac-

36 *Time charters* (2008) p. 136

37 *The Helen Miller*, (1980) 2 Lloyd's Rep. 95

38 London arbitration 12/00, L.M.L.N. 546

cessible by reason of ice.[39] The vessel in this particular case was chartered on the *Synacomex* form and was heading to Mariupol, a port acknowledged by the owners as being safe and suitable for the vessel. The charterparty also incorporated the *Gencon* General Ice Clause, which provided that if the port of loading was inaccessible by reason of ice, the master for fear of being frozen in had the liberty to leave without the cargo and the charter should be cancelled. On December 2 the owner declared Mariupol icebound and the master consequently sailed to Ilychevsk. The tribunal found that in doing so the master had exercised his rights under the ice clause and subsequently would have been entitled to treat the charterparty as null and void. However, the owner had never definitively claimed the protection of the clause and, because both parties had accepted that the charterparty was frustrated without agreeing upon other terms, the tribunal found that neither party had a claim against the other.

3.2 Concluding remarks

As mentioned above, the general rule under Norwegian law is that when the charterparty is silent with regard to liability for damage to the ship, the charterer or his representatives will only be liable for such damage if they have been negligent, cf. Sections 328 and 385 of the NMC. This is contrary to the position under English common law, whereby the charterer will be liable due to his express warranty that he will nominate safety ports. In any of the two systems of law, the charterer may, however, undertake strict liability under an express clause. Thus, the legal basis for the shipowner's claim lies in the charterparty or, alternatively, in the provisions of the statute.

The charterer's liability is triggered if the ship suffers ice damage and when the charterer is in breach of the ice clause e.g., when he has nominated an unsafe port or, typically, has ordered the ship outside the charterparty trading limits. To avoid liability in such cases the charterer will have to demonstrate that the damage was in fact caused by the fault

39 *Voyage charters* (2007) p. 713

of the shipowner due to navigational error. As described above, risks connected to the operation of the ship are in principle borne by the shipowner.

The facts of any dispute, however, must be analysed on a case-by-case basis. The shipowner cannot refrain from investigating the safety of a port and must make a reservation concerning the charterer's nomination of a port. In addition, a shipowner who has acknowledged the time charterer's breach, where the timecharter has ordered the vessel outside the agreed trading limits, will be held liable for failure to act prudently. In such a situation, liability will be apportioned according to the each party's degree of fault.

4 Claims by the charterer for delays to the ship caused by ice

4.1 Legal basis for the claim

Individual charterparties usually contain express provisions regarding the performance of the voyage, e.g., the shipowner generally promises that the vessel shall proceed with all convenient speed[40] or with the utmost despatch.[41] If the charter is silent in this regard, under Norwegian law it will be supplemented by statutory provisions, i.e., those of the NMC. Similarly, under English law the shipowner and the charterer are free to vary the terms of their contract by the inclusion or exclusion of provisions, but the obligations of the parties to a charter go beyond those specified in writing. In addition to the express undertakings, every charterparty gives rise to certain implied undertakings, such as

40 Norgrain 1989, Line 12:"*Loading port(s) 1. That the said vessel, being tight, staunch strong and in every way fit for the voyage, shall with all convenient speed proceed to (…)*"

41 New York Produce Exchange 93 clause 8 (a): "*The master shall perform the voyage with due despatch, and shall render all customary assistance with the Vessel's crew (...)*"

the shipowner's implied duty to proceed with reasonable (utmost) despatch or to proceed without unjustifiable deviation.[42]The breach of any charterparty provision, whether the provision is express or implied, entitles the injured party to a remedy, which may be either to cancel the charterparty or sue for damages.[43] As regards deviation, in the Norwegian case ND 1914.470 NSC SKARP, where the vessel, during a wrongful deviation, took in sea water and the cargo was damaged, the Supreme Court concluded: *"The consequence of this contractual breach by the owner must, in my view, be limited to damage arising during the deviation. But the owner will also have the burden of proof for establishing that the damage discovered at the end of the voyage did not occur during the deviation or at least that the damage would have occurred even if the original course had been maintained"*. In this case, the owner could not demonstrate that the damage discovered at the end of the voyage did not occur during the deviation or that the damage would have occurred even if the original course had been maintained. Thus, the Supreme Court concluded that the shipowner was liable for the cargo damage.

Provisions regarding delay differ considerably in voyage and time charters. Accordingly, time and voyage charterers' rights against the shipowner in the event of delay will be discussed separately.

With respect to voyage charterparties, the NMC provides that the voyage carrier – the shipowner – shall perform the voyage with due despatch, cf. Section 339. Delays frequently occur during the actual voyage before or after the arrival/departure of the vessel at/from the loading/discharging port. At the preliminary stage of the voyage, the shipowner generally promises that the vessel will proceed with all reasonable despatch to the port of loading in order to arrive on an expected date. The meaning of "due despatch" will depend on the facts of the particular case, but essentially this means that the choice of route should be reasonable and the actual voyage should be performed at a reasonable speed. [44] Sometimes the shipowner may find it necessary to

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[42] Braden Vandevender, 49 Tul.L. Rev. p.806 1974-1975

[43] Ibid.

[44] Falkanger (2011) p. 381

deviate from the intended route. Even if the vessel is delayed or damaged as a result, so long as the deviation is legitimate there is no breach by the shipowner. According to Section 340 of the NMC, deviation on reasonable grounds is permitted.

If the delay or deviation is caused by ice, this may affect the outcome of a claim by the charterer. For this reason the allocation of ice-related risks will be discussed separately and in detail in the following subchapter.

Generally, the provisions regarding loading and discharging operations are of particular importance to both parties to the contract because of their direct effect on the timing of the commercial activity. The main obligation of the shipowner under loading and discharging provisions in any specific contract will be to ensure that the vessel arrives at the loading port. Under the contract, a certain period of time, so-called "laytime", will be set aside for loading. If loading is completed within this time, no additional payment will be due from the charterer. As the laytime does not commence until the vessel has arrived, the risk of delay is borne by the shipowner.

With regard to time charters, if the vessel is damaged or otherwise hindered from performing the required services,[45] and the delay is attributable to a cause that is specified in the charterparty, the charterer will not be liable to pay hire, i.e., the charterer has the right to claim off hire. Fault is irrelevant when considering whether the loss of time is caused by the shipowner. Thus there is no need to consider whether the owner or anyone for whom he is responsible can be blamed for what has occurred and the underlying reason for the off-hire situation is irrelevant. Under Norwegian law, the rules governing off-hire situations are based on a system of risk allocation. These rules apply unless otherwise agreed, cf. the first paragraph of Section 392 of the NMC. In fact, the charterparty will usually contain provisions allocating these risks, but if the relevant clause is unclear or incomplete, the rules in the first paragraph of Section 392 may supplement the contractual provisions.

The legal position where ice prevents the vessel from proceeding to

[45] Ibid., p. 417

the loading port or leaving the discharge port is discussed in the following subchapter.

4.2 Delays caused by ice

Under a voyage charter, the shipowner has no liability for deviation or delay necessitated or caused by the ice.

As described above, the voyage must be carried out with due despatch. However, the shipowner will not be liable if he orders the ship to deviate or the ship is delayed by a major obstruction such as ice. Situations where there is danger of the ship freezing in or being stranded in ice, or where forcing the ice may cause damage to the ship, may be considered reasonable grounds for deviation. However, liability for the resulting loss of time for the charterer is borne wholly by the shipowner. Ice-related hindrances will normally be temporary in nature. When they cease to exist, the shipowner will have to complete the voyage without any right to additional freight. This is because the amount of freight is stipulated for the voyage, not for the time used. Accordingly the risk in respect of delay remains with the owner.[46] Moreover, according to Section 349 of the NMC, if the delay is such that the purpose of the contract is essentially frustrated, the charterer has the right to cancel the charter.

In contrast, under a time charter the performance of the voyage is among the charterer's obligations. For example, clause 9 of *Baltime* gives the charterer the right to give orders to the ship within such parameters as the parties have agreed.[47] The charterer is obliged to pay hire continuously throughout this period, except for time lost due to "hindrance on part of the owner". The rules governing off hire are based on a system of risk allocation and apply unless agreed otherwise, cf., Section 392 of the NMC. Typical situations that would give the charterer the right not to pay hire include loss of time due to a strike on board, non-functioning loading equipment, or a breakdown of the main

[46] Brækhus (1968) p. 256

[47] See 3.1.1.

engine. But where the vessel is being traded in icy waters and the vessel becomes inoperative or delayed because of ice, the charterer is not relieved of his obligation to pay hire. It was after all the charterer who ordered the vessel into such waters and in principle it is his responsibility to obtain information about the prevailing conditions at sea. Accordingly the charterer will be liable if there is a causal link between any ice-related damage and a subsequent delay. The reason for establishing the original cause of any delay is that if it is found that the actual cause of the delay was a mechanical breakdown, then the off-hire rules will apply and the charterer will be relieved of his obligation to pay hire for the relevant period. A typical example would be where a vessel's random engine breaks down while trying to get through ice with the consequence that she remains stranded in a partially damaged condition before once again proceeding with the help of icebreakers. In such a case the cause of the delay would be the random engine breakdown and not the prevailing conditions at sea.

Delays as a result of ice-related problems at the loading port, during the sea voyage or at the discharging port are dealt with in the ice clause. There are many varieties of ice clauses, all of which are intended to establish limits and give several options to the parties. The General Ice Clause for voyage charterparties as drafted by BIMCO has separate rules for the port of loading and the port of discharging.

According to the rules for the port of loading, if the vessel is impeded by ice or if on arrival the loading port is inaccessible by reason of ice, the charterer is required to nominate a safe and accessible alternative port. The clause will only apply if the port is inaccessible for a reasonable period. If the charterer has given a safe port warranty and the vessel has to wait because the port is inaccessible, the charterer will only be in breach of warranty if the delay is long enough to frustrate the commercial object of the charterparty.[48] A similar example of an ice clause is found in the *Asbatankvoy* standard form for tanker voyage charters:

[48] Voyage charters (2007) p. 707

"Clause 14 (a) ICE

In case port of loading or discharge should be inaccessible owing to ice, the Vessel shall direct her course according to Master's judgment, notifying by telegraph or radio, if available, the Charterers, shipper or consignee, who is bound to telegraph or radio orders for another port, which is free from ice and where there are facilities for the loading or reception of the cargo in bulk. The whole of the time occupied from the time the Vessel is diverted by reason of the ice until her arrival at an ice-free port of loading or discharge, as the case may be, shall be paid for by the Charterer at the demurrage rate stipulated in Part I.

14 (b)

If on account of ice the Master considers it dangerous to enter or remain at any loading or discharging place for fear of the Vessel being frozen in or damaged, the Master shall communicate by telegraph or radio, if available, with the Charterer, shipper or consignee of the cargo, who shall telegraph or radio him in reply, giving orders to proceed to another port as per Clause 14 (a) where there is no danger of ice and where there are the necessary facilities for the loading or reception of the cargo in bulk, or to remain at the original port at their risk, in either case Charterer to pay for the time that the Vessel may be delayed, at the demurrage rate stipulated in Part I."

In sub-clause (a), notwithstanding the owner's navigational control that applies in any event, the master is granted discretion to direct the vessel's course in circumstances where the port is inaccessible owing to ice. Upon receiving the master's notification that the port is inaccessible, the charterers have an express obligation to transmit, telegraph or send radio orders for an ice-free port. The clause provides that "the whole of the time occupied from the time the vessel is diverted by reason of ice" until her arrival at a substitute ice-free port shall be paid for by the charterers at the demurrage rate. The wording "occupied" in

this context does not mean time lost or extra time taken.[49] Accordingly, if the port of discharge becomes inaccessible, the owner can claim full freight and demurrage from the time the diversion commences until arrival at the alternative port.[50]

Sub-clause (b) provides that on receiving the master's notification regarding "fear of the vessel being frozen in or damaged", the charterer has the option either to order the ship to an ice-free port or to order her to remain at the original port. In the latter case, if the vessel is damaged or delayed, the charterer will be obliged to pay compensation at a rate equivalent to the rate of demurrage.

A peculiar feature of this sub-clause is that the owner, rather than having the right to refuse to remain at the port, is obliged to rely on the charterer's ability to indemnify him for damage or delay caused to the ship.

If the charterer does not nominate a safe port, his second option under the General Ice Clause is to reckon laytime as if the port named in the contract were accessible. The usual effect of ice during laytime is to prevent the loading of cargo. Thus, if the port does not become accessible within the laytime, the charterer will be obliged to pay the owners demurrage because the ship has been delayed.

A third option for the charterer is to cancel the charterparty. Doing so, however, is rarely in the charterer's interest.[51] In the circumstances where the charterer has failed to take up any of the options he has under the ice clause, the shipowner has the right to cancel the charterparty. In this case the charterer will be obliged to pay compensation for all the shipowner's proven loss of earnings under that charterparty.

At the port of discharge, if ice is impeding the vessel or if the port is inaccessible due to ice, the charterer once again has the option either to nominate a substitute accessible port or to keep the vessel waiting against the payment of compensation. Such compensation will

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49 Ibid, p. 863

50 Ibid, p. 863

51 Brækhus (1968) p. 257

be due at a rate equivalent to the rate of demurrage. The general rule under the ice clause is that a charterer who nominates a substitute port will pay the same freight to the shipowner as for discharge at the original port of destination. If, however, the voyage to the substitute port exceeds 100 nautical miles, there will be a pro rata increase in the freight that the charterer must pay for delivery of the cargo.

The General Ice Clause for time charters stipulates that the time charterer shall bear any risks of delay or deviation by reason of ice. As pointed out above, an off-hire clause relieves the charterer of the obligation to pay hire where delay is attributable to any of the causes specified in the charter or by statute. If, however, the charterer breaches his obligation (as stipulated in the ice clause) not to enter or remain in ice-bound ports or areas, he will be liable to pay hire unless the charterer can show that the event causing the detention or delay is covered by the wording of the off-hire clause.

Clause 14 of the *Baltime* form includes an ice clause and stipulates that the consequences of detention by ice due to any of the causes described shall be for the charterer's account:

> "Excluded ports (…) Ice b) any ice-bound place or any place where lights, lightships, marks and buoys are or likely to be withdrawn by reason of ice on the Vessel's arrival or where there is risk that ordinarily the Vessel will not be able on account of ice to reach the place or to get out after having completed loading or discharging. The Vessel not to be obliged to force ice. If on account of ice the Master considers it dangerous to remain at the loading or discharging place for fear of the Vessel being frozen in and/or damaged, he has liberty to sail to a convenient open place and await the Charterer's fresh instructions. Unforeseen detention through any of above causes to be for the Charterer's account."

In addition, the ice clause provides that the master is not obliged to force ice and if he does so, when the charterer has provided icebreaker assistance, he may not hold the charterer responsible for damage sustained by the ship. A port which is accessible due to the assistance of ice-

breakers cannot, as held in *The Inishboffin,*[52] be described as an icebound port. However, if the port of destination cannot be reached in safety, icebreaker assistance has not been provided and the master needs to force the ice the charterer may be liable for damage to the ship on the grounds that the port is unsafe.[53]

4.3 Concluding remarks

Under a voyage charter, the shipowner has a general duty, which will either be stipulated in the contract or implied by statute, to proceed with the utmost despatch. An illegitimate deviation or other wrongful decision made by the master that causes delay may give the charterer the right to hold the shipowner liable for any losses that arise as a result.

The situation is typically different, however, where the voyage is hindered by ice. This is because a major obstruction such as ice represents an exception to the general restriction on deviating from the initial route. Such circumstances do not make the shipowner liable towards the charterer.

At the loading or discharging port, the allocation of risk for ice-related delay is stipulated in the relevant ice clauses. Since the main purpose of an ice clause is to protect the owners against the risk of ice on the approach voyage, an ice clause increases the level of liability on the charterer's side. Thus a charterer will have to pay compensation to the shipowner for time lost if the vessel is impeded by ice at the loading or discharging port.

Under a time charter, the master has great discretion when ordered to an icebound port. Nevertheless, any delay or deviation caused by ice shall still be for the charterer's account and the charterer shall continue to pay hire, cf. the General Ice Clause for time charters.[54]

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52 *Limerick Steamship Co. Ltd. v. W.H. Stott & Co. Ltd* [1921] 7 LIL Rep 69 (CA) Rep. 190. See also footnote 17.

53 See subchapter 3.1.2. and *The MV Sussex Oak*, footnote 31

54 BIMCO Special Circular No. 1, 24 February 2005 https://www.bimco.org/~/media/Documents/Special_Circulars/SC2005_02_24.ashx, accessed on 27 September 2011

5 Claims by the cargo owner against the shipowner

5.1 Legal basis for the claim

As mentioned earlier, ice-related risks may also affect the interests of the cargo owner, who may suffer losses as a result of damage to the cargo and/or delay.

In connection with the carriage of goods by sea, the legal position regarding damage to cargo transported under bills of lading is governed primarily by the Hague-Visby Rules. The Rules have been incorporated by many countries involved in maritime trade, including Norway, but they only apply to charterparties where they have been expressly incorporated so as to apply between the shipowner and the charterer.[55]

Where the goods have been damaged or delayed, the cargo owner (who may be a shipper,[56] the sender[57] or the charterer himself) must pursue his rights under the underlying contract – the bill of lading. The liable party under the bill of lading is the shipowner who undertakes the transport. Furthermore, a claim may also be brought against the charterer of the vessel. In this case, the legal basis for the claim will arise from the charterparty provisions, which will provide for the same risk allocation as applies under the bill of lading. In addition, the cargo owner may also claim for cargo damage on the basis of ordinary tort rules. Under Norwegian law, the carrier's (shipowner's) liability under a charterparty for damage to, loss of or delay to cargo is regulated by the NMC, cf. Sections 347 and 383, which in turn refer to Chapter 13 of the Code. Moreover, these provisions have mandatory application as between the shipowner and the holder of a bill of lading (cargo owner), cf. the second paragraph Section 383 of the NMC, which refers to the

[55] *Voyage Charters* (2007) p. 941

[56] The person who delivers the goods for carriage, cf.§ 251 of the NMC

[57] The person who enters into a contract with the carrier (shipowner) for the carriage of general cargo by sea, cf. § 251 of the NMC.

second sentence of the second paragraph of Section 325.

An important rule regarding liability for cargo damage under Norwegian law concerns the requirement for fault or neglect by the shipowner. For the shipowner to be liable for loss of/damage to the goods or for delay, the shipowner, or someone for whom he is responsible, must have caused the loss/damage/delay through some culpable conduct, cf. Section 275 of NMC. The shipowner has the burden of proving that the damage was not caused by his fault or neglect. Under English law, the principle is that the carrier is strictly liable for the goods.[58]

For example, the liability of the shipowner may be triggered by the unseaworthiness of the vessel, cf. Section 276 NMC. If a vessel is to be traded in areas at risk of ice, the shipowner has a duty to comply with regulations for ice-going ships.

5.2 Shipowner's liability and defences against the cargo owner's claims

The NMC outlines the shipowner's duties with respect to the cargo. According to Section 262 of the NMC, the shipowner has a duty to "*take care of the goods and in other respects protect the interests of the owner from the reception and to the delivery of the goods*". This includes a duty not to deviate from the initial or intended route. Claims for damage or delay to cargo are the most frequent types of claims to confront a shipowner. There may be various reasons why this is so. Damage to the cargo because of direct contact with ice is rare. Major commercial activities that may increase in the Arctic region in the future due to greater use of the Arctic Ocean are container shipping, oil and gas exploration and tourism. As far as container ships are concerned, it is possible that accidents due to contact with large pieces of ice may cause cargo to become scattered. The most common scenario, however, is for the vessel to be delayed and the cargo damaged because the transport takes too long, e.g., the fruit decays or the goods arrive in good condition but too late. In either case, the value of the goods will fall significantly. In any of

58 Falkanger (2011) p.270

these situations, the relevant factor for establishing the shipowner's liability will be his negligence.

With respect to the period during which liability may arise, Section 274 stipulates that the shipowner is liable while he has the cargo in his possession at the loading port, during the voyage, and at the port of discharge. As a starting point, the claimant, i.e., the cargo owner, must show that the damage occurred while the cargo was in the shipowner's custody and that he has suffered economic loss as a result. Moreover, Section 275 of the NMC sets forth the general rule that the shipowner is liable for damage, loss or delay caused by his own fault or neglect or the fault or neglect of someone for whom he is responsible. The shipowner can only avoid liability by proving that he and his servants acted reasonably.

An example of a situation where a shipowner may be held liable for damage to the cargo is where the vessel was unseaworthy before the commencement of the voyage. The term "seaworthy" must here be interpreted broadly, i.e., the ship must be in a condition that allows it to perform the contemplated voyage without endangering human life. The requirements will depend on the type of voyage (coastal/transatlantic), the type of cargo to be transported and the time of the year. More specifically, if a vessel is to be traded in waters that are known to be dangerous by reason of ice, the shipowner must make sure that the vessel is able to complete the voyage without endangering the goods. Thus, the requirement of reasonable care will not only vary according to the particular type of goods, but also to the type of voyage. For example, more stringent requirements will typically apply to a voyage across the North Atlantic in midwinter.

However, according to the first paragraphs of Section 276 of the NMC and Article 4.2 (a)-(q) of the Hague Visby Rules, in certain situations the shipowner is exempt from liability. Of particular interest here is sub-clause (d) of the Rules which refers to an exemption from liability in the case of loss or damage caused by an Act of God. This concept is similar to the civil law concept of force majeure and is one of the few common law exceptions to the strict liability of common carriers. The

exemption applies where an event occurs that is external to man due to natural causes, directly and exclusively without human intervention and where the shipowner can show that the event could not have been prevented by any amount of foresight or reasonable care. It has been held that, apart from extraordinary conditions of wind, sea or lightning, frost may amount to an "Act of God" (*Siordet v. Hall* (1828) 4 Bing. 607).[59] Thus if the cargo is damaged by reason of ice during the voyage and this event can be considered to have been unforeseeable and irresistible,[60] the shipowner may invoke this provision of the Hague-Visby Rules.

Where however a vessel is being traded in waters that are known to the shipowner to be dangerous by reason of ice, and where accordingly the goods are at risk of damage or delay, the shipowner cannot invoke the exemption under the Hague Visby Rules. The same applies where the vessel calls at an icebound port that should have been known to be unsafe and delay or damage to the cargo results. Moreover, if a ship grounds while navigating in ice, the Act of God defence does not apply because of the human act of navigating in such conditions. Nevertheless, Article 2 (a) of the Rules provides the shipowner with a defence by setting forth that the shipowner is free of liability if cargo is damaged or lost due to negligence in the navigation or management of the ship. This rule can also be found in the NMC at Section 276, although Section 276(3) stipulates that the rule does not apply to contracts for the carriage of goods by sea in domestic trade in Norway. However, regarding the charterparty relationship between the shipowner and charterer, cf. the second sentence of the first paragraph of NMC Section 347 *"The provisions relating to domestic trade in Norway in section 276 paragraph three (…) do not apply"*, and similarly cf. the second sentence of Section 351. Thus the exemptions from liability set forth in Section 276 for navigational errors and fire are still available to the shipowner.

59 *Time Charters* (2008) p. 504

60 *Voyage Charters* (2007) p. 1031

5.3 Concluding remarks

When damage or delay to the cargo occurs during a voyage, the cargo owner may in principle bring a claim against either the shipowner or the charterer based on, respectively, the underlying bill of lading or the underlying charterparty.

The shipowner's liability for damage to or loss of cargo by reason of ice will mainly depend on the contractual provisions and the allocation of such risks. As mentioned above, the principle is the freedom of contract and the allocation of risk will vary from one charterparty to the next. Nevertheless, in cases of dispute, the mandatory rules on cargo damage and delay in Chapter 13 of the NMC will prevail. This is also true where a bill of lading has been issued (cf. Section 325) and this document will determine the legal relationship between the shipowner and the holder of the bill of lading (the cargo owner). Thus, the shipowner will be liable for damage to or loss of the cargo unless he can prove that he was not negligent. However, where Section 276 can be proved to apply, i.e., where the loss is a consequence of neglect or fault in the navigation of the ship, the shipowner will be free from liability.

6 Third-party claims against the shipowner

The discussion in the previous subchapters concerned situations where a contract exists between an injured party and the shipowner. This chapter focuses mainly on non-contractual scenarios, including oil pollution and collisions between ships, as well as third-party claims. Liability for loss caused by oil pollution is governed in many countries by the Civil Liability Convention 1969 and 1992, which imposes on the shipowner strict but limited liability for pollution damage. Under Norwegian law, liability for oil pollution is regulated by Chapter 10 of the NMC. This chapter incorporates the CLC Convention 1992.

As global demand for energy rises, there is increasing interest in exploring the oil and gas resources of the Arctic, which are estimated

at in excess of 100 billion tonnes of oil equivalent.[61] This means that a greater number of ships is likely to navigate these waters in the years ahead, increasing the importance of contractual provisions regarding ice at loading ports. Two examples of the various types of tanker charterparties designed for the transport of any type of liquid cargo are *Shellvoy 5* and *Shelltime 4*. *Shellvoy 5* incorporates an ice clause (clause 22) that is intended primarily to regulate the position of the parties where there is a threat of ice in three situations: 1) before any cargo has been loaded, 2) after cargo has been loaded, and 3) at a discharging port. *Shelltime 4*, under clause 4, deals briefly with navigation in ice. Lines 69-72 stipulate that the charterer may order the ship to icebound ports "or to any part of the world" outside Institute Warranty Limits, provided the shipowner has granted his consent and subject to the charterer's duty to pay any additional insurance premium. None of these clauses deal with oil pollution, however.

When damage occurs due to oil pollution caused by a vessel, any injured party may bring a claim against the shipowner. This aspect of a shipowner's liability is governed by Sections 183, 191 and 193 of the NMC. (Regarding the shipowner's liability for such damage and insurance cover, see chapter 9 below).

Third-party claims may also result from collisions between ships. In such situations, an injured party may claim damages against the negligent ship. The traditional approach under Norwegian law is that both negligence and causation must be established. This means that the shipowner must have acted negligently and caused loss or damage to a third party as a result. Anyone who acts in a culpable manner, whether through an act or an omission, so as to cause damage to a third party, is liable for the damage. Such liability is not contractual, but is based on the law of tort.

Suppose, for example, that two passenger ferries collide in conditions where there are strong winds and thick ice along the coastline. Both ships suffer major damage some persons on board are injured.

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[61] Corkhill, (2011) https://www.bimco.org/Home/News/2011/09/14_Feature_Week_37.aspx

Suppose further that the collision could have been avoided if one of the ships had respected the ice warnings and waited for the assistance of icebreakers. In this situation, the injured persons on board the innocent ship will have the right to claim damages from the vessel that was at fault (cf. the first paragraph of Section 161 of the NMC). To avoid liability, the shipowner will have to prove that no fault or neglect occurred. This results from the second sentence of the second paragraph of Section 421 of the NMC, which stipulates that the burden of proof is reversed in cases of collision damage.

In relation to personal injuries suffered by passengers on board the negligent vessel, Chapter 15 of the NMC applies. Section 428 of the NMC determines who is entitled to bring a claim against the owner. The claimant must prove the extent of the damage and also that the injury arose as a result of a collision that took place during carriage. Another scenario where passengers may suffer loss is where delay occurs because the vessel is stranded in ice. A claimant will have to show that a delay occurred and that he thereby suffered loss. Once again, in order to avoid liability, the shipowner will have to prove that the loss was not caused by his personal fault or neglect or by the fault or neglect of those for whom he is responsible, cf. the fourth paragraph of Section 421 the NMC and the second sentence of Section 418.

Injured seamen, as well as employees injured in Norway in connection with the operation of the ship, are covered by the compensation provisions of the Norwegian National Insurance Act. As mentioned earlier, ordinary tort principles are applied to determine whether the tortfeasor is liable, cf. Chapter 3 of the Norwegian Tort Act. In this particular case, however, the damages available in tort must be considered in the light of social security regulations.[62] For example, a seaman injured during the course of his employment is entitled to certain benefits cf. the Section 13-3 of the National Insurance Act of 28 February 1997. If the seaman chooses to sue the shipowner, however, a deduction will be made from his damages corresponding to benefits paid out under the National Insurance Act.

62 Falkanger (2011) p. 172

In the light of the above, we may conclude that where a third party who has suffered losses in connection with the operation of the ship has a right to claim damages, the liable person will usually be the shipowner. Furthermore, in certain situations the shipowner will be strictly liable, i.e., his liability will not depend on the presence of any culpable conduct. As discussed above, this is usually the case under statutory rules regarding damage or loss caused by oil that has escaped or been released from the ship. Another example of this type of strict liability may occur in practice if the reversed burden of proof is effectively insurmountable. In such circumstances the shipowner will be liable even in the absence of negligence.

Thus, unless the shipowner can prove that he was not at fault or negligent when his vessel collided with another vessel in icy conditions or stranded in ice, he will be held liable to pay damages to third parties who have suffered a loss as a result.

7 Claims against the hull insurer for damage to the ship

7.1 Legal background and legal basis for the claim

The ownership and operation of a vessel involves considerable risk. As discussed above, this risk typically consists of damage to or loss of the vessel, as well as the risk of liability arising in connection with the operation of the ship. Those involved in maritime activities, e.g., the shipowner or the charterer, therefore need to be protected against such risks. In practice, this is done through insurance. The main feature of marine insurance cover for a shipowner is protection against loss of or damage to the principal asset, i.e., the ship. This is typically achieved by effecting hull and machinery (H&M) insurance.

In Norway, marine insurance has traditionally been based on the conditions of the Norwegian Marine Insurance Plan (NMIP).

Chapter 1 of the NMIP contains introductory provisions concerning the marine insurance contract. According to Section 1-1(b) of the NMIP, the persons entering into the insurance contract are the insurer and the person effecting the insurance. The person entitled to claim compensation under the insurance contract is referred to as the assured, cf. Section 1-1(c). The NMIP is not binding on the assured unless it is incorporated into the insurance contract in question.[63] Furthermore, the assured is entitled to claim against the insurer for loss or damage that is covered under the insurance contract.

In the UK, marine insurance is regulated by the Marine Insurance Act 1906. The main set of insurance clauses governing hull insurance for oceangoing ships is the "Institute Time Clauses (Hulls)" (the "ITCH"), and seventy-five per cent (75%) of the market is insured on ITCH 1983. Our discussion, however, will focus only on Norwegian marine insurance.

Traditionally, H&M insurance covers three types of losses: 1) total loss of the ship, 2) damage to the ship, and 3) the owner's liability for collision damage to another ship. Typical claims resulting from contact with ice or icebergs concern damage to the propeller or rudder, collision damage (either collisions with icebergs or with other vessels), damage caused by freezing conditions (pipelines, etc.) or wear and tear to paint.[64] The hull insurance will cover the costs of repair, subject to a certain portion of the repair costs that must be paid by the assured (the deductible). Total loss compensation will be triggered if the ship is lost or is so badly damaged that repair is economically unfeasible. An example of a total loss was the cruise vessel *The MS Explorer,* which sank in the Antarctic Ocean in 2007 after colliding with ice.

In addition, H&M insurance can also protect the owner against liability arising from a collision or "striking by the ship", cf. Section 13-1 of the NMIP. Usually this type of cover will be supplemented by P&I insurance, since the H&M insurance will not cover the shipowner's

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63 Wilhelmsen (2007) p. 31

64 Haahjem, Reidun, Insurance for Arctic shipping http://presenter.qbrick.com/?pguid=b6e52824-ea52-4bad-a4cd-686dd13b2880

liability for any pollution or personal injury claims that might arise from the collision. Furthermore, the H&M insurer's liability will be limited to the sum insured, which in practice is the assessed insurable value of the ship.[65]

Lastly, an H&M insurance policy based on the NMIP also covers loss of hire to a limited extent. Accordingly the H&M insurer will cover a portion of the loss of hire incurred by the assured in connection with the repair of the vessel following a casualty.

7.2 H&M insurance

When concluding the insurance contract, ordinary background contract law will apply. The general rule in Norwegian insurance is that the insurer will be liable for a casualty or an insured event that occurs during the insurance period. According to Section 2-8 of the NMIP, "insurance against marine perils covers all perils to which the interest may be exposed". This means that marine insurance covers all risks that are not specially excluded. According to the Commentaries of the NMIP on Section 2-8, typical examples of the perils covered are perils of the sea and nature, perils connected to the carriage of goods, injurious acts by third parties or the negligence of the assured[66]. Ice is a peril of the sea and is also covered, albeit subject to a special deduction of one fourth, cf. Section 12-15 of the NMIP.

As a general rule, Section 12-18 of the NMIP states that for each casualty the deductible stated in the policy shall apply. However, the special deduction for ice damage, cf. NMIP Section 12-15 of the NMIP, is calculated as a percentage (25%) of the gross costs before any other deductions are made, cf. Section 12-19 of the NMIP. The main purpose of this deduction is its preventive effect. Shipowners who intend to trade their vessels in icy waters should have prior to the inception of the policy, knowledge not only as regards to navigation but also as regards

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65 Wilhelmsen (2007) p.478

66 Commentary to Norwegian Marine Insurance Plan, 1996, version 2010 http://www.norwegianplan.no/eng/index.htm [Visited 11 August 2011]

to the type of vessel used. Generally transportation in icy waters is especially difficult and hazardous and, if an accident occurs, salvage operations will be lengthy and expensive. Accordingly an insurer will typically require a higher premium for vessels trading in such areas. As regards the deductible, in practice, insurers usually impose a deductible that is fixed according to the trading areas and the allocation of risks under the specific charterparty.

As a general rule, Section12-18 of the NMIP stipulates that the deductible shall be deducted in respect of each separate casualty. However, the second paragraph of Section 12-18 stipulates that damage that occurs when navigating in ice between departure from one port and arrival at the next shall be treated as a single casualty (i.e., only one deductible will apply). This was illustrated in Rt. 1974.410, where *The T/S Sunvictor* had drifted aground in the St. Lawrence River. The cause of the grounding was that the cooling-water intake had become blocked by ice, which meant that the engine had to be stopped. The vessel received assistance and was towed next day to a port of refuge. A day later the vessel continued her voyage from the port of refuge to Quebec where she was docked. The vessel suffered additional ice damage both during the initial towage and during the voyage to Quebec. This additional damage, the insurers argued, represented a new casualty and, as such, was subject to a new deductible. A clause in the insurance policy stated that a separate deductible of USD 100,000 should apply for damage *"arising out of each separate accident"*. Furthermore, the same clause stipulated that this expression should be understood to mean *"(a) that a sequence of damage arising from the same accident shall be treated as due to that accident"*. The causative link between the individual incidents of damage, as well as the circumstances, made it natural to consider the damage as "a sequence of damage". Accordingly the Supreme Court held that only one deductible should apply.[67]

Coastal states adjacent to seasonal or year-round ice-covered waters generally require shipowners, ship managers and charterers to ensure their vessels are suited to operation in extremely cold climates (i.e., that

[67] Falkanger (2011) p. 545

they have proper ice class). Ice class is typically certified by the various classification societies and in Norway, according to Section 3-22 of the NMIP, ice-class rules prescribed by a classification society constitute a safety regulation. Breach of such a rule may invalidate the shipowner's insurance, cf. NMIP 3-22. Rules classified as safety regulations are aimed primarily at preventing oil spills or other types of losses. Special winter rules may be imposed by the authorities that provide ice-breaking services in countries such as Finland and Sweden. These rules, which are intended to limit access to ships of a certain size and with a minimum ice class, come into force when the ice is getting thick.[68] A casualty that does not comply with the rules will not receive assistance except to save lives in an emergency.

For the insurer to be able to invoke breach of safety regulation, the assured or the shipowner must be responsible for the breach. There must also be a close causal connection between the infringement of the safety regulation and the loss. According to the first paragraph of Section 3-25 of the NMIP, the sanction for breach of a safety regulation is loss of all insurance cover. However, when the negligence is of a nautical nature, e.g., the breach relates to navigational rules, cf. the second sentence of the first paragraph of Section 3-25, the sanctions for breach of safety regulations do not apply.

As mentioned above, H&M insurance can also cover the owner's liability arising from collision or "striking of the ship", cf. Section 13-1 of the NMIP. The legal basis for the owner's liability is irrelevant: the liability may be fault-based, strict or contractual. Moreover, the liability does not need to have been established by a judgment in order to be covered, cf. Section 4-17. The only indispensable condition is that the loss must have been caused by the insured ship "through collision". In this case, the hull insurer's collision liability will cover the damage, but will be limited to the sum insured, cf. Section 13-3. Any liability in excess of the sum insured may be recoverable from the hull-interest insurer and, if this is not sufficient, the P&I cover will supplement the

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[68] Claes, Lindh (2003) http://www.swedishclub.com/upload/Loss_Prev_Docs/Heavy_weather/Avoid%20trading%20in%20ice..._TSCL%202-2003.pdf

cover for collision liability under the hull insurance. This is discussed in chapter 9 below.

As regards trading limits, as mentioned above, the seasonally excluded areas are typically the St. Lawrence Seaway, the Northwest coast of North America, Northwestern Russia and the Baltic, which cannot be navigated during the winter season. Section 3-15 of the NMIP regulates three types of trading limits: ordinary, excluded, and conditional. A detailed geographical description of these limits is incorporated into the NMIP by way of a separate Appendix. As a starting point, insurance cover lapses if a vessel navigates in an excluded trading area, cf. the third subparagraph of Section 3-15. However, there are two important exceptions: 1) the assured is permitted to sail in excluded areas subject to the insurer's advance consent and the payment of an additional premium; and 2) situations where the infringement was not the result of an intentional act by the master of the ship.

7.3 Concluding remarks

As seen above, the H&M insurer will in principle cover damage caused by striking ice or colliding with icebergs in the open sea. In the latter case, no deductible will apply, cf. Section 12-15.[69] No significant problems are caused by the exception from insurance cover in connection with breaches of safety regulations and trading limits. If safety regulations have been infringed, the shipowner will be covered for damage to the extent it can be proved that the loss is not a consequence of the breach or that he was not responsible for the breach, cf. the first paragraph of Section 3-25. As for trading limits, the hull underwriters may allow vessels to trade outside the limits set forth in the NMIP and its Appendix depending on the prevailing conditions and the time of year. However, as regards compensation for any losses incurred, the shipowner will be exposed to a significant extent unless payment of an additional premium has been agreed. In practice, once an additional premium has been agreed and paid, this will decrease the amount of the originally

[69] Wilhelmsen (2007) p.281

applicable deductible. Otherwise the special one-fourth deduction will apply, cf. Section12-15, assuming the insurance was effected on Norwegian terms. The shipowner's right to claim on the insurance policy will in any case depend on the provisions of his insurance contract. Thus a shipowner needs to be aware of the risks involved when trading a vessel in the High North or in icy waters and to keep his insurers informed.

8 Claims against the loss-of-hire insurer for delays caused by ice

8.1 Legal basis for the claim and legal issues

An H&M insurance policy based on the NMIP will also include limited loss-of-hire cover. This is because the H&M insurer will cover a portion of the hire lost by the assured in connection with repairs to a damaged vessel. However, a shipowner wishing to effect wider-ranging loss-of-hire insurance on the basis of the NMIP will find the relevant provisions in Chapter 16, in combination with the provisions of Part One.

The term "loss-of-hire insurance" suggests that the policy will cover incidents that put the vessel out of service and deprive the owner of income.[70] This does not mean, however, that loss-of-hire insurance will apply in all situations where a ship fails to produce income. In fact, loss-of-hire insurance only applies where the ship has incurred damage of a nature that would be covered under hull insurance effected pursuant to the conditions of the NMIP, cf. Section 16-1, first paragraph.

Accordingly, loss-of-hire insurance will not cover incidents where the ship is delayed due to a strike or ice or other similar situations, cf. Chapter 16 of the Plan,[71] e.g., delay caused by ice preventing the vessel from leaving the port is not covered. However, there are some

[70] Stang-Lund (2008) p.23

[71] Falkanger (2011) p. 554

exceptions, cf. Section 16-1, second paragraph.

Initially this type of insurance was effected primarily for ships on time charter in order to protect the shipowner against loss of income if the ship went off hire. Today, however, loss-of-hire insurance is effected for ships employed under any type of contract of affreightment.

As a general principle, Section 16-1 of the NMIP stipulates that losses may only be recovered under the loss of hire insurance if the vessel has suffered damage recoverable under the Plan. Thus the owner of a vessel that has suffered hull damage due to colliding with an iceberg or becoming trapped in ice will be compensated for time lost while the vessel is repaired, cf. Section 16-1. However, loss-of-hire insurance also extends to loss of income resulting from, e.g., a grounding that does not cause any damage to the vessel, see NMIP Section 16-1 subparagraph 2.

For example, a vessel may also be prevented from moving due to a build-up of ice and become stranded as a result. The cause of the stranding is immaterial as long as it is: 1) due to a peril covered under the policy; and 2) the exclusions set forth in Chapter 3 do not apply.[72]

As mentioned above, loss-of-hire insurance does not cover delay caused because ice prevents the vessel from leaving port. The same applies if the vessel is prevented from entering the port because of ice. This means that the extra costs involved in loading or discharging at another port where the vessel can arrive safely are not covered under the loss-of-hire insurance. Nevertheless, the shipowner will generally be able to recover his losses. For example, the charterer may well have breached the ice clause and failed to nominate a safe port. In such a situation, the shipowner will be able claim compensation from the charterer.

In contrast to the situation with hull insurance, the deductible under loss-of-hire insurance is a period counted in days that will usually be agreed in the policy, cf. Section 16-7 of the NMIP. In practice, the most common deductible periods are 14, 30 or 60 days, but the parties may agree any number of days. Earnings lost during the deductible period are not recoverable from the insurer, cf. Section 16-7 (1). However,

72 Stang-Lund (2008) p.50

the shipowner may claim compensation from a tortfeasor pursuant to tort law or (if there is a contract) the law of contract. For example, if two vessels collide while manoeuvring in icy waters and one of the vessels is at fault, the innocent vessel will be entitled to recover any resulting losses.

The rules governing the deductible period where there are several casualties during one voyage apply in the same way as the equivalent rules under H&M insurance. This means that all ice damage occurring after departure from one port and before arrival at the next shall be deemed to constitute a single casualty, cf. Section 16-7 (2).

8.2 Concluding remarks

In general, a shipowner who effects loss-of-hire insurance is protected against economical losses while the chartered vessel is under repairs or where the vessel is otherwise prevented from trading. The insurer will provide compensation according to the rules in Chapter 16. In some situations, loss-of-hire insurance will not cover the shipowner's economical loss. However, compensation may still be claimed by the shipowner from a tortfeasor or, where there is a contract, from a party who is in breach of contract. This also applies to losses that are uncovered due to the operation of a deduction period.

9 Claims against the P&I insurer for damage to third parties

9.1 Legal basis for the claim

As we have seen in chapter 6, in general the shipowner will be liable to compensate third parties for damage associated directly with the operation of the ship. Such liability is covered by the shipowner's protection and indemnity (P&I) insurance.

P&I insurance is basically a variety of liability insurance and in this thesis we will take Gard's Rules (GR) as our point of reference. In order to qualify for cover, according to GR Rules 2.1 and 2.2, the type of liability in question must be expressly mentioned in the insurance terms and conditions. This means that P&I insurance cannot be characterised as general liability insurance. The liability in question must be a legal liability: an *ex gratia* payment made by the assured that does not have any legal basis will not be covered.[73] The following factors, however, do not affect the cover: whether the liability is contractual or non-contractual; the basis of liability (negligence or strict liability); or the country under whose laws the liability has arisen.

An important condition according to GR Rule 2.4 (a) is that the liability in question must have arisen in direct connection with the operation of the insured ship.

P&I insurance was developed in response to shipowners' need for insurance cover to protect against third-party liabilities that were not covered under standard hull and machinery (H&M) policies.[74] Accordingly, P&I insurance is a type of liability insurance that protects the shipowner against liability for personal injury and death, as well as against the one-fourth collision liability not covered by H&M insurance and excess collision liability, i.e., liability in excess of the sum insured under the H&M policy. Furthermore, standard modern P&I insurance also covers loss, damage and expenses incurred by the assured (e.g., liabilities arising from the carriage of cargo, pollution liability, liability for damage to fixed or floating objects).

Nowadays the threat of climate change has materialised and is the subject of frequent debate among the leading maritime countries. As ice melts in the Arctic and greater sea areas are left open, opportunities are arising for the shipping and oil-exploration.

For shipping companies, ice-free Arctic summers would provide opportunities to take new shorter routes between Europe and Asia. For oil companies, new opportunities lie in the Arctic's substantial

73 Falkanger (2011) p. 556

74 Gold (2002) p. 81

oil and gas reserves. However, such a potentially high level of economic activity may have a significant impact on the region's inhabitants, as well as on the Arctic environment. This is because of the greater risk of accidents and oil spills.[75] Guidelines provided by the International Maritime Organisation (IMO) for ships operating in Arctic ice-covered waters are designed to ensure maritime safety and pollution prevention. However, the challenge of cleaning up an oil spill under ice, if such an event should happen, would be immense. Indeed, arguably,[76] there is no technology today capable of recovering oil from ice and traditional clean-up methods would be ineffective in capturing oil trapped under the ice. Such arguments have been countered by claims[77] that in fact ice would act as a natural barrier that would trap the oil and give responders more time to clean up.

In the case of an oil spill, under GR Rule 38 the shipowner's liability for actual losses incurred by third parties, as well as expenses in connection with measures to prevent or limit such liability will be covered.

In a situation where two vessels collide in icy waters, we have already seen that P&I insurance will cover the shipowner's liability, cf. GR Rules 36 and 37, as long as this is not already covered under the ship's H&M insurance. However, in connection with a collision, the H&M insurer will exclude from cover certain types of liability, e.g., personal injury. Accordingly the P&I insurer will cover both the shipowner's excess liability and also types of liability not covered by the H&M insurer.

GR Rules 27-33 deal with cover for the shipowner's liability to individuals. The P&I insurer will cover the shipowner's legal liabilities arising as a result of passengers' personal injury or death (cf. GR Rules 27-29). The P&I insurance also covers liability to persons who have no

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75 *High North High Stakes* (2009) p. 88

76 BarentsObserver.com, *No way to clean up oil spill under ice: Canadian expert* http://www.barentsobserver.com/no-way-to-clean-up-oil-spill-under-ice-canadian-expert.4793639-16334.html

77 Ibid.

association with the ship, but who are nonetheless affected by an incident arising in direct connection with the operation of the ship, e.g., the crew or passengers of another ship or the victims of a collision (cf. GR Rule 30). Such liability may arise under statute or under the law of torts. In the latter case, however, cover would be available only to the extent that the contractual provisions had previously been approved by the P&I insurer.[78] In addition, important limitations apply to cover for passenger liability, i.e., liability for delay will be covered only if this flows from mandatory law. Likewise, the P&I insurer is only liable to the extent to which the shipowner would have been liable under the transportation contract had the shipowner exercised any applicable statutory rights to limit his liability.

As regards the shipowner's liability for cargo, generally the shipowner's liability will arise either from mandatory or discretionary law or by virtue of an agreement. Accordingly, the shipowner will be able to claim on his P&I insurance to cover his liability to cargo owners whose goods have been lost or damaged, cf. GR Rule 31.1.a. The shipowner's liability for delay to cargo is also covered, provided that such liability follows from mandatory legislation, cf. GR Rule 34.2.

9.2 Concluding remarks

No particular problems exist as between the shipowner and his P&I insurer in relation to the shipowner's liability to third parties. As we have seen, the main pre-condition for a successful claim by the shipowner against his P&I insurer is the existence of legal liability. The basis of the liability is irrelevant (contractual or non-contractual, negligence or strict liability), as is the country under whose laws it has arisen. However, as far as contract law is concerned, the P&I insurer will be liable only to the extent he has previously approved the terms of the contract, cf. GR Rule 55.a. Where the shipowner has undertaken a contractual liability more far-reaching than that which otherwise would have flowed from general law, the P&I insurer remains free of liability.

78 Williams (2008) p.185

10 The charterer's cover under the charterer's liability insurance

Both voyage and time charterers need to cover their potential liability towards the party from whom they charter the ship (typically the shipowner or another charterer). Any such liability will usually arise from vessel damage caused by, for instance, cargo-handling or the nomination of an unsafe port or berth, as discussed in subchapter 3.1.2 above. In addition, a charterparty will generally specify that the charterer must return the ship to the owner *"…in like good order and condition, fair wear and tear excepted"* (*NYPE* 93 form clause 10, *Baltime* clause 7). Finally, even where a charterparty imposes liability on the shipowner, some jurisdictions allow a claimant to pursue a claim for compensation against whichever party he finds most convenient. Clearly it is important for the charterer to be covered against such exposure. This is achieved through so-called charterer's liability insurance (CL), which is typically offered by P&I clubs. The charterer's liability for loss of or damage to the vessel will be then covered by the charterer's hull insurers, while liability for loss of or damage to cargo, loss of life or third-party liability claims will be covered by an extended cover, namely, the charterer's P&I insurance.

For the purposes of this thesis, the discussion will be limited to two types of cover. Firstly, cover for the charterer's liability for hull damage resulting from the nomination of an unsafe port. Secondly, cover for the charterer's liability for cargo damage. Hence this subchapter will not discuss all the typical features of charterer's liability insurance.

It is important to note that the typical features of H&M insurance, as outlined in the previous subchapter, do not apply to a time or a voyage charterer. This is because the shipowner is primarily responsible for the operation of the ship and for the ship itself, both of which come within the scope of the shipowner's H&M insurance. It is unlikely that a charterer would undertake such responsibility contractually.

However, the potential for liability does not disappear entirely. As we saw in subchapter 3.1.2 above, either a voyage or a time charterer may be found liable for damage incurred because he ordered a vessel to an unsafe port or berth. Thus, if the port is unsafe – in our case because of ice – the charterer may be liable to compensate the shipowner if damage occurs to the ship. In such a case, the charter will be protected by his charterer's hull insurance. For example, if the vessel is directed by the charterer into a port where, even with an icebreaker's assistance, the vessel sustains hull damage because of heavy ice, the charterer's hull insurers will cover the shipowner's claim for consequential dry-docking and repair costs. Such insurance is usually considerably less expensive than the shipowner's H&M insurance for the same ship.[79] In addition, where agreed in advance in the charterparty by virtue of a special clause, the charterer's hull insurance will also cover damage caused by trading in excluded trading areas, subject to the payment of an additional insurance premium by the charterer.[80]

In chapter 5 we discussed the liability of the shipowner towards a cargo owner whose cargo has suffered damage while being transported in ice-covered waters. We mentioned that a cargo owner may also bring a claim against the charterer. Such a claim may be based on the underlying sale of goods contracts, the bill of lading or in tort. Two typical situations are where the charterer is shipping cargo that belongs to a third party (customer) or where the charterer has sold the cargo prior to the shipment. In such circumstances, the charterer would generally be liable for the cargo as third- party property. In such a case the cargo owner may have arranged "all-risks" cargo insurance. Nevertheless, the charterer may still face a subrogated claim under the terms of the charterparty. In this situation, the charterer's P&I insurance will cover his liability, incurred under the contract of carriage, for loss of or damage to the cargo. Generally this contract will be either the charterparty or the charterer's bill of lading.

As seen in the previous chapters, the charterer is exposed to a

[79] Gohlish (2008) p. 48

[80] See subchapter 7.2.

wide range of legal and contractual liabilities, especially where the vessel is traded in areas or ports that are difficult to navigate because of ice. A prudent charterer will therefore be sure to effect insurance to cover this exposure. Assuming that he has done so, his liability for hull damage, for loss of or damage to cargo will be covered by his insurers.

11 Conclusion

The main rule in the Norwegian legal system is that anyone has the freedom of contract, subject only to limited restrictions. The parties to a charterparty, i.e., the shipowner and the charterer, are accordingly free to decide what provisions will govern the contract according to their specific needs. Ice clauses are provisions that are agreed by parties intending to trade the vessel in waters covered by ice or where the ports of loading or discharging may be considered dangerous by reason of ice. The purpose of an ice clause is generally to give the shipowner additional rights in situations involving ice and to permit the master not to proceed if the port is icebound or when there is a risk that the vessel will not be able safely to enter or leave the port on account of ice. However, the ice clause alone does not resolve all the legal issues that may arise between the parties. For example, there is no clear allocation of risk in connection with ice damage to the vessel's hull. In this respect, the solution may be found in the safe port clause, assuming the parties have agreed upon such a provision. According to English law, the safe port provision is the most relevant clause in relation to damage caused by ice. Such a clause will usually take the form of an express warranty given by the charterer. This means that if the vessel is damaged due to the nomination of an unsafe port, the shipowner may claim compensation from the charterer for damage to the ship. This was the result in *The Helen Miller*,[81] where the time charterer was held liable for ice damage. In Norway, the shipowner will be entitled to bring a claim

[81] See subchapter 3.1.3.

against the charterer for damage to the ship on the basis of the same (safe port) provision. However, the charterer will be liable only if it can be proved that he acted negligently.

Pursuant to the provisions of the Norwegian Marine Insurance Plan, the shipowner's H&M insurance will generally cover ice damage to the vessel's hull. The charterer, however, may also effect hull insurance. A special deductible applies to ice damage, cf. NMIP Section 12-15. This deductible is intended to have a preventive effect and must be therefore covered by the shipowner. However, where the charterer's liability for ice damage has been established, the shipowner may claim compensation from the charterer. This compensation may be based either on the provisions of the charterparty or on the tort-law principle that anyone acting in culpable manner so as to cause loss to another party is liable for the damage. Whether the charterer will be able to claim against his insurers in respect of such liability will depend mostly on the terms and conditions of his hull insurance.

With the opening of the Northern Sea Route to commercial exploitation, companies that wish to explore the potential opportunities will have to consider the challenges involved. These will include the effects of extreme cold and the risk of damage to the vessel, as well as the risk of oil spills and the consequences to the environment. Due to the thinning of the polar ice cap, the NSR is now effectively considered to be open to shipping all year round,[82] although trading in icy conditions requires shipowners to ensure that their vessels have proper superior ice class. Furthermore, even though, at the time of writing, official reports stated that "almost the entire NSR is open to icebreaker-free shipping"[83] the ice conditions remain relatively harsh even in the summer season, thus the assistance of icebreakers is still required.

The parties involved in the operation of the vessel need to be aware of these risks and to be fully prepared for a worst-case scenario. The specific provisions in a charterparty that deal with the ice situation,

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82 Corkhill (2011) https://www.bimco.org/Home/News/2011/09/14_Feature_Week_37.aspx

83 Ibid.

i.e., the ice clauses, are not sufficient to allocate clearly the risk between the parties. Even though the general ice clause may be modified by the contractual parties in accordance with their specific needs, this may be a lengthy and expensive process. Accordingly it would be of interest for the future to revise the general ice clauses in order to respond to the challenges of commercial transportation in the Arctic.

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List of Abbreviations

BIMCO	Baltic International Maritime Conference
H&M	Hull and machinery insurance
NMC	Norwegian Maritime Code
NMIP	Norwegian Marine Insurance Plan
NSR	Northern Sea Route
P&I	Protection & indemnity

The international group pooling agreement and the international group agreement of P&I clubs under EU competition law

Review and Outlook

Zhihe Ji

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1 Introduction

1.1 Topic

As a typical risk-intensive industry, shipping has been associated with marine insurance for centuries. In general, the marine insurance market comprises three main sectors: hull insurance, cargo insurance and protection and indemnity (P&I) insurance. Being operated uniquely, P&I insurance has formed a relatively independent market providing marine liability insurance with extraordinary limits.

Historically, P&I insurance was operated individually by mutual associations located primarily in England and Scandinavia. The oldest shipowner's mutual protection society, Britannia Steam Ship Insurance Association Limited, was created in 1855; the first Norwegian P&I association, Assuranceforeningen Skuld, was established in 1897.[1] By the turn of the 20th Century, most of today's existing major P&I clubs had been set up and the global P&I insurance market was gradually formed. As part of this development, vaious clubs began to enter into pooling arrangements. The purpose of pooling is to spread risks that exceed specified financial limits among all members within the pool. The development of pooling arrangements culminated in the 1980s and 1990s with the formation of the International Group of P&I Clubs (IG) operated under the International Group Pooling Agreement (Pooling Agreement) and the International Group Agreement (IGA).[2]

According to the IG, "[T]he thirteen principal underwriting member clubs of the International Group of P&I Clubs between them provide liability cover for approximately 90% of the world's ocean-going tonnage. Individually competitive, the International Group of P&I Clubs brings together the collective influence of the mutual clubs as a force for security and stability in international maritime trade."[3] This brief statement,

1 Bull (2004) p.532

2 British Maritime Technology (2005)

3 http://www.igpandi.org/Home

with its undertone of concerns about competition, indicates the multi-faceted status of the IG: on the one hand the IG provides an unparalleled function in offering global marine liability insurance, while on the other hand, the IG is subject to possible antitrust investigations on account of oligopoly via collective dominance.

The IG has undergone two completed investigations under European Union (EU) competition law. These were recorded as 85/615/EEC-Commission Decision of 16 December[4] (1985 Commission Decision) and 1999/329/EC-Commission Decision of 12 April 1999[5] (1999 Commission Decision). The Pooling Agreement and the IGA, after modification, were granted individual exemptions and ruled as compatible with Articles 101 and 102 of the Treaty on the Functioning of the European Union (TFEU)[6]. The 1999 Commission Decision was valid until February 2009. In August 2010 the Commission reopened its third competition investigation of the Pooling Agreement and the IGA. This third investigation remains in process.

It is of interest at this time systematically to review the Commission's pre-1999 application of competition measures to the IG and map out the prospects of the Pooling Agreement and the IGA under the Commission's reopened investigation from 2010. The dissertation seeks to offer a comparative analysis of the 1985 and 1999 Commission Decisions, addressing the differences between the two Decisions and the deficiencies of each. Based on this comparative analysis, the dissertation then examines subsequent changes in the legal environments in which the Commission's current investigation is conducted. In this context, the dissertation then reappraises of the Pooling Agreement associated with the IGA under the revised analytic framework. The final part of the dissertation provides observations and suggestions.

The purpose of this dissertation is partly to look back at history, providing comments on the EU's application of competition measures

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4 [1985] OJ L376/2

5 [1999] OJ L125/12

6 (ex Articles 85 and 86 EEC Treaty; 81 and 82 EC Treaty) The new numbering of the EU competition provisions will be used throughout this article.

to the Pooling Agreement and the IGA, and partly to look to the future, offering predictions as to the possible results of lobbying by the parties concerned.

1.2 Synopsis

Chapter 1 presents the scope of the article and reasons for choosing this topic. It then sets forth the purpose of the dissertation and provides an outline.

Chapter 2 lists the legal sources used in the dissertation.

Chapter 3 provides an overview of the P&I insurance market and addresses the specific issues raised by the Pooling Agreement and the IGA under EU competition law.

Chapter 4 systematically reviews the 1985 and 1999 Commission Decisions to the Pooling Agreement and the IGA with comparative critiques.

Chapter 5 analyses the prospects of the Pooling Agreement and the IGA in relation to the Commission's ongoing third investigation.

Chapter 6 completes the dissertation with a summary of major findings and the overall outlook.

2 Legal Sources

2.1 TFEU

As a starting point, the Pooling Agreement and the IGA are regulated by Articles 101 and 102 TFEU, the twin pillars of EU competition law. In addition, Article 106 provides guidance on resolving conflicts between the policies of promoting competition and protecting environment.

2.2 EU Secondary Legislation

The application of Articles 101 and 102 TFEU to the Pooling Agreement and the IGA is also subject to EU secondary legislation including Council Regulations, Commission Regulations and Commission Notices. The 1985 and 1999 Commission Decisions relied on Council Regulation No 17 of 6 February 1962: First Regulation implementing Articles 85 and 86 of the Treaty (Regulation 17/62), while the ongoning investigation reopended in 2010 is relying on Council Regulation No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (Regulation 1/2003); the 2004 Commission Guidelines on the application of Article 81(3) of the Treaty (2004 Guidelines); and the 2008 Commission Guidance on its enforcement priorities in applying Article 82 of the EC Treaty to abusive exclusionary conduct by dominant undertakings (2008 Guidance). With respect to the inapplicability of the insurance block exemption to the Pooling Agreement and the IGA, the dissertation also examines Commission Regulation No 3932/92 of 21 December 1992 on the application of Article 85(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector (Regulation 3932/92) and its successor Commission Regulation No 267/2010 of 24 March 2010 on the application of Article 101(3) of the Treaty on the Functioning of the European Union to certain categories of agreements, decisions and concerted practices in the insurance sector (Regulation 267/2010).

2.3 Case Law

The relevant leading cases of the EU courts and prominent decisions by the Commission are indispensable to the discussion and hence are referred to throughout the dissertation to elaborate on numerous specific issues. *FEDETAB*[7] is quoted to clarify that the IG Clubs, though non-profit-making, cannot escape Articles 101 and 102 TFEU. *Belasco*[8] is

[7] Joined Cases 209/215 to 218/78 [1980] ECR 3125, 3278

[8] Case 246/86 [1989] ECR 2117

cited for the conclusion, which was sidestepped in the 1999 Commission Decision, that annual recommendations by the IG, even though non-binding, should be treated as "agreements" under Article 101 TFEU. *Delimitis v. Henninger*[9] is referenced to clarify the narrow approach to block exemption enunciated by the European Court of Justice (ECJ). *Langnese-Iglo GmbH & Co KG v. Commission*[10] is referred to in order to criticise the 1985 Commission Decision's the leapfrogging of Article 101(3) over Article 101(1). *Compagnie Maritime Belge v. Commission*[11] is mentioned to justify the simultaneous application of Articles 101 and 102 TFEU to the Pooling Agreement and the IGA. A group of cases including *United Brands*[12], *Tetra*[13]and *Oscar Bronner*[14] illuminate the application approaches of Article 102 TFEU to the Pooling Agreement and the IGA prevailing before the 2008 Guidance, namely "objective justification" and "sliding scale test" to "special responsibility". *GlaxoSmithKline*[15] in contrast to *CECED*[16] shows the ambivalence to environmental considerations that is inherent in the implementation of EU competition law. The lasted ECJ ruling *Alrosa*[17] reaffirms the Commission's "margin of appreciation" established by the early cases of *Consten & Grundig*[18] and provides the IG with some enlightenment on the commitment procedure. A comprehensive list of case law is incorporated into the list of references.

2.4 International Conventions

Additionally, as background law for the polluter pays principle in relation to the minimal cost for tankers, the dissertation refers to the Inter-

9 Case C-234/89 [1991] ECR I-935
10 Case T-7/93 [1995] ECR II-1533
11 Case C-395/96 P [2000] ECR I-1365
12 Case 27/76 [1978] ECR 207
13 Case C-333/94P [1996] ECR 5951
14 Case C-7/97 [1998] ECR I-7817
15 Case T-168/01 [2006] ECR II-2969
16 [2000] OJ L 187/47
17 Case C-441/07P *Commission v. Alrosa Company Ltd.*
18 Joined Cases 56 to 58/64 [1966] ECR 299

national Convention on Civil Liability for Oil Pollution Damage (CLC) of 1969 (as amended by the Protocol of 1992 and renamed the CLC of 1992) and the International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage (Fund Convention) of 1971 (as amended by the Protocol of 1992 and renamed of the Fund Convention 1992). The Small Tanker Oil Pollution Indemnification Agreement (STOPIA) of 2006 combined with the Tanker Oil Pollution Indemnification Agreement (TOPIA) of 2006 is mentioned as well.

3 The P&I Insurance Market and the Operation of the IG under Competition Policy

3.1 Existing State of P&I Insurance

3.1.1 Market Players and Share of P&I Insurance

P&I insurance can trace its roots back to the mid-1850s.[19] Originally it was intended as a supplement to hull insurance to provide extra cover against collision liability. Today P&I insurance is an independent sector specializing in third-party liability and expenses arising from the operation of ships.

In general, modern P&I insurance can be obtained either through membership of a mutual association with variable calls or through commercial underwriting at a fixed premium. The latter is a "niche market" that focuses on smaller tonnage and covers merely around 10% of the world's P&I insurance market. There are five main commercial underwriters: British Marine Limited, Charterers Club, Navigators P&I, Osprey and RaetsMarine. In 2010, the bellwether among them,

[19] See *supra* note 1, pp.532

British Marine Limited, reported entered tonnage of only 13.5 million with USD 131 million in premium revenue. The remaining 90% of the market—850.3 million owned tonnages with [USD] 3.3 billion accounting year premium ,[20] as of 20 February 2010—is dominated by the 13 IG Clubs:[21] American Club, Britannia, Gard, Japan Club, London Club, North of England, Shipowners, Skuld, Standard Club, Steamship Mutual, Swedish Club, UK Club and West of England. These IG Clubs are domiciled and conduct busniess principally in the EU/EEA Member States, where, of course, EU competition policy prevails.

3.1.2 Oligopoly of the P&I Insurance Market via Collective Dominance

Although the comparative market statistics described above relate to 2010, they reflect the the state of the P&I insurance market over the past three decades. No significant fluctuation in market share has been recorded since the birth of the IG in 1981. This is to be expected, since the IG Clubs cover the overwhelming majority of the world's P&I insurance market, leaving very limited room for other fringe players to compete in terms of pricing and service. The latest example of an attempt to break into this market was that of the South of England Protection and Indemnity Association. An independent mutual club that mainly insured larger tonnage that the IG normally would not accept for reasons of age or class, it went into provisional liquidation and ceased trading in October 2011.[22]

The ECJ confirmed in the *AKZO*[23] case that a market share of 50 per cent or more is normally a fair indication of dominance. More accurately, the EU competition authority usually looks at high market share as a preliminary parameter or starting point in assessing market power. Accordingly, the proxy of strong market power, the over 50-percent

20 Tysers (2011)

21 Here the market share of the non-IG P&I clubs (*e.g.* Korea P&I Club) is negligibly small.

22 Lloyd's List (2011)

23 Case C-62/86 [1991] ECR I-3359

market share of the IG, is merely one potential trigger for an anti-trust investigation by the EU competition authority. The authority will also apply the test in *Hoffmann-La Roche*[24] to scrutinize other competitive factors in the relevant market, including the extent of comparative advantage to nearest rival,[25] barriers to market entry, etc.

In the case of the Pooling Agreement and the IGA, a huge gap in market share between the IG and its contenders satisfies the test in *Hoffmann-La Roche* very clearly. Much light should be shed on the fact that market entry barriers are inseparable from the P&I insurance being the economy of large scale. Barriers inherent in the nature of the market include "economies of scale or scope, and the risk of having to make large capital investments to enter the market that may turn out to be irrecoverable (referred as to as 'sunk costs')".[26] Significant entry barriers to the P&I insurance market exist in the form of economies of scale. Based on the law of large numbers, the extremely high proportion of P&I insurance covering catastrophic risks means that such insurance can funtion efficiently only on the basis of a large number of risk units. Otherwise, below the minimum scale, risk not spreaded could swallow the sunk costs of the underwriter easily should an astronomical claim emerge. These factors have resulted in the IG holding a long-standing dominant position in the P&I insurance market. This conclusion also applies under the 2008 Guidance. This sets a standard of "over-40 percent market share" held "for a significant period of time", which is easily satisfied by the IG.

Economists illustrate the workings of the competitive process by reference to four models. The two extremes are perfect monopoly and perfect competition: in the real world it is rare to find either. The other two principal models are workable competition and oligopoly. An oligopoly is a market in which some degree of competition remains but only a handful of competitive undertakings possess significant market power. The concept of an oligopoly, which was described by the Com-

[24] Case 85/76 [1979] ECR 461

[25] *Ibid.* para 42

[26] Goyder (2009) pp.302

mission in its decision of *Gencor/Lonrho*[27] in terms of a supply-demand analysis, was also addressed by the General Court (GC) subsequently. The quantitative and qualitative market-power analysis described above indicates that the P&I insurance market possess the characteristics of an oligopoly. In the context of EU competition law, the oligopoly that exsits in the P&I insurance market means that there is no room for applying the *de minimis* rule established by *Volk v. Vervaecke*[28] and then codified as the Commission's Notice on agreements of minor importance.[29] The P&I insurance market easily satisfies the test of "appreciable" effect on competition between Member States.

An oligopolistic market typically involves a marked degree of interdependence among the market players. This is not a notable feature of markets that enjoy workable competition.[30] It is this so-called collective dominance that primarily attracted the Commission's attention in *Compagnie Maritime Belge v. Commission*,[31] where multiple businesses operating in a specific market were united by certain economic links. In the case of the IG, such economic links were achieved via the collaboration under the Pooling Agreement and the IGA, which falls simultaneously under the jurisdiction of Articles 101 and 102 TFEU. Consequently, the intervention by the EU competition authority became inevitable.

3.2 Operation of the IG

3.2.1 Roots of Function of the IG

Large risks would jeopardize the business performance and long-term viability of any individual P&I insurer. Pooling excessive risks is sensible risk management for P&I insurers and ultimately benifits both shipowners and operators. With the purpose of enhancing mutual

27 [1997] OJ L11/30
28 Case 5/69 [1969] ECR 295
29 Issued in 1970 with subsequent amendments up until 2001
30 See *supra* note 26, pp.15-17
31 See *supra* note 11

	Pollution only		Non-pollution		
			Overspill		
General Excess Loss Contract Layer 4			US$ 1bn Collective Overspill One reinstatement		US$ 3.05bn
Layer 3			US$ 1bn		US$ 2.05bn
Layer 2	US$ 500m		US$ 500m		US$ 1.05bn
Layer 1 25% Reinsured to Hydra	25%	US$ 500m 75%	US$ 500m 75%	25%	US$ 550m
Upper Pool Reinsured to Hydra	US$ 20m				US$ 50m
Lower Pool	US$ 22m				US$ 30m
Club Retention	US$ 8m				US$ 8m

assistance, the principal P&I associations entered into an alliance in the form of the IG with its constituent basic agreements, the Pooling Agreement and the IGA.

The Pooling Agreement is a mutual agreement between the IG Clubs to reinsure each other by sharing claims proportionally with no premium paid. It defines the types of claims to be pooled and provides a multi-layer mechanism for sharing all claims in excess of USD 8 million up to, currently, approximately USD 6.9 billion[32]. Its operation may be illustrated by the chart[33] on the previous page.

Through the pooling arrangement, *viz.* claim-sharing system, the IG Clubs share a common interest in long-term loss prevention that satisfies the long tail nature of P&I risk.

The IG also recognizes that the viability of the Pool Agreement depends on goodwill and equity between the member clubs. The mutually interdependent relationships would risk being eroded in the absence of appropriate mechanisms for governance. So just like other industry associations, the IG operates pursuant to its constitution, the IGA, which prescribes the rights and duties of the member clubs and governs the management and administration of the IG.

As most recently revised in 2008, the IGA is an essential agreement for ensuring the equilibrium between the IG Clubs in the operation of the Pooling Agreement. Briefly, it regulates the manner in which clubs can accept entries from shipowners who wish to move their insurance from one club to another; specifies how clubs may quote rates; and the information which they should obtain from each other before quoting premium rates; and requires that clubs disclose in their annual financial statements a ratio relating to their expenses, the Average Expense Ratio.[34]

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[32] http://www.igpandi.org/Group+Agreements/The+Pooling+Agreement

[33] See *supra* note 20

[34] http://www.igpandi.org/Group+Agreements/The+International+Group+Agreement

3.2.2 Competition Issues Raised by the Pooling Agreement and the IGA

Judging from experience, there is no better business model than that offered by the Pooling Agreement and the IGA for dealing with the nature of P&I risk. The majority of the world's shipowners and operators rely upon the unparalleled liability cover provided by the IG. However, in the view of the EU competition authority, certain aspects of the Pooling Agreement and the IGA give cause for concerns. These concerns, which will be thoroughly discussed in Chapters 4 and 5 are as follows:

1) The high minimum common level of cover is considered to impede the IG Clubs from competing at the lower lend of the market, as well as to limit the range of cover to the prejudice of consumers;

2) Release calls, viz. the charge imposed by a club on a withdrawing member to cover the member's proportionate share of outstanding loss, could be abused as the barrier to market entry and the dissimilar condition;

3) Restrictions imposed on clubs' ablity to provide quotes for ships potentially transferring to a new club, and for newly- acquired ships, are deemed to inhibit internal competition on premiums within the IG;

4) The minimum cost for tankers constitutes price fixing;

5) The reinsurance provisions without certain criteria and procedures governing reinsurance supply to a third-insurer are regarded as the refusal of access to essential facilities.

4 Pre-1999 EU Competition Authority Responses to the Pooling Agreement and the IGA

4.1 Summary of Previous Competition Investigations by the Commission

It is widely accepted within the EU that competition is not goal but *per se*, but merely an indicator of economic welfare. However, economic welfare, as a macroeconomic concept, was rooted originally in the use of empirical market data to test various hypotheses. Economic analysis based on hypothesis testing, to some extent, is bound to conflict with legal reasoning based on legal certainty. The experience of the EU competition authority shows that nothing except a hybrid of common-law and civil-law reasoning is helpful for reconciling legal and economic analysis. Effective implementation of competition policy depends on applying a handful of core rules in a case-by-case approach. Articles 101 and 102 TFEU, the twin pillars of EU competition law, due to be construed in the light of case law to draw a proper conclusion, with commentary, on the Pooling Agreement and the IGA.

Additionally, the implementation of EU competition law has been modernized in the period between Regulation 17/62 and Regulation 1/2003. The previous Commission investigations into the Pooling Agreement and the IGA were recorded as the 1985 and 1999 Commission Decisions. The Commission's application of pre-1999 competition measures should be analyzed in the light of Regulation 17/62.

For ease of retrieval and reading, the following chronological table shows the pre-1999 EU competition authority responses to the Pooling Agreement and the IGA:

Year Date	Events and Related Statutes
1981 18 June	According to Article 4 of Regulation 17/62, the IG made its first notification to the Commission concerning the IGA. The IG's intention was to obtain a negative clearance or, alternatively, an exemption.
1983 18 Feb.	Taking the view that certain clauses of the IGA failed to satisfy the conditions of Article 101(3) TFEU, the Commission sent a Statement of Objections to the IG after a preliminary examination, prior to a final decision under Article 15(6) of Regulation 17/62.
1983 1 Nov.	After discussion, the IG submitted a memorandum to the Commission proposing certain amendments to the IGA.
1984 12 July	The Commission issued a second Statement of Objections, stating that some clauses of the amended IGA still violated Article 101(1) TFEU and could not be exempted upon Article 101(3).
1984 27 July	The IG made further amendments to the IGA and renewed its request for a negative clearance or alternatively an exemption.
1984 2 Aug.	The Commission informed the IG that the proceedings under Article 101(1) TFEU concerning the IGA would be continued until all the issues in the Statement of Objections were settled.
1985 20 Feb.	The IG notified the Commission of the third amended IGA.
1985 16 Dec.	The Commission issued its the decision granting a 10-year exemption to the IGA pursuant to Article 101(3) TFEU and disapplying the prohibition set forth in Article 101(1).
1995 20 Feb.	The IG requested a renewal of the exemption granted on 16 December 1985.
1997 2 June	The Commission issued a Statement of Objections to the IG stating that the Pooling Agreement and the IGA infringed the competition rules of the TFEU.
1998 7 July	Adopting the Statement of Objections, the IG formally applied to the Commission for exemption for its amended version of the Pooling Agreement.

1998 21 Oct.	Adopting the Statement of Objections, the IG formally applied to the Commission for exemption for its latest version of the IGA.
1999 12 Apr.	The Commission issued its decision: (1) holding that the Pooling Agreement and the IGA, both as amended, did not contravene Article 102 TFEU; and (2) granting an exemption to the Pooling Agreement and the IGA, both as amended, pursuant to Article 101(3) TFEU, valid from 20 February 1999 to 20 February 2009.

The following legal analysis is based on the facts in this chronological table and the issues listed in 3.2.2.

4.2 Prerequisite: Whether of IG Clubs Constitute "Undertakings" for the Purposes of Articles 101 and 102 TFEU

For the purposes of EU competition law, the term "undertaking" in Articles 101 and 102 TFEU is defined in accordance with the ECJ's teleological approach and, as such, boardly based on function rather than status. The concept has been clarified by a number of precedents in EU case law, ranging from earlier case of *Mannesman v. High Authority*[35] to the recent *Pavlov*[36], holding that any entity engaged in an economic activity offering goods or services in a given market, regardless of other factors such as legal status, is considered an undertaking. Generally speaking, then, the IG Clubs providing insurance service are "undertakings" under Articles 101 and 102 TFEU.

Nor does the non-profit-making nature of the IG clubs preclude them being considered as "undertakings". The view of Directorate-General of the Commission responsible for competition policy (DG Comp) is that "competition is not just about prices and profits. Non-profit undertakings are still competing albeit not with the goal of profit. And, although they cannot reduce profit, they can reduce all other elements of cost. Thus competition is still very important in order to make them

35 Case 19/61 [1962] ECR 357, 371

36 Cases C-180/98 [2000] ECR I-6451

more efficient."[37] This position was previously upheld by the ECJ in its ruling in *FEDETAB*[38] that a price recommendation made by an association to its members "cannot escape [Article 101 TFEU] simply because it has been made by a non-profit-making association." More on point, in a case involving the insurance sector on this issue, *Fédération française des Sociétés d'Assurance v. Ministre de l'Agriculture*[39], the ECJ applied this position to hold that a non-profit-making organization managing an optional pension scheme is an undertaking within the meaning of Articles 101 and 102 TFEU. Being non-profit-making *per se* did not alter the fact that the organization was competing with other private insurance companies. In another French insurance case, *Poucet v AGF and Pistre v Cancava*,[40] however, the ECJ made a distinction between the non-profit-making organization at issue in *Fédération française des Sociétés d'Assurance v. Ministre de l'Agriculture* and non-profit-making insurance organizations operating social security schemes based on "national solidarity", holding that the latter could not be considered as "undertakings".

Given the above precedents, the EU competition authority clearly does not intend to provide asylum from Articles 101 and 102 for entities alleging non-profit-making status. Because the IG clubs do not fall within the distinction made in *Poucet v AGF and Pistre v Cancava*, the IG Clubs "compete between themselves as well as with other mutual and profit-making insurers in some segments of the P & I insurance business."[41] On this ground, the IG Clubs fall within the scope of "undertaking". Consequently, Articles 101 and 102 TFEU apply to the Pooling Agreement and the IGA.

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37 Bennet (2000) pp.61

38 See *supra* note 7

39 Case C-244/94 [1995] ECR I-4013

40 Joined Cases C-159/91 to C-160/91 [1993] ECR I-637

41 See *supra* note 5, para 50

4.3 Legal Analysis of the Pooling Agreement and the IGA under Article 101(1) TFEU

4.3.1 Subcategory for the Pooling Agreement and the IGA under the Concept of Agreements in Article 101(1) TFEU

Theoretically, agreements that fall within the scope of Article 101(1) TFEU can be categorized into two groups, namely, hardcore cartels and ancillary restraints. The first type is defined by DG Comp as "the arrangement(s) between competing firms designed to limit or eliminate competition between them, with the objective of increasing prices and profits of the participating companies and without producing any objective countervailing benefits".[42] The second category is omprised of agreements with principal objectives such as service cooperation or sharing specialization rather than anti-competition, but which nonetheless contain certain clauses that, on their face, may fall within the scope of Article 101(1) TFEU.

In practice, hardcore cartels are mostly found in business sectors with limited product differentiation and often involve market division, quantity restrictions, and other factors that directly undermine the competitive process. Accordingly, these blatantly anti-competitive agreements have received much more intensive monitoring by DG Comp. Heavy fines have been imposed in a series of cases, notably the EUR 462 million fine imposed on Hoffmann-La Roche[43] in 2001 for involvement in the Vitamin Cartel. Moreover, the EU courts have adopted a straightforward approach to hardcore cartels. The ECJ originally held in *Consten & Grundig*[44] that once the object of anti-competition is established, there is no further need to examine the effects of the agreement concerned. Despite one somewhat confusing recent decision by the GC in *GlaxoSmithKline v. Commission*,[45] most of the cases, such

42 DG Comp. (2002)

43 *Hoffmann-La Roche (Vitamins Cartel)* [2003] OJ L6/1

44 See *supra* note 18

45 See *supra* note 15

as *Miller International v. Commission*[46] and *Parker Pen*,[47] have reaffirmed this *illegal per se* doctrine established by *Consten & Grundig.*[48]

At the other end of the scale, the level of scrutiny applied to ancillary restraints depends more on the economic context. The main authority is *Societe La Technique Miniere v. Maschinenbau Ulm*,[49] in which the ECJ also introduced the well-known counterfactual test, under which the competitive process must be judged by comparing the *status quo* with the assumed situation without the purportedly anti-competitive agreements. This approach was also applied by the GC in *O2 (Germany) GmbH & Co OHG v. Commission*[50] recently.

Even though the Pooling Agreement was stigmatized as a "cartel" by laymen based on its multi-year oligopoly of the P&I insurance market,[51] the 1999 Commission Decision regarded the Pooling Agreement as "in essence a claim-sharing agreement".[52] At first sight, the restrictive provisions of the claim-sharing agreement appear to prevent the P&I Clubs from providing diversified levels of insurance. However, the supply side of P&I insurance, as described in the analysis of economies of scale and sunk costs set forth in section 3.1.2, justifies claim sharing within the

46 Case 19/77 [1978] ECR 131

47 Case T-77/92 [1994] ECR II-549

48 See *supra* note 20

49 Case 56/65 [1966] ECR 235

50 Case T-328/03 [2006] ECR II-1231

51 Joe Hughes, chairman and chief executive of American Club, took issue with those who persisted in describing the IG as a "cartel". "To describe the International Group as a cartel is totally misguided. This betrayed a fundamental misunderstanding of its nature. A cartel is a group of for-profit suppliers of goods or services who combine to create a malignly dominant market position in order to inhibit competition and to impose high prices on the consumers of those goods or services with the aim of achieving exceptional profitability for themselves at the expense of those consumers with no benefit, direct or indirect, to the wider community. By contrast, the International Group is an association of not-for-profit shipowner-consumer co-operatives, a combination that gives it a benignly dominant position in the best interests of the shipowner-consumers themselves. Its purpose is to provide the lowest prices and the broadest cover in the insurance of marine liability risks for those shipowner-consumers." --speaking at the annual Houston Marine Insurance Seminar on the theme "The P&I World in Transition", 4th Oct 2010

52 See *supra* note 5, para 14

IG. To quote the chairman of the American Club: "The minimum dimension required to offer such cover can only be attained by insuring more than 50% of world-wide tonnage."[53] Accordingly the market has room only for a *fait accompli* soloist, in this case the IG. Without the ability to share claims, no club could independently offer cover up to the current amount. Therefore, the Pooling Agreement measurably increases the underwriting capacity of individual clubs – a factor that acts in the Pooling Agreement's favour when applying the aforementioned counterfactual test.

On these grounds, the Pooling Agreement and the IGA were treated by the Commission as ancillary restraints, which may inhibit competition only by their "effect" rather than their "object". To ensure that they came within this preferential subcategory, the Pooling Agreement and the IGA went through a number of modifications (as listed in the foregoing chronological table). The relevant legal analysis appears below, in section 4.3.2, in the context of a discussion of the characteristics of P&I insurance.

4.3.2 Application of Article 101(1) TFEU to the Pooling Agreement and the IGA

4.3.2.1 Structure of Article 101 TFEU and Internal Order of Application

In order to understand the pre-1999 Commission's approach to the Pooling Agreement and the IGA under Article 101(1) TFEU, it is necessary first to understand the integral structure of Article 101 TFEU. Paragraph (1) is "primarily designed to assert jurisdiction",[54] which could embrace extensive agreements that raise questions in terms of competition. Paragraph (3), providing the exemption for certain specified arrangements, actually sets forth the concrete standards by which agreements are to be assessed under Article 101. In this two-fold structure, Article 101 TFEU differs from its American counterpart, Section 1 of

[53] *Ibid*. para 68

[54] See *supra* note 26, pp.111

Sherman Act, which is a succinct hybrid of jurisdictional and assessment provisions.

The *pro forma* split between paragraphs (1) and (3) requires that to a large extent, any appraisal of economic context under paragraph (1) must also refer to paragraph (3). Put differently, the assessment element in Article 101 TFEU "is found in paragraph (3), and only to a more limited extent in paragraph (1)".[55] This viewpoint may be demonstrated by the case of *Gottrup Klim v. DLG*[56], which examined a set of restrictions agreed to by members of a cooperative. In determining the applicability of Article 101(1) TFEU, the issue was whether the restrictive rules were necessary to ensure the cooperative functioning properly. The test of necessity is identical or comparable to the criterion of indispensability in Article 101(3)(a) TFEU.

On the other hand, at the end of last century, EU jurisprudence indicated that scrutiny under paragraph (1) should be exhausted before invoking paragraph (3). Only once the issue has been thoroughly examined under paragraph (1) but is still intractable, should an analysis under paragraph (3) be considered. Any short cut to Article 101(3) TFEU circumventing a legal appraisal under Article 101(1) TFEU would render the reasoning flawed. In *Langnese-Iglo GmbH & Co KG v. Commission*[57], the GC held that the Commission's legal analysis of market factors under Article 101(3) TFEU was invalid because the analysis should have been undertaken instead under Article 101(1). Also, in *European Night Services*[58], the GC emphasized that the Commission must give good reasons for deciding that an agreement infringes Article 101(1) TFEU. For lack of such reasoning, the decision was quashed.[59]

This stringent test under Article 101(1) TFEU, which was established by GC precedents around 2000, should be understood with an eye towards the modernisation of the rules implementing Article 101(3)

55 *Ibid.* pp.112
56 Case C-250/92 [1994] ECR I-5641
57 See *supra* note 10
58 Case T-374, 375, 384 and 388/94 [1998] ECR II-3141
59 Korah (2007) pp.87

TFEU. By virtue of Article 9 of Regulation 17/62, the application of Article 101(3) TFEU was under the exclusive competence of the Commission. By contrast, national courts and authorities had no alternative but to rely on Article 101(1) TFEU when faced with competition issues. However, the Commission's monopoly of Article 101(3) TFEU has no place in the new system of Regulation 1/2003. Under the level playing field of EU jurisprudence, the Commission, which was prone to apply Article 101(3) TFEU directly, must overcome this tendency and instead align its analysis with that of national courts and authorities, for which the usual practice is to analyse situations fully under Article 101(1) TFEU.

Understanding the structure of Article 101 TFEU and the order in which its internal provisions are to be applied is of vital importance to the implementation of this key competition provision. The divergence between the 1985 Commission Decision and the 1999 Commission Decision on this point brings about different results, as described below in sections 4.3.2.2 to 4.3.2.5.

Minimum Common Level of Cover

In the policy years prior to 1998, the ceiling of common cover under the Pooling Agreement was fixed at USD 18 billion. However, this exorbitant minimum level of cover failed to pass the test of "indispensable for the proper functioning of the Pooling Agreement"[60] and consequently restricted competition within the meaning of Article 101(1) TFEU.

The 1997 Statement of Objections considered that the minimum level of cover fixed at USD 18 billion had objectively impeded clubs from offering a lower level of cover, for which there was substantial demand. Taking the Commission's opinion into account, the IG adjusted the figure to USD 4.25 billion in the 1998 notification.

The 1999 Commission Decision finally concluded that the new minimum common level of cover was a necessary arrangement for the

[60] See *supra* note 4, para 74

functioning of the Pooling Agreement and, on this ground, would no longer fall into the scope of Article 101(1) TFEU.

Release Calls

When a shipowner enters one or more ships in a P&I association, he agrees implicitly to share the liabilities of the membership as a whole for the policy years during which the ship is insured. Accordingly, he accepts liability for the payment of any deferred calls or supplementary calls that the P&I association may consider necessary to balance the income and expenditure of those policy years. The member's obligation to pay such calls for any policy year that has not yet been closed continues even if the member's participation is terminated or ceases for any other reason.

In such circumstances, it may be inconvenient for the association to have to pursue the member for deferred or supplementary calls. Equally, it may be inconvenient for the former member to have a continuing uncertain liability for such calls.[61] The solution provided by the IGA at the outset was that the IG Clubs were entitled to impose a lump sum. Once paid, this would release the member from liability to pay any future deferred or supplementary call.

Release-call levying was designed to prevent members from escaping liability by means of transfer, and to preserve the principle of mutuality. However, the Commission expressed doubts about this solution, on the basis that it could be used maliciously to deter transfers among clubs. Accordingly, the Commission felt that the release-call mechanism should be modified by certain parallel alternative measures. In response, the IGA of 1985 was subsequently modified to provide that "the operator has the option of paying the release call or providing a bank guarantee for his share of outstanding liabilities".[62].

In the 1985 Commission Decision, the issue whether the rules relating to release calls did infract Article 101(1) TFEU was ambiguously

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[61] Williams (2008) pp.122

[62] See *supra* note 4, para 16

worded as having "not clear-cut"[63] or merely "potentially"[64] restrictive effects on competition. These rules were still examined under Article 101(3) TFEU and granted the exemption on the ground that indispensability of restriction provided by Article 101(3)(a) TFEU was satisfied. However, in the 1999 Commission Decision, the Commission analysed the rules relating to release calls under Article 101(1) TFEU, without invoking Article 101(3) TFEU.

The change in the Commission's analysis from the 1985 Decision to the 1999 Decision could be read in the light of precedent *Gottrup Klim v. DLG*[65], which introduced the test on indispensability of restriction provided by Article 101(3)(a) TFEU to Article 101(1) TFEU. The 1999 Commission Decision concluded that a release-call levy that provided for the alternative of a bank guarantee was not "disproportionate"[66] to the proper functioning of the Pooling Agreement, given the fact that the bank guarantee permitted payment to be deferred until the liabilities were actually determined. As a result, the rules relating to release calls were excluded from the items that the 1999 Commission Decision held to be prohibited restrictions on competition[67]. This new approach, adopted in 1999, was also consistent with the GC's ruling in *Langnese-Iglo GmbH & Co KG v. Commission*[68], which emphasized that the Commission must first determine the validity of a particular provision under Article 101(1) TFEU before analysing the provision under Article 101(3) TFEU. Whether the rules relating to release calls could escape Article 101(1) TFEU directly or be caught but exempted upon Article 101(3) TFEU is of practical importance in respect of the burden of proof. In the 1985 Commission Decision, the burden of proof lay with the IG who invoked Article 101(3) TFEU for acquiring the redeeming virtues of non-restriction on competition. By contrast, in the 1999 Commission

63 *Ibid*. para 27
64 *Ibid*. para 53
65 See *supra* note 56
66 See *supra* note 5, para 86
67 *Ibid*. para 102
68 See *supra* note 10

Decision, the rules relating to release calls were valid under Article 101(1) TFEU and hence IG was free from such onus, invoking the exemption, to justify these rules.

Restricted Quotation

The original IGA of 1981 prohibited a club from offering a lower quotation to a prospective member, provided that the rate the prospective member was paying to his current club was reasonable. This restriction, which also covered newly acquired ships of the member, could be challenged only before the expert committee of the IG.

After discussions with the Commission from 1983 to 1985, the IG reversed the burden of proof between new clubs and holding clubs concerning the reasonableness of rate quotation. The new club was rebuttably presumed to be free to offer the quotation on the condition that the it must notify the holding club without delay of "a contractually binding commitment at the quoted rate having been entered into between the operator and the new club by 30 September of the year preceding that for which the new insurance policy is to be effective"[69]. This pre-30 September procedure also applied immediately to new ships acquired by the operator.

However, the pre-30 September procedure as subsequently implemented was far removed from how it had been envisaged: from 1986 to 1994, a total of 11 requests were recorded, with only one transfer finally being effected.[70] This result suggested that the new procedure had not promoted rivalry efficiently and led to the 1997 Statement of Objections, which maintained that the quotation procedures were still in violation of Article 101(1) TFEU. One year later, the IG announced an amendment that narrowed the scope of the quotation procedures to costs of claims, with reinsurance and administrative costs being excluded. In order to increase the transparency of administrative costs, the amendment also introduced a requirement that each club make an annual

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69 See *supra* note 4, para 14

70 See *supra* note 5, reference (1)

disclosure of its past five-year average expense ratio.

This amendment presented a breakthrough in freedom of quotation on the level of claim sharing was accepted by the 1999 Commission Decision. The Commission recognized that "[…] any claim-sharing agreement requires some degree of discipline between the participants in that agreement on the rates corresponding to the costs that they share. No club would be ready to share claims with another club that would be offering a lower rate for covering these same claims. No customer would remain with the first club because it would know that it could obtain from the second club exactly the same cover, covered also by all the P&I Clubs, but for a lower rate."[71] The Commission tacitly applied the counterfactual test (described in 4.3.1) to justify restricted quotation as inherent to a system of claim sharing. Meanwhile, the Commission considered that internal administrative costs were not relevant to the cost of claim sharing and accordingly freedom of quotation and competition should be introduced to internal administrative costs. For the same reason, on the retention level, the 1999 Commission Decision did not approve the restricted quotation procedures and pointed out that "[…] indeed, for non-shared costs there is no need to ensure that the clubs do not undercut each other. The clubs which could achieve a reduction of these costs below the level of their competitor's costs should be able to charge lower rates."[72]

Since it made no contribution to the claim-sharing arrangement, the restricted quotation as applied to retention constituted "price fixing" as described in Article 101(1)(a) TFEU. It interposed party autonomy between the prospective new club and the shipowner, and reduced the possibility of lower rates, the incidence of membership transfer and, ultimately, competition between the clubs. Parenthetically, the 1985 Commission Decision neither applied the counterfactual test nor differentiated between the level of claim sharing and the level of retention under Article 101(1) TFEU. Instead, it swallowed whole the issue of restricted quotation and resorted to Article 101(3) TFEU outright without

71 *Ibid.* para 89

72 *Ibid.* para 92

appropriate digestion. Comparatively, the 1999 Commission Decision contained more credible and accurate legal reasoning in this regard. This improvement could be read as a positive response by the Commission to the GC's ruling in *Langnese-Iglo GmbH & Co KG v. Commission,*[73] as well as *European Night Services*[74].

Minimum Cost for Tankers

Under the IGA, cover for tankers was underwritten at a unified minimum rate called the ETC (estimated total cost). In the 1985 revised version of the IGA, the concept of the ETC was softened and reserved in the form of an annual recommendation to be made by the IG based on the principle of total cost, including administration. Theoretically, this particular rule should be subjected to a two-stage test under Article 101(1) TFEU. The preliminary issue is whether such a non-binding rate recommendation for tankers could fall into the scope of an "agreement" under Article 101(1) TFEU. If so, then, what is the proper treatment for the minimum cost for tankers?

The 1985 Commission Decision did not address the first question. However, a few years later in the *Belasco* decisions[75], the ECJ affirmed that the recommendations by associations, even if non-binding, should be treated as agreements between the members. It was regrettable that this authority was not quoted by the 1999 Commission Decision, which failed to address the impact of the non-binding nature of the recommendations before blaming the minimum cost for tankers on "over-deterrence of depriving reinsurance".[76]

With respect to the second question, that is, if a non-binding rate recommendation can constitute an "agreement," then what is the proper treatment of the minimum cost for tankers, under the pressure of the Statement of Objections, the principle of total cost was further neutralized in 1998. The IGA extended the approach of excluding the admi-

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[73] See *supra* note 10

[74] See *supra* note 58

[75] See *supra* note 8

[76] See *supra* note 5, para 99

nistrative costs (referred to in 4.3.2.4) to the minimum cost for tankers and required that "quotations for tankers must make fair and adequate provisions for all relevant elements of cost other than internal administrative costs".[77] As far as the level of claim sharing, the 1999 Commission Decision treated these modified rules on the minimum cost for tankers in a fashion similar to the treatment given to restricted quotation. As far as the retention level, the minimum cost for tankers fell into the scope of "price fixing" under Article 101(1)(a) TFEU.

4.4 Implementation of Article 101(3) TFEU to the Pooling Agreement and the IGA under the Old System of Regulation 17/62

4.4.1 Questionable Alternative Pleading in reliance on Articles 2 and 4 of Regulation 17/62

Regulation 17/62 was approved by the Council and came into effect in 1962 as the first regulation to set out the procedural application of Article 101 TFEU. Articles 2 and 4 constituted the backbone of Regulation 17/62, and set forth the means by which Article 101 TFEU was to be implemented. The preliminary test was to determine whether negative clearance under Article 101(1) TFEU could be satisfied. If not, the conditions of exemption under Article 101(3) TFEU would be examined. Nevertheless, in practice, this envisaged route was blurred by the undertakings' alternative pleading for negative clearance or exemption. This tactic was also used by the IG in its original notification.[78]

As explained in 4.3.2, undertaking an analysis of possible exemption under Article 101(3) TFEU without first assessing the issues under Article 101(1) TFEU is not good legal reasoning under the system of Regulation 17/62. To some extent, it was the IG's strategy of alternative pleading that encouraged the 1985 Commission Decision's inexact application of Article 101 TFEU. The applicability of negative clearance

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77 *Ibid*. para 39

78 See *supra* note 4, para 1

under Article 2 of Regulation 17/62 remained unexamined for one-and-a-half decades until it was eventually addressed by the 1999 Commission Decision. To sum up, compared to the 1985 Commission Decision, the 1999 Commission Decision narrowed the scope of application of Article 101(3) TFEU, confirming that the amended minimum common level of cover and rules relating to release calls would no longer infringe Article 101(1) and leaving only the practices of restricted quotation and the minimum cost for tankers on the retention level to be examined further under Article 101(3).[79]

4.4.2 Essence of Regulation 17/62: Notification and Authorisation

The chronological table in 4.1 and the sub-issues analysis in 4.3.2 illustrate how the Commission applied the competition policy to the Pooling Agreement and the IGA, *inter alia*, notification and authorisation provided by Articles 4 and 9 of Regulation 17/62.

Article 4 provided the undertaking concerned with a preliminary administrative procedure that enabled the undertaking to notify the Commission and adjust the practice in question. In practice, most of the agreements notified under this procedure, including the Pooling Agreement and the IGA, fell into the grey area between entirely pro-competition and absolutely anti-competition. The preliminary administrative procedure did have the merit of providing the undertakings with legal certainty in the form of the Commission's concrete objections and instructions.

Article 9 granted the Commission the exclusive power to declare Article 101(1) TFEU inapplicable pursuant to Article 101(3). In the early days of EU competition law, the top priority was to centralize case law and apply the law in a uniform fashion. Granting exclusive competence to the Commission eliminated the risk of inconsistent application by state courts and authorities.

The notification and authorisation procedure, which constituted the

[79] See *supra* note 5, para 79 and para 102

essence of Regulation 17/62, remained unaltered until the implementation of Regulation 1/2003 (to be discussed in 5.2) at the beginning of this century. The following discussion (4.4.3 and 4.4.4) will be made on the basis of the notification and authorisation procedure.

4.4.3 Unfeasible Proposal: Block Exemption

On the premise that the practices of restricted quotation and minimum cost for tankers fall within the scope of Article 101(1) TFEU, logically, the next test is whether they could be covered by a block exemption as the "fast track" to Article 101(3) TFEU. Only when a block exemption is not available must the final result depend on availability of an individual exemption. For the sake of a watertight argument, consideration of a block exemption in relation to the Pooling Agreement and the IGA cannot be overlooked, even it is found to have been an unfeasible proposal in hindsight.

In the context of the Pooling Agreement and the IGA, Regulation 3932/92 was *prima facie* relevant and attracted the attention of Commission in its 1999 Commission Decision.[80] Articles 10(1) and 10(2)(b) of Regulation 3932/92 state that the insurance block exemption shall "apply to agreements which have as their object the setting-up and operation of co-reinsurance groups in order to reinsurance mutually". The Commission in its 1999 Commission Decision sidestepped the issue of the compatibility of claim-sharing arrangements with this statement. Instead, the Commission denied applicability of the insurance block exemption by invoking Article 11(1)(a) of Regulation 3932/92. Under Article 11(1)(a), the combined market share of the IG Clubs far exceeded 15%, the upper limit for applying Article 10(2)(b). This market-share-based limitation on applicability of the insurance block exemption stemmed from the Commission's reform of block exemption regulation since 1999, of which the starting point was to provide small-or medium-sized undertakings with legal certainty by replacing lengthy "white lists" with a "safe harbour" in market-share percentage. Without

[80] *Ibid.* para 103

question, because the IG held the dominant market position, it fell outside the "safe harbour" intended for small-or medium-sized undertakings. On this ground, the practices of restricted quotation and minimum cost for tankers were finally excluded from the scope of the block exemption.

One more point worth noting here is that, even though the 1999 Commission Decision stated that "it is not clear from Community case law whether the insurance block exemption also covers claim-sharing arrangements between insurance mutuals",[81] in fact, the ECJ had set down the narrow approach to block exemption in *Delimitis v. Henninger*[82]. Being secondary legislation to apply Article 101(3) TFEU, block exemption regulations should be construed rigidly. Only when the agreement in question squares neatly with the provision governing block exemption will the safe harbour be available for the undertaking concerned. Similarly, in post-1986 maritime transportation, "the various investigations of the practices of the members of liner conferences illustrate the narrowness of block exemption regulation".[83] In the light of these factors, it could be inferred that under the vague wording of "not clear" in its 1999 Commission Decision, the Commission hold a negative position on applying the insurance block exemption to the Pooling agreement and the IGA.

4.4.4 Final Treatment: Individual Exemption

When the Pooling Agreement and the IGA, particularly the practices of restricted quotation and minimum cost for tankers, could not be embraced by the "safe harbour" of block exemption, the final opportunity for escape from Article 101(1) TFEU was the individual exemption under Article 101(3). Article 101(3) sets forth four separate and cumulative conditions for declaring Article 101(1) inapplicable, namely, contribution to economic welfare, fair share of benefit to consumers, indispensability of restriction, and non-elimination of competition. All four

81 *Ibid.* para 104

82 See *supra* note 9

83 Greaves (2010) pp.130

conditions must be satisfied. Credit obtained by a restraint for passing any particular condition by a considerable margin cannot be taken advantage of at a later stage if the restraint fails to satisfy a subsequent condition for exemption.[84] Establishing whether a restraint satisfies all four conditions involves a series of tests to establish both the positive and negative effects of the restraint.

Contribution to Economic Welfare

As the main goal of competition policy, economic welfare is asserted by Article 101(3) TFEU in terms of "improving the production or distribution" or "promoting technical or economic process". The practices of restricted quotation and minimum cost for tankers essentially are both the price measures of P&I insurance. The issue whether these practices on the retention level, outside the Pooling Agreement, can contribute to economic welfare should be assessed in view of premium setting of P&I insurance.

Insurance is a typical cyclical market, where "prices are pushed down due to fierce competition between rival insurers, for many of whom the distinction between market share and profitability has become blurred"[85] until losses become apparent. In the context of P&I insurance, mutual associations underwrite "at cost" without profit included in the computation of calls. The basic equation for underwriting is that calls plus investment income should equal claims plus expenses plus reinsurance premiums.[86] In fact, the principle of "at cost" without profit making is more likely to be jeopardized by price-cutting rather than pricing fixing. Once free pricing prevails in the P&I insurance market, premium anarchy is inevitable under ultra-competition and it will be unfavourable to the supply sustainability on the basis of cost.

The practices of restricted quotation and minimum cost for tankers are designed to guarantee net premium on the basis of cost, which is highly linked to loss claims *ex post* and *ex ante*. Even on the retention

[84] See *supra* note 26, pp.156

[85] See *supra* note 37, pp.57

[86] Hazelwood (2010) pp.98

level, such practices avert the feast or famine cycle of price and thereby endow the supply of P&I insurance with predictability and stability. Furthermore, under the system of net premium that well connects cost and loss, the practices of restricted quotation and minimum cost for tankers create incentives for loss prevention and consequently better safety performance by the shipowners at sea. Less damaging incidents occur in seaborne trade, the economic process enjoys more efficiency.

In the appraisal of contribution to economic welfare, the Commission adopted different approaches in its 1985 and 1999 Commission Decisions. Neither of them seems to be laudable in retrospect. The Commission in its 1985 Commission Decision stated that "improvement in production or distribution" of insurance service was satisfied.[87] However, the reasoning to this positive condition was then virtually subject to the negative condition "indispensability of restriction". Sub-arguments composed of "preserving the principle of mutuality", "stability of premiums" and "continuation of the pool arrangement"[88] did justify that the IGA was indispensable to the operation of P&I insurance, but it is extremely dubious to simply equate "maintenance" of P&I insurance operation with "improvement" of insurance service.

14 years later, the Commission in its 1999 Commission Decision substituted "promotion of economic progress" for "improvement in production or distribution". Notwithstanding this shifted argument, the legal reasoning remained more or less discursive. As mentioned in the end of 4.4.1, the Commission in its 1999 Commission Decision confirmed that the practices of restricted quotation and minimum cost for tankers insofar as the retention level were left to be further examined under Article 101(3) TFEU. Paradoxically, the appraisal of the first condition of Article 101(3) TFEU did not centred on the retention level but rushed back to the Pooling Agreement and concluded that "the IG's arrangements, therefore, contribute to economic progress by ensuring that P&I insurance cover of up to EUR 3.9 billion (USD 4.25 billion) is

87 See *supra* note 4, para 39

88 *Ibid.* para 35, para 36 and para 37

available in the market."[89] Comparatively, in the scenario of P&I insurance being the intangible financial service, the Commission's argument of "promotion of economic progress" in 1999 was more likely to be justifiable than that of "improvement in production or distribution" in 1985. However, there was still some room left for the Commission to improve its legal reasoning on this point. Had it been limited to the retention level, the Commission's argument might have demonstrated more credibility when the stability of P&I insurance premiums, its significance to the market supply on the basis of cost and its contribution to loss prevention and economic efficiency were addressed behind the price measures, viz. the practices of restricted quotation and minimum cost for tankers.

Fair Share of Benefit to Consumers

Economic welfare advocated by mainstream economists is overall social welfare, which comprises both "consumer welfare and producer welfare".[90] Nonetheless, the primary goal served by EU competition law is to maximize consumer welfare. This is the background for understanding "fair share of benefit to consumers" as the second positive condition of Article 101(3) TFEU. The practices of restricted quotation and minimum cost for tankers satisfied the condition of "fair share of benefit to consumers" here.

Firstly, due to the essence of P&I Clubs that "they are mostly mutual associations, where the members are both insured and insurers",[91] identification between the producer and the direct consumer is established. In the consumer-owned business, no gap could be formed to block the economic welfare gained by P&I Clubs from floating to their members. This consumer benefit was furthermore requested to entertain third parties in the case of *Cobelpa VNP*.[92] Given the underpinning position of P&I insurance providing global marine liability, the credits

[89] See *supra* note 5, para 106

[90] Whish (2008) pp.4

[91] See *supra* note 86, pp.1

[92] [1977] OJ L242/10

gained under the first positive condition pass to final consumers of maritime industry smoothly. Stable supply of P&I insurance guarantees sufficient compensation available to passengers and other customers of the shipowners. Loss prevention also gains efficiency favourable to all potential consumers downstream in the long term.

The 1985 and 1999 Commission Decisions kept the same position with *Cobelpa VNP*[93] in this connection.[94] The former did a more detailed analysis while the latter merely embedded this issue into the discussion of "promotion of economic progress". Notwithstanding this disparity in form, the Commission had the same deficiency of legal reasoning described in 4.4.4.1. that the appraisal of "fair share of benefit to consumers" did not centred on the retention level but rushed back to the Pooling Agreement.

Indispensability of Restriction

The first negative condition of indispensability relates to the concept of necessity and proportionality. The restriction could justify itself on two sides: it is the only solution without alternative, and not out of proportion. This was held by *Cooperative Stremsel-en Kleurselfabriek v. Commission*[95] at the heart of its judgment.

In the context of the practices of restricted quotation and minimum cost for tankers insofar as the retention level, the question of necessity is settled with no hurdle considering how the risk assessment is carried out in the underwriting of P&I insurance. Modern P&I associations apply an empirical approach to the individual characteristics, requirements and risk profile of a particular member.[96] Assuming that the practices of restricted quotation and minimum cost for tankers are only applicable to the level of claim sharing, the separate risk assessment over the retention level should be provided objectively and accurately as a prerequisite. However, severability in respect of risk assessment

93 *Ibid.*

94 See *supra* note 4, para 41 and note 5, para 108

95 Case 61/80 [1981] ECR 851

96 See *supra* note 86, pp.98

between the level of claim sharing and retention is not feasible due to the fact that "as risk assessment is based on subjective parameters (such as vessel safety measures and training of the crew), it would be easy for a club to manipulate this assessment by decreasing the relative weight of the retention costs and increasing the weight of the shared cost."[97] For the sake of preventing quotation of discriminatory rate, preserving the principle of mutuality and accordingly continuing of the pool arrangements, the practices of restricted quotation and minimum cost for tankers, even on the retention level, are borne out as the necessities in the absence of any viable alternative.

Under the parameter of proportionality, the practices of restricted quotation and minimum cost for tankers have been tailored strictly since the pre-30 September procedure of de-administrative costs was incorporated. The mechanism which is thus set up appears to the Commission to constitute an acceptable compromise between the legitimate interests of the clubs in maintaining stable membership and the interests of the operators who now take advantage of competition between clubs with respect to rates and services offered.[98]

Comparatively speaking, the 1999 Commission Decision discussed indispensability of restriction mainly on the side of necessity while the 1985 Commission Decision shed more light on the side of proportionality. Different approaches lead to the same conclusion, nevertheless, had both sides been combined, a more cogent argument might have been provided by the Commission.

Non-elimination of Competition

The final condition concerns the question to what extent would the practices of restricted quotation and minimum cost for tankers eliminate competition. The analysis cannot be made apart from the uniqueness of P&I insurance, the system of levying calls, which differs from single premium or regular premium in general insurance. Before the

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97 See *supra* note 5, para 111

98 See *supra* note 4, para 49

commencement of the policy year, "club managers calculate the total 'premium' for the year as a figure of 100% and then proceed to call up, as an advance call, a proportion of that total, say 75%, leaving the remaining 25% to be collected by way of supplementary calls."[99] Levying supplementary calls is further subject to a proviso of flexibility that any such estimate shall be without prejudice within the right of the directors to adjust at a greater or lesser percentage than indicated. Under this system of levying calls, quotation in advance is not final binding and hence cannot determine the premium competition single-handedly. Taking supplementary calls into account, it is not a corollary for the practices of restricted quotation and minimum cost for tankers to eliminate competition in the context of actual total calls.

The Commission also recognized that "competition among the P&I clubs on the elements of rate reflecting the cost of claim (the elements subject to the quotation procedure) is a very important parameter of competition, but it is not the only one. Clubs remain free to compete on non-price parameters (such as the level of claim-handling service) as well as on the part of the rate which reflects the administrative costs."[100] Indeed, price rivalry is not the fundamental competition in the P&I insurance market, where service quality carries weight in the competitive process. More concerns should be bestowed on long-term competition of loss prevention, claim handling and counselling service rather than price-cutting of short-termism. On this ground, the practices of restricted quotation and minimum cost for tankers are far away from the elimination of competition.

Additionally, it is laudable that the Commission in its 1999 Commission Decision underlined that elimination of competition could not be established, "despite the fact that IG covers 89% of the world-wide market for P&I insurance".[101] It implicated that "dominant position" in Article 102 TFEU could not be read intuitively as a synonym for "elimination of competition" in Article 101(3) TFEU. This was later reaffirmed

99 See *supra* note 86, pp.104

100 See *supra* note 5, para 114

101 *Ibid*. para 113

by the GC in the judgment on the *TAA* appeal[102] with the opinion that "the prohibition on eliminating competition is a narrower concept than that of the existence or acquisition of a dominant position".

Conclusion

Given that four separated and cumulative conditions in Article 101(3) TFEU were all fulfilled, the practices of restricted quotation and minimum cost for tankers as far as the retention level were granted the individual exemption as the final treatment by the Commission, valid from 1999 until 2009.

4.5 Legal Analysis of the Pooling Agreement and the IGA under Article 102 TFEU

4.5.1 Relevance of Article 102 TFEU to Pooling Agreement and IGA

As the twin of Article 101 TFEU, Article 102 concerns abuse of the dominant position including but not limited to the items listed from (a) to (d) that largely overlap with the conducts proscribed by Article 101(1) TFEU. Since the Pool Agreement and the IGA are granted the individual exemption and deemed compatible with Article 101 TFEU, it appears reasonable to question whether they still risk being targeted by Article 102, which to some extent shares identity with the former.

3.1.2 has elaborated that P&I insurance is a long-standing oligopolistic market, owing to collective dominance of the IG Clubs. From the perspective of the authority, the oligopolistic market is unquestionably the most intractable arena to implement competition policy. On the demand side, buyers are highly susceptible to potential abuse of dominance due to inelastic demand with limited room for bargaining. On the supply side, "oligopolies often manage to adjust their relationships with competitors to mutual advantage".[103] Whereas collective domi-

[102] Case T-395/94 [2002] ECR II-875

[103] See *supra* note 26, pp.375

nance had been conspicuous at the heart of oligopoly for a long period, the Commission did not illustrate the simultaneous applicability of Articles 101 and 102 TFEU to it until *Italian Flat Glass*.[104] On the strength of this Commission Decision, double straightjackets were put on oligopolies. Article 102 combined with Article 101 to cope with collective dominance via "economic links". Afterwards, this reinforced approach was assented to and reiterated by the ECJ in *Compagnie Maritime Belge v. Commission*[105] as follows: "it is clear from the very wording of [Article 101 and Article 102] that the same practices may give rise to an infringement of both provisions. Simultaneous application of [Articles 101 and 102 TFEU] cannot be ruled out *a priori*."

As a conclusion, oligopoly via collective dominance may simultaneously contravene two main headings of the EU competition law. In this scenario, the credits gained in the examination upon Article 101 TFEU cannot transfer to the appraisal under Article 102. The Pooling Agreement and the IGA after modification, though acceptable under the former one, still needs scrutiny by the latter. The relevance of Article 102 TFEU to the Pooling Agreement and the IGA should have been articulated as the prerequisite for discussion but was slurred over by the Commission in its 1999 Commission Decision.

4.5.2 Appraisal of Abuse

4.5.2.1 Conception, Classification and Approach

The wording of Article 102 TFEU, "such abuse may […] in particular […] consist in", means that the items from (a) to (d) hereunder are not intended to exhaust all instances. The deductive approach adopted by Article 102 shows more flexibility comparing with Article 101 and leaves open a wide margin to various new circumstances. Academically, abuses are often classified into exploitative and exclusionary. Exploitative abuses are imputable to the detriment of consumers directly while

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[104] [1989] OJ L33/44

[105] See *supra* note 11

exclusionary abuses, on the other dimension, are engaged in undermining the competitive process where contenders are involved.

It is remarkable that "the authentic English text of the Treaty uses the single word 'abuse', but most of the other languages use the double concept of 'abusive exploitation'".[106] It implies that, as the starting point, exploitative abuse was the main target of Article 102 TFEU, which placed importance primarily on the protection of consumers, for example prohibiting the imposition of unreasonable terms and conditions. It corresponded to "consumer welfare" (referred to in 4.4.4.2) adopted by the EU competition authority as the policy goal.

However, the concept of abuse was expanded to the dimension of exclusion in the leading authority *Hoffmann-La Roche*[107] as follows: "the behaviour of an undertaking in a dominant position which is such as to influence the structure of a market where, as the result of the very presence of the undertaking in question, the degree of competition is weakened and which, through resources to methods different from those which condition normal competition in products or services on the basis of the transactions of commercial operators, has the effect of hindering the maintenance of the degree of competition still existing in the market or the growth of the competition." New concerns addressed the distortion of market structure via weakening competition by the exclusionary abuse.

There is no denying that prominence of institutional legislation has long been given to Article 101 TFEU in the implementation of the EU competition policy, leaving the application of Article 102, to which less resources were devoted, at the formalistic level. The disequilibrium in this connection had not been ameliorated until the Commission adopted and published the 2008 Guidance (to be discussed in 5.3), which became to represent a reform-minded approach more economic and effect based by introducing new parameters and tests. Before the innovation of this much awaited 2008 Guidance, nonetheless, case law of the EU Courts and the Commission predominated in the analysis of

[106] See *supra* note 59, pp.136

[107] See *supra* note 24

Article 102 TFEU. The 1999 Commission Decision was made under this pre-2008 reign of case law. Not surprisingly, only the principles distilled from the precedents could be applied to the following appraisal of exploitative and exclusionary abuses at that time, even though from today's perspective they may be in conflict with the modernised 2008 Guidance.

Non-Exploitative Abuse: Minimum Common level of Cover

As explained in 4.5.1, even though not imputable under Article 101 TFEU, the minimum common level of cover is still subject to appraisal under Article 102 TFEU. The relevant fact has been stated in 4.3.2.2 and it *prima facie* constitutes "limiting production to the prejudice of consumers"[108] within the meaning of Article 102(b) TFEU.

Two leading authorities were provided by the ECJ to draw the boundary between exploitative abuse and ostensible abuse of limiting production, *United Brands Company and United Brands Continentaal BV v. Commission*[109] and *British Petroleum v. Commission*[110]. In *United Brands*[111] involving resale of bananas, the ECJ acknowledged that limiting production could be justified for the assurance of quality as a legitimate interest. The *BP*[112] case in the scenario of supply shortage showed another reasonable defence based on certain external causes. They combined to offer a objective justification to certain behaviours of limiting production that appear outwardly as exploitative abuse but indeed should fall outside the scope of Article 102 TFEU for being legitimate *per se*.

The Commission in its 1999 Commission Decision did not directly quote these two precedents, but *de facto* applied the objective justification to the minimum common level of cover. Empirical analysis on large claims and successful experience of shipping industry were em-

[108] See *supra* note 5, para 128

[109] See *supra* note 12

[110] Case 77/77 [1978] ECR 1513

[111] See *supra* note 12

[112] See *supra* note 110

ployed by the Commission to justify that "from an objective point of view, the new level of cover cannot be considered incapable of meeting customer needs".[113] In view of this, exploitative abuse is unlikely be established in the context of the minimum common level of cover.

Non-Exclusionary Abuse: Reinsurance Provisions

Before the 1997 Statement of Objections, the Pooling Agreement had set forth the conditions in relation to offering reinsurance to mutual insurers outside the IG but without procedure rules. Even worse, stock insurers had never been considered for such reinsurance arrangements. These unilateral provisions, barely on the framework level, left too much discretion to the IG in determining whether or not reinsurance could be offered to a third insurer and therefore constituted exclusionary abuse within the meaning of "dissimilar conditions" in Article 102(c) TFEU. Adopting the 1997 Statement of Objections, the IG notified amendments to Appendix X of the Pooling Agreement 1998, which supplemented detailed criteria and appropriate procedures governing reinsurance offers to mutual insurers as well as stock insurers.

The obligation to refrain from exclusionary abuse since *Hoffmann-La Roche*[114] was later named by the ECJ as "special responsibility" not to impair undistorted competition in *Nederlandsche Banden-Industrie Michelin v. Commission*[115] and reached a crescendo at *Tetra Pak International SA v. Commission*[116] where the oligopoly of over 90% market share was imposed on more onerous duty in the competitive process. Similarly, in *Oscar Bronner v. Mediaprint*,[117] AG Jacobs referred that there may be wider duties to help rivals where the super-dominant position is found. From today's perspective, this "sliding scale approach" to special responsibility seems controversial and is no more favoured by the 2008 Guidance. Its factual protection of competitors weakened the

[113] See *supra* note 5, para 131
[114] See *supra* note 24
[115] Case 322/81 [1983] ECR 3461
[116] See *supra* note 13
[117] See *supra* note 14

protection of consumers as the first priority in EU competition law. Nonetheless, it offered some stretching notions to deal with different situations in different market structure at that time. One example is the creation and development of "essential facilities". It is of high relevance to the oligopolistic market, *inter alia* P&I insurance overarched by multilayer reinsurance arrangements.

The doctrine of "essential facilities" derived from a series of cases in transport sector involving utilisation of harbours or ports such as *Sea Containers v. Stena Sealink*[118] and *Maritime Container Network*.[119] By virtue of these Commission Decisions, the duty was imposed on the dominant undertaking to open its facility on a non-discriminatory basis to rivals by request for business operation. Otherwise, the dominant undertaking could be condemned for exclusionary abuse. However, this initial notion was shrunk by the ECJ in *Oscar Bronner120* to the extent of indispensability. Only if there are no alternatives or substitutes for the facility and it is unreasonably difficult for a competitor to replicate it, would the dominant company be obliged to grant access to it.[121]

The Commission in its 1999 Commission Decision tacitly adopted case law noted above and addressed that "independent insurers are not able to obtain reinsurance for large P&I cover, owing to their limited market shares".[122] As the starting point, the doctrine of "essential facilities" was applied for the appraisal of the reinsurance provisions under Article 102 TFEU. Should there had been no adoption of the Statement of Objections, the IG as the oligopoly would undoubtedly have constituted escaping special responsibility and thereby exclusionary abuse. However, this was not the case in fact. The IG finally provided objective conditions in relation to the provision of reinsurance and adequate procedures allowing any independent P&I insurers to acquire reinsu-

118 [1994] OJ L 15/8

119 [1994] OJ L 104/34

120 See *supra* note 14

121 See *supra* note 26, pp.362

122 See *supra* note 5 para 135

rance from the IG.[123] On this ground, exclusionary abuse on refusing access to essential facilities could not be established in the context of the reinsurance provisions.

Conclusion

With the analysis of case law noted above, it is safe to conclude that the amended Pooling Agreement and the IGA would no longer give rise to an infringement of Article 102 TFEU.

5 Prospects of the Pooling Agreement and the IGA under the Reopened EU Competition Investigation

5.1 Delineation of Reopened Commission's Competition Investigation and Altered Legal Environment

The validity period of the 1999 Commission Decision granting exemption for ten years expired in February 2009. Afterwards, it should come as no surprise that the Commission reopened the competition investigation into the Pooling Agreement and the IGA in August 2010.

Comparing with the previous two competition investigations in the past 30 years, there is no specific complaints from the side of shipowners on this occasion and consequently the IG believes that the Pooling Agreement and the IGA "may be expected to benefit 'automatically' from exemption as long as there are no material changes in the way in which the Group is structured and operates and there are no major changes in the basic structure of the P&I market."[124] However, the Commission disapproves of allowing exemption to roll forward *a priori*,

[123] *Ibid.* para 136

[124] IG (2008)

albeit no conclusive proof of contravening competition rules has been new found. The DG Comp officials have begun background research and canvassed shipowner views.[125] Hopefully the direction of the investigation as well as the new issues will become clear as time goes by.

It is clear that the Commission is undertaking a very serious and in-depth survey of the Pooling Agreement and the IGA presently. Understandably, the third investigation is bound to be substantive and much more than a ritual one, bearing in mind that in the first decade of the new century past, tranquil exemption period in the IG's eyes, the external legal environment of EU competition law has experienced fundamental transition. The modernised Regime of Regulation 1/2003, having far-reaching impact on the implementation of Article 101 TFEU, has been established to replace the old system of Regulation 17/62. The long awaited 2008 Guidance has been finalised from the Discussion Paper and provides new approaches to Article 102 TFEU. After the incident of *Erika*,[126] the IG has been more actively embarking on the oil pollution liability regime with STOPIA and TOPIA incorporated since 2006. The IG's unparalleled performance in this arena is envisaged to obtain environmental consideration by the Commission in its implementation of competition policy, but it is still hard to reach a palatable conclusion considering the ambivalence between the 2004 Guidelines and the TFEU on this point. Anything less than overall scrutiny to these eventful themes will not help the observation and suggestion to the prospects of the Pooling Agreement and the IGA under the reopened Commission's competition investigation.

[125] Arthur J. Gallagher (2011)

[126] MV Erika, a tanker with roughly 20,000 tons of fuel oil as cargo, sank off the coast of Brittany in 1999, releasing massive oil and causing the greatest marine pollution to France in 20th Century.

5.2 Modernised Regime of Regulation 1/2003 and Its Impact on the Appraisal of the Pooling Agreement and the IGA under Article 101 TFEU

5.2.1 Self-Assessment instead of Notification and Authorisation

It has been stated in 4.1 that the implementation of EU competition law experiences two stages: the early years under Regulation 17/62 and the new era with the adoption of Regulation 1/2003. The previous two EU competition reviews to the Pooling Agreement and the IGA were both under the system of Regulation 17/62. With the theme of centralised notification and authorisation, the old system of Regulation 17/62 was well suited for the EU in its youth of limited Member States. "It enabled the Commission to build up a coherent body of precedent cases, and to ensure that the competition rules [in particular Article 101 TFEU] were applied consistently."[127] However, it had the unintended consequence of a massive backlog of notifications, most of which would turn out to be non-imputable before the Commission but deplete limited administrative resources. This situation could not be resolved as time went by and the enlargement of the union increased the Commission's stress in this connection.

In order to allocate administrative resources effectively and ensure supervision in the changed circumstances, the Commission initiated a momentous modernisation, with Regulation 1/2003 replacing Regulation 17/62, taking effect since May 2004. The most notable change of Regulation 1/2003 is abolishing the notification and authorisation under Regulation 17/62 and introducing direct applicability of Article 101(3) TFEU. According to Article 1 of Regulation 1/2003, Article 101 TFEU now takes direct effect as a whole and prior decision by the Commission under Regulation 17/62 is no longer a prerequisite for the application of Article 101(3) TFEU.

This development is reasonable to the Commission in that sufficient

[127] EU (2004)

experience has been accumulated through decisions on numerous individual cases in the past 40 years of competition policy implementation. Nonetheless, on the position of undertakings, the new system that shifts from prior notification and authorisation to *ex post* control indicates that self-assessments of legal risk have to be carried out. To the IG, it means that the individual exemption via notification and authorisation is not available anymore. Hence the self-assessment of the Pooling Agreement and the IGA under Article 101 TFEU now has to be completed as if Articles 101(1) and 101(3) TFEU were conflated.

5.2.2 No Help from Renewed Insurance Block Exemption Regulation 267/2010

Firstly, the block exemption is still of no help to the Pooling Agreement and the IGA under the new regime of Regulation 1/2003. The tide has not and will not turn from the previous Commission's Decisions on this point. In principle, the block exemption has no position in the modernised regime of Regulation 1/2003 but rather is a mere exposition of Article 101(3) TFEU for enforcement purposes. Moreover, the Commission on principle dislikes sectoral block exemptions unless the characteristics of the sector are so special, and the lobbying power of its members so great, that a tailor-made block exemption is inevitable.[128] This standpoint could be inferred from the renewal of insurance sector block exemption, which appears relevant to the Pooling Agreement and the IGA.

As the successor of Regulation 3932/92 (referred to in 4.4.3), Commission Regulation No 358/2003 of 27 February 2003 on the application of Article 81(3) of the Treaty to certain categories of agreements, decisions and concerted practices in the insurance sector (Regulation 358/2003) was supposed to expire in 2010. Even having received outright dissent from the European insurance and reinsurance federation (CEA)[129], the Commission insisted on its original proposal on the renewal of Regulation 358/2003. It finally narrowed the scope of exemp-

128 See *supra* note 26, pp.612

129 CEA (2009)

tion and applied a harsher calculation of market share as what we see now in Regulation 267/2010. These variations are disadvantageous to all insurers and indicate more intense enforcement of EU competition law to the whole insurance sector.

With this background, it is a sobering thought to thoroughly reduce the relevance of insurance block exemption to the Pooling Agreement and IGA especially when the bias of block exemption against the oligopoly, here the IG, is aggravated by the new formula of calculating market share in Regulation 267/2010.

5.2.3 Conceivable Procedure of Commitment Decision

On the basis that the renewed insurance block exemption, Regulation 267/2010, still cannot provide any help to the Pooling Agreement and the IGA, the self-assessment of potential competition issues will return to the criteria laid down by Article 101(3) TFEU in the modernised procedure stipulated by Regulation 1/2003. Although the notification and authorisation have been abolished, the negotiated settlement procedure at the time of Regulation 17/62 is inherited by Regulation 1/2003 and codified as Article 9, *inter alia*, the commitment decision.

Roughly analogous to the US consent decree, Article 9 empowers the Commission to early terminate its proceedings without any formal finding of competition law violation. The Commission is entitled to adopt decisions giving legal force to commitments proposed by the undertakings concerned, instead of making prohibition decisions upon Article 7. This commitment procedure is introduced into Regulation 1/2003 and operated by the Commission to "increase the administrative efficiency in public enforcement by securing early closing of cases, and thereby saving of resources, where there are no hard-core violations which require punishment and where the parties cooperate with the public authority by showing their willingness to take action to address the negative effects of their behaviour".[130] Recital 13 of Regulation 1/2003 excludes the finable infringements from the application scope of

[130] Cengiz (2010) pp.130

Article 9 and foresees a formal settlement procedure to ancillary restraints of competition.

It has been explained in 4.1.1 that the Pooling Agreement and the IGA by nature of claim sharing are operated with no hard-core violation of EU competition law. Simply ancillary restraints are envisaged to receive a treatment upon Article 9, rather than Article 7, by the Commission under the modernised regime of Regulation 1/2003. When the potential competition issues of the Pooling Agreement and the IGA eventually materialise, the commitment decision will be the fitting instrument for regulation from the Commission's perspective. On the IG's side, it would be optimal as well because securing of the commitment decision circumvents a protracted Commission's investigation and the possible appeal before the EU judicature involving excessive legal costs and uncertainty in the future.

However, it should be pointed out that the Commission has not issued any substantive guidance on the application of the commitment decision under Article 9. The legal lacuna left by the secondary legislation on this point has been more or less filled lately by the final judgment of *Alrosa*[131] in which the Commission's exercise of the commitment decision was first challenged before the EU judicature. By virtue of this leading case, the ECJ has provided "interesting guidance on the nature and scope of the Article 9 procedure and on the obligations of the Commission when resorting to it in a particular case".[132]

In the case of the Pooling Agreement and the IGA, the focus of the reopened investigation will be placed on certain provisions that narrowly escaped from the previous Commission Decisions but have provoked controversy later in the sectoral practice. Several industry reports[133] concurrently infer that, with the imputation of disproportionality, the rules relating to release calls may be the prime target in the new round investigation. 5.5 in the end will provide some observation and suggestion to help the rules relating to release calls acquire the re-

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131 See *supra* note 17

132 Latham & Watkins LLP. (2011)

133 See *supra* note 2 and note 129

deeming virtues of Article 101(3) TFEU under the envisaged commitment procedure and the enlightenment from *Alrosa*.[134]

5.3 2008 Guidance and Its Consequence on Assessment of the Pooling Agreement and the IGA under Article 102 TFEU

5.3.1 Approach Shifted from Formalistic to Economic-Focused

4.5.2 has illustrated that the Pooling Agreement and the IGA, by adopting the Statement of Objections, should not be longer condemned for abuse of dominance. This Commission's position in its 1999 Commission Decision is not likely to be changed, but rather strengthened when the prolonged Discussion Paper finally results in the 2008 Guidance on exclusionary abuse of dominance, which applies a more economic-focused approach to the enforcement of Article 102 TFEU.

It is widely oppugned by many academics and consultants[135] that as to whether or not certain conduct would lead to anti-competitive foreclosure, case law of the EU Courts and decision-making practice of the Commission used to slide into formalistic analysis. In order to shift this approach and provide greater clarity and predictability on the application of Article 102 TFEU, DG Comp published the 2005 Discussion Paper and finalised it as the 2008 Guidance.

The 2008 Guidance introduces some new factors for assessment into the analytic framework of Article 102 TFEU. Albeit the scope of the 2008 Guidance is limited to exclusionary abuses and not extended to exploitative abuses, it is helpful to grasp the trend led by the Commission on the enforcement of Article 102 TFEU and accordingly provide the outlook in the case of the Pooling Agreement and the IGA.

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[134] See *supra* note 17

[135] See *supra* note 59, pp.469

5.3.2 Substitute Efficiency Defence for Objective Justification to Minimum Common Level of Cover

The primary approach shift in the 2008 Guidance is about competition defence, from the concept of "objective justification" to the doctrine of "efficiency defence". As elaborated in 4.5.2.2, objective justification was distilled from *United Brands*[136] and *BP*[137]. The 1999 Commission utilised this concept to justify the minimum common level of cover. It also appeared in the 2005 Discussion Paper but is left out by the 2008 Guidance.

In the 2008 Guidance, a new doctrine of efficiency defence is established in paragraph 30, which sets four cumulative conditions from (a) to (d). This in fact "imports the test of [Article 101(3) TFEU] into [Article 102]".[138] Comparing with objective justification, efficiency defence additionally requires in paragraph 30(c) that the efficiency must be advantageous to the consumer as a new factor of assessment.

It is not clear whether the Commission will extend this efficiency defence to exploitative abuses in the near future. If so, then it is likely to be welcomed by the IG since the Pooling Agreement and the IGA have gained sufficient credits in the exam of consumer benefit under Article 101(3) TFEU (illustrated in 4.4.4.1 and 4.4.4.2). Just by legal analogy, the IG could mirror the tried-and-tested arguments to Article 102. Conversely, if there is no such reform in a short term, with respect to exploitative abuses, the IG could still rely on objective justification, which is robust enough to withstand the new investigation, as long as there is no material change of the minimum common level of cover.

5.3.3 Replace Sliding Scale Test with Balancing Test to Reinsurance Provisions

Under the parameter of exclusionary abuse, 4.5.2.3 also made mention of access to essential facility, *inter alia*, the reinsurance supply as the

[136] See *supra* note 12

[137] See *supra* note 110

[138] Gravengaard (2010)

special responsibility of the oligopolistic IG. The "sliding scale approach" to special responsibility established by a series of precedents before the EU judicature, nevertheless, made some controversy. It appeared to protect particular competitors much more than consumers.

This ambiguity is quenched by the 2008 Guidance's opening remark, which reiterates that "the Commission is mindful that what really matters is to protect an effective competitive process and not simply protecting competitors."[139] The 2008 Guidance does not follow the traditional methodology to make the division between refusals to supply good or services, intellectual property rights and access to essential facility. Instead, paragraph 81 sets down a new approach of universal applicability.

It could be inferred that the "sliding scale approach" to special responsibility is no more favoured by the Commission when the "balancing test" is established here. In the light of the new formula of greater clarity and certainty, no new deficiency is found to offset the quality of non-exclusionary abuse that has been affirmed by the Commission in its 1999 Commission Decision. Conversely, in the new balancing test that "the likely negative consequences to consumers must outweigh the negative consequences of a supply obligation to the dominant undertaking",[140] the identification (explained in 4.4.4.2) between the insurer and insured in the "consumer owned" business of P&I insurance will earn additional credits for the reinsurance provisions. Hence, it is not too ambitious to say that the amended reinsurance provisions will stay further away from the allegation of exclusionary abuse under Article 102 TFEU in the future.

[139] The 2008 Guidance, para 1

[140] *Ibid.* para 81(3)

5.4 Increasing Complex Regime of Oil Pollution Liability Underpinned by the IG and Ambivalent Environmental Consideration between 2004 Commission Guidelines and TFEU

5.4.1 Developing CLC and Fund Convention underpinned by the IG

During the past several decades, oil pollution has been centralised as the key risk in the shipping industry followed by the increasing size of tankers. The landmark case of *Torry Canyon*[141] in 1967 initiated international focus to make global compensation schemes for oil pollution damage and resulted in the CLC of 1969 and the Fund Convention of 1971. The CLC and the Fund Convention established channelling liability to the shipowner, its P&I insurer and the oil pollution fund financed by the oil companies. Furthermore, they were combined with some new protocols to form the revised version of 1992. The compensation regime of 1992 CLC and Fund Convention preliminarily satisfied ascending liability of oil pollution, notwithstanding further measures were provoked by a second milestone incident of *Erika*[142] in 1999.

Following the sinking of *Erika143*, the international liability and compensation regime (1992 CLC and Fund Convention) relating to persistent oil spills from tankers was reviewed by the clubs and the International Oil Pollution Compensation Funds (IOPC).[144] As the compromise between the IG and IOPC on the distribution of increasing liability, a new Supplementary Fund Protocol 2003 was approved and took effect from 2005 to "treble the amounts available for oil pollution compensation as compared with previous scheme."[145] Under the Supple-

[141] The Torrey Canyon was a supertanker capable of carrying a cargo of 120,000 tons of crude oil, which was shipwrecked off the western coast of Cornwall, England in March 1967 causing an environmental disaster. At that time, the tanker was the largest vessel ever to be wrecked. --http://en.wikipedia.org/wiki/Torrey_Canyon

[142] See *supra* note 129

[143] *Ibid*.

[144] See *supra* note 86, pp.181

[145] See *supra* note 1, pp.198

mentary Fund Protocol 2003, two agreements have been reached, namely, STOPIA 2006 and TOPIA 2006. On the side of the IG, a greater burden of oil pollution compensation is imposed by these two agreements. Minimum limit of the IG for small tankers under CLC is raised from SDR 4.5 million to SDR 20 million and 50% of the compensation from the Supplementary Fund will be indemnified by the tanker-owner members of the IG.[146] Also taking into account that the traditional "pay to be paid" rule is eroded by the prevailing direction action against the P&I insurer under CLC, the IG no doubt has over the years displayed flexibility and continues to play an unparalleled role in the increasing complex regime of oil pollution liability.

5.4.2 Ambivalent Environmental Justification to Minimum Cost for Tankers

In fact, the increasingly complex compensation scheme for oil pollution underpinned by the IG is not workable if it departs from the polluter pays principle, which has been institutionalised as the minimum cost for tankers in the IGA. However, the 1999 Commission Decision did not give a clear articulation of environmental consideration as a compelling justification to the minimum cost for tankers. It is interesting that earlier the same year in the *CECED*[147] case, the environmental benefit was recognised by the Commission, with the acknowledgement that the higher energy efficiency of new model would cause less pollution. This case ignited a theoretical contention as to whether environmental benefits could constitute "technical or economic progress" to balance against competition restraints, on which the 2004 Guidelines notwithstanding cast doubts. Literally, the 2004 Guidelines simply referred to "efficiency gains" but made no mention of the public interests justification like environmental or other social benefits. Considering the 2004 Guidelines was mostly rooted on case law and decision-making practice, silence on environmental consideration could be viewed as a

146 See *supra* note 86, pp.181

147 See *supra* note 16

departure from *CECED*[148] that did provide the exemption on environmental grounds. Protecting the environment is now a policy of the EU, but it is not entirely clear that the Commission should promote it at the expense of competition.[149]

Such a dim view to environmental consideration is concomitant to the doctrine of "pure economic efficiencies" that has been affirmed by the GC in *GlaxoSmithKline v. Commission*[150] later. However, it needs to be reappraised in a bigger picture when "Article 3(1)(g) of the Treaty of Rome, which establishes the maintenance of competition as a main activity of the Community" ,[151] has been deleted from the opening articles of the TFEU. Bearing mind that "Article 3(1)(g) has been cited by the ECJ in several seminal cases in the development of European competition law, including *Continental Can*[152] and *Crehan*[153], which concerned conflicting policy objectives" ,[154] it may not be sensational that the EU judicature could change their position regarding the priority of competition policy in the EU legal order when Article 3(1)(g) of the Treaty of Rome is no longer available. It was explicitly affirmed by the ECJ in *Eco Swiss China Time Ltd. v. Benetton International*[155] that "the provision of [Article 101 TFEU] may be regarded as a matter of public policy within the meaning of the New York Convention". Should competition policy is treated equally with the other public policies including environmental task before the EU judicature, "pure economic efficiencies" will not necessarily be accented as the highest ranking.

On the grounds that the TFEU has taken effect from December 2009, the conflicts between competition promotion and environmental protection may be brought into the open and it is imperative for the Commission to reconcile the policy boundaries. Korah suggests that "it

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148 *Ibid.*

149 See *supra* note 59, pp.94

150 See *supra* note 15

151 See *supra* note 26, pp.632

152 Case 6/72 [1973] ECR 215

153 Case C-453/99 [2001] ECR I-6297

154 See *supra* note 26, pp.632

155 Case C-126/97 [1999] ECR 1-3055

would be better to use [Article 106(2) TFEU] to reconcile conflicting [the EU] policies in relation to bodies entrusted with a task in the general interest because competition would then give way only to the extent necessary for the performance of the task" ,[156] to which the IG's operation under 1992 CLC is identical or comparable. The 1992 CLC stipulates that any shipowner of a tanker (≥2000 tons of oil as cargo) is required to maintain compulsory insurance or other financial security for pollution liabilities. This obligation is mostly fulfilled by effecting P&I insurance and obtaining a "Blue Card" issued by the IG's Club. Without the Blue Card, the CLC certificate cannot be issued by the authority and the shipowner will risk the detention of the vessel and criminal liability.[157] This being the case, the IG is entrusted with compulsory insurance for ascending oil pollution liability and thereby environmental consideration may provide a new alternative justification to the minimum cost for tankers in the third investigation the to the Pooling Agreement and the IGA.

5.5 Observations and Suggestions

5.5.1 Remaining Issue: Wide Margin Discretion on Amount of Release Call

After an overall appraisal of the altered legal environment relating to the Pooling Agreement and the IGA, a fundamental rectification of the whole system seems to be overreached. It is reasonable for the IG to hold cautious optimism with regards to the net result of the third Commission's competition investigation. The remaining competition issue lies in the rules relating to release call, which after modification was deemed as compatible with Article 101 TFEU by the previous two Commission Decisions but has received oft-repeated critiques from the shipping industry afterwards. The new concerns are raised as to the wide margin of discretion on the amount of release call enjoyed by the

156 See *supra* note 59, pp.94
157 See *supra* note 86, pp.180

IG Clubs. The prestigious insurance broker Tysers points out that "at the moment Clubs fix release calls at any figure they choose, with the current range varying from 0% to 30% in excess of any deferred call".[158] Arthur J. Gallagher calls into question alike that "over the past 10 years, we have seen release calls as low as 0% and as high as 40% on policy years of similar maturity".[159]

Release call levying is devised to fund the unbudgeted call arising on the policy year when the retiring member was in the Club. In the extreme case where there is no deficit in certain policy year, it is arguable to continue any release call levying. Even though release call levying *per se* was justified by the previous two Commission Decisions, the IG Club's exercise of this discretionary power on the call amount has not been addressed. It is vulnerable to the allegation of "apply[ing] dissimilar conditions to equivalent transactions" in Article 101(1) TFEU or "not indispensable" in Article 101(3). The divergence in approaches taken by the previous two Commission Decisions concerning whether the rules relating to release call should be directly justified within Article 101(1) or further exempted by invoking Article 101(3) (explained in 4.3.2.3) is no longer of practical importance under the post-modernised EU competition law regime. When the notification and authorisation system is abolished and Article 101(3) becomes directly applicable, Article 101(1) and Article 101(3) "may have been conflated and operated as if they were a single provision".[160] In the "self-assessment world", the IG bears the burden of proof to justify the rules relating to release call under Article 101 TFEU as a whole. When the rules relating to release call deviates from the proper functioning of the Pooling Agreement and causes ancillary restraints of competition (*e.g.* preventing the free flow of business to underwriters outside the IG), it will receive the commitment procedure prescribed by Article 9 of Regulation 1/2003, certainly, in the light of the latest ruling case of *Alrosa*[161].

[158] See *supra* note 20

[159] See *supra* note 125

[160] See *supra* note, pp.106

[161] See *supra* note 17

5.5.2 Enlightenment of Alrosa and Legal Advice

At the heart of the final judgment in *Alrosa*[162] that upholds the Commission's appeal and annulled the previous ruling of the GC, the ECJ has clarified that "the underlying administrative efficiency rationale and the participatory nature of commitment regime required application of a different, lighter standard in the judicial review of the proportionality of commitment decisions than that applied in the judicial review of prohibition decisions".[163] Under this leniency, the acceptable scope and means of commitments proposed by undertakings could be wider than the remedies that the Commission could impose in an infringement decision following a full length investigation. It means that in the new era with the adoption of Regulation 1/2003, the ECJ retains and develops its deferential position of judicial review to the Commission's "margin of appreciation", which was established by *Consten & Grundig*[164] as far back as 1960s.

Alrosa[165] carries substantial importance to the IG, which is, likewise, envisaged to offer the commitment in exchange for possible earlier termination of investigation. The Commission' extended discretion on Article 9 of Regulation 1/2003 assented by the ECJ's ruling and its flexible timing of the commitment decisions in practice drive the risk-averse undertaking to offer onerous conditions as far as it could to secure a commitment decision. Speculation on the Commission's action will be full of uncertainty. The Commission may always decide to conduct a full investigation with the aim of taking a prohibition decision if the settlement negotiations fail.[166] *Alrosa*[167] signals that under the EU judicature, it is legitimate, albeit probably not optimal, for the Commission in the new era with the adoption of Regulation 1/2003 to occupy a vantage position *vis-à-vis* the undertakings concerned and hence it is

[162] *Ibid.*
[163] See *supra* note 130, pp.148
[164] See *supra* note 20
[165] See *supra* note 17
[166] See *supra* note 130, pp.136
[167] See *supra* note 17

advisable for the IG to propose a "bullet-proof" commitment on the computation of the release call amount in order to be on the safe side. An operable solution is to set the ceiling, "perhaps based on 5% in excess of the average unbudgeted call made by each Club over a certain number of years".[168] Additionally, a reduction in number of policy years subject to release calls, at the moment three years, may be over-needed but the IG may consider offering such a half-hearted proposal for securing a commitment decision.

6 Epilogue

In the world's P&I insurance market, the IG is a long-standing oligopoly of *fait accompli* owning to large economies of scale. The IG Clubs achieve and maintain such collective dominance via the Pooling Agreement and the IGA that fall into the application scope of Articles 101 and 102 TFEU simultaneously. However, it should be clarified that the Pooling Agreement and the IGA are merely ancillary restraints to competition rather than hard core cartels. It is the starting point for analysing what treatments the IG has received and will receive under EU competition law.

For the sake of a watertight argument, firstly, additional analyses to non-profit making basis and non-binding recommendation of the IG based on case law are incorporated into assessment part of the previous two Commission Decisions.

It is highlighted that under the old regime of Regulation 17/62, the Commission was prone to directly invoke Article 101(3) TFEU in its 1985 Commission Decision due to the exclusive competence of the Commission on granting exemption and the IG's questionable alternative pleading for negative clearance or exemption. Comparatively, the Commission in its 1999 Commission Decision gave a more cogent legal reasoning under Article 101(1) TFEU that applied the counterfactual test and differentiated between the level of claim sharing and the level

[168] See *supra* note 20

of retention. The minimum common level of cover and rules relating to release call, after modification were deemed compatible with Article 101(1) TFEU while the practices of restricted quotation and minimum cost for tankers insofar as the retention level were left to be further examined under Article 101(3). The narrowed application scope of Article 101(3) TFEU to the Pooling Agreement and the IGA was of practical importance to the burden of proof under the notification and authorisation system. The IG's onus to acquire the redeeming virtues upon Article 101(3) TFEU was partly relieved by the Commission in its 1999 Commission Decision.

Even though the Commission in its 1999 Commission Decision stated that it was not clear from case law whether the insurance block exemption could also cover the Pooling Agreement and the IGA, it should be remarked that in fact the narrow approach to block exemption had been established before the EU judicature and consequently Regulation 3932/92 could only be construed rigidly. When Regulation 3932/92 was not applicable to the oligopolistic IG, the individual exemption was the final treatment to the Pooling Agreement and the IGA, *inter alia*, the practices of restricted quotation and minimum cost for tankers.

In relation to the appraisal of four conditions for providing the individual exemption to the practices of restricted quotation and minimum cost for tankers, both the 1985 and 1999 Commission Decisions had certain deficiencies in legal reasoning. On the point of "contribution to economic welfare", the 1985 Commission Decision virtually shifted the argument to "indispensability of restriction" and made a dubious conclusion that simply equated "maintenance" of P&I insurance operation with "improvement" of insurance service. The 1999 Commission Decision discussed "promotion of economic progress", whereas the argument did not centre on the level of retention but rushed back to the level of claim sharing paradoxically. Such a digression also existed in the appraisal of "fair share of benefit to consumers" by both Commission Decisions.

A fair conclusion could be drawn from the feast or famine cycle of insurance premium and the "at cost" principle of P&I insurance. The

restricted quotation and minimum cost for tankers, even on the retention level, endow the supply of P&I insurance with predictability and stability, create incentives for loss prevention and consequently better safety performance by the shipowners at sea. Less damaging incidents occur in seaborne trade, the economic process enjoys more efficiency.

On the point of "indispensability of restriction", the 1999 Commission Decision discussed indispensability of restriction mainly on the side of necessity while the 1985 Commission Decision shed more light on the side of proportionality. Different approaches lead to the same conclusion, nevertheless, had both sides been combined, a more cogent argument might have been provided by the Commission.

On the point of "non-elimination of competition", it is laudable that the 1999 Commission Decision recognized that "dominant position" in Article 102 TFEU cannot be read intuitively as the synonym for "elimination of competition" in Article 101(3) TFEU and price rivalry is not the fundamental competition in the P&I insurance market, where service quality carries weight in the competitive process. Regrettably, both Commission Decisions made no allusion to the unique calls levying system of P&I insurance, under which quotation in advance is not final binding and hence cannot determine the premium competition single-handed. Taking supplementary calls into account, it is not a corollary for the practices of restricted quotation and minimum cost for tankers to eliminate competition in the context of actual total calls.

In relation to the application of Article 102 TFEU to the Pooling Agreement and the IGA, the 1999 Commission Decision made a relatively simple discussion with no reference to the approaches adopted. Actually, before the 2008 Guidance, the methodology of implementation of Article 102 TFEU was led by case law. A series of precedents are incorporated and annotated to help understand the Commission's reasoning. "Objective justification" was tacitly adopted by the Commission to the minimum common level of cover with respect to non-exploitative abuse. The doctrine of "access to essential facilities" as the "special responsibility" was also utilised by the Commission in the assessment of the reinsurance provisions with respect to non-exclusionary abuse.

These approaches distilled from the bygone authorities may be in tension with the modernised 2008 Guidance from today's perspective but they indeed offered useful notions to deal with different situations like the case of the IG at that time.

Looking ahead, the prospects of the Pooling Agreement and the IGA under the reopened Commission's competition investigation cannot be provided without the analysis of altered legal environment. First and foremost, the modernised Regime of Regulation 1/2003, having far reaching impacts on the implementation of Article 101 TFEU, has been established to replace the old system of Regulation 17/62. To the IG, it means that the individual exemption under the notification and authorisation system is no longer available and meanwhile the internal order of application between Article 101(1) and Article 101(3) TFEU is no longer of practical importance. Under Regulation 1/2003, the self-assessment of the compatibility of the Pooling Agreement and the IGA with Articles 101(1) and 101(3) TFEU must now be completed as if the two Articles were conflated.

The renewed insurance block exemption, Regulation 267/2010, is still of no help. It can be inferred from the harsher formula of market share in Regulation 267/2010 that the bias of block exemption against the oligopolistic IG is even aggravated. On these grounds, the Pooling Agreement and the IGA as the ancillary restraints of competition are envisaged to receive the commitment decision, which inherits the negotiated settlement procedure at the time of Regulation 17/62 and is codified as Article 9 of Regulation 1/2003.

Meanwhile, the publication of the long awaited 2008 Guidance shifts the application of Article 102 TFEU from formalistic to economic-focused. Some new factors of assessment are introduced and available to the IG. "Efficiency defence" could be a proper substitute for "objective justification" to the minimum common level of cover and "balancing test" would replace "sliding scale test" to the reinsurance provisions. Under the parameter of the 2008 Guidance that places emphasis on the protection of consumers rather than competitors, the Pooling Agreement and

the IGA will stay further away from the allegation of dominant abuse.

One interesting issue sidestepped by the 1985 and 1999 Commission Decisions is the environmental justification for the minimum cost for tankers. The increasing complex compensation scheme to oil pollution underpinned by the IG cannot work if it deviates from the polluter pays principle and accordingly it is conceivable for the minimum cost for tankers to obtain environmental justification. However, it is still hard to reach a clear-cut conclusion in view of the ambivalence between the 2004 Guidelines and the TFEU on this point. Hopefully the policy conflicts between competition promotion and environmental protection may be reconciled by the invocation of Article 106(2) TFEU considering the IG's Clubs are entrusted with compulsory insurance of "general economic interest".

After an overall appraisal of the altered legal environment relating to the Pooling Agreement and the IGA, a fundamental rectification of the whole system seems to be excessive. It is reasonable for the IG to hold cautious optimism on the net result of the third Commission's competition investigation. The remaining issue lies in the rules relating to release call, which after modification was deemed to be compatible with Article 101 TFEU by the previous two Commission Decisions but has received repeated critiques from the shipping industry afterwards. The new concerns are raised as to the wide margin of discretion on the amount of release call enjoyed by the IG Clubs.

The latest leading case of *Alrosa* providing interesting guidance on Article 9 procedure carries substantial importance to the IG, which is likely to offer the commitment when the problem of the rules relating to release calls is materialized. The ECJ's ruling of *Alrosa* signals that in the new era with the adoption of Regulation 1/2003, the Commission still enjoys a "margin of appreciation" established as far back as 1960s in practice of decision-making. Particularly in the commitment procedure, it will drive the risk-averse undertaking to offer onerous conditions as far as it could secure a commitment decision. Therefore, it is advisable for the IG to propose a "bullet-proof" commitment on the computation of the release call amount in order to be on the safe side.

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Abbreviations

CEA Comité Européen des Assurances (Insurance Europe)

CLC International Convention on Civil Liability for Oil Pollution Damage of 1969 (as Amended by Protocol of 1992 and Renamed International Convention on Civil Liability for Oil Pollution Damage of 1992)

DG Comp Directorate-General of the Commission Responsible for Competition Policy

EC European Community

ECJ European Court of Justice

ECR European Court Reports

EEC European Economic Community

EU European Union

Fund Convention International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage of 1971 (as Amended by Protocol of 1992 and Renamed International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage of 1992)

GC General Court

IG International Group of P&I Clubs

IGA International Group Agreement

IPOC International Oil Pollution Compensation Funds

OJ Official Journal of the European Communities

P&I Protection and Indemnity

Pooling Agreement International Group Pooling Agreement

Regulation 17/62 Council Regulation (EEC) No 17 of 6 February 1962: First Regulation Implementing Articles 85 and 86 of the Treaty

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Regulation 267/2010 Commission Regulation (EU) No 267/2010 of 24 March 2010 on the Application of Article 101(3) of the Treaty on the Functioning of the European Union to Certain Categories of Agreements, Decisions and Concerted Practices in the Insurance Sector

STOPIA Small Tanker Oil Pollution Indemnification Agreement of 2006

TOPIA Tanker Oil Pollution Indemnification Agreement of 2006

TFEU Treaty on the Functioning of the European Union

Treaty of Rome Treaty Establishing the European Economic Community

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Duty of Disclosure in English and Norwegian P&I Contracts

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Innhold

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1 Introduction

The focus of this paper is the contractual regulation of the duty of disclosure. The text provides a comparative look at the regulation of this duty in protection and indemnity ("P&I") insurance contracts. This text analyses the insurance contracts applied by the two largest P&I clubs located in England and the two P&I clubs located in Norway.

P&I clubs are associations offering P&I insurance to shipowners. P&I insurance covers primarily liabilities of the insured shipowner, but in certain circumstances also covers loss, damages and incurred expenses.[1] P&I insurance is provided by mutual P&I clubs, which are a form of co-operative association, where the assured also becomes a proportional owner of the association. The insured shipowners are therefore typically referred to as Members. As will be explained in the text, the concept of mutuality in P&I insurance has developed in order to provide shipowners with economically efficient insurance. The insurance provided is cheaper due to the fact that the mutual P&I clubs are not run with a view of making maximal profit. Rather they are owned and managed by the assured shipowners with a view of providing cheap and efficient insurance. The mutuality concept was further developed when the leading P&I clubs agreed a framework of agreements ensuring similarly economical re-insurance arrangement. This co-operation is governed by the International Group of P&I clubs. The mutuality and international sharing of losses requires that all participating P&I clubs offer insurance covers under same conditions.

Duty of disclosure is a legal requirement obliging the contractual parties to volunteer all information relevant to the insurance agreement to the other contractual party. The need for a duty of disclosure in P&I insurance contracts follows from the fact that the assured shipowner has a much better access to information regarding his vessel than the insurer of the vessel. This imbalance of information is both inequitable

[1] Falkanger T., Bull H.J. and Brautaset L, Scandinavian Maritime Law: The Norwegian Perspective (3rd ed., Universitetsforlaget, Oslo 2011), p 558.

and economically inefficient, and therefore needs to be regulated. Furthermore, the mutually responsible shipowners wish to ensure that they will not be financially liable for the unacceptable risks. The duty of disclosure therefore obliges shipowners to disclose all particulars concerning their vessel to the insurer.

This text will analyse the requirements laid down in the contracts of insurance of Norwegian and English P&I clubs. Such a comparative analysis provides an understanding of the convergence and divergence of the rules applied by the selected clubs in the two jurisdictions. There are three basic motivations for a discourse on this topic. Firstly, the detailed understanding of the disclosure requirements provided in this text is of practical importance for a shipowner entering a contract of insurance in one of the clubs. The comparative analysis will explore whether entry with either of the clubs, or in either of the jurisdictions, carries any form of benefit for an assured shipowner. Secondly, an analysis of disclosure requirements is of interests in light of the International Group's framework of agreements. This framework requires, inter alia, all participating P&I clubs to provide insurance under similar conditions and requirements. This text aims to investigate whether this holds true for the requirements of the duty of disclosure. Thirdly, the text contributes to the discourse on P&I rules applicable in Norway. This is of practical significance due to a rather limited amount of texts dealing with P&I insurance in light of Norwegian and English law.

The text is structured into five chapters, which should provide a clear and concise approach to the main issues. In Chapter 2 the text introduces the legal sources applicable in respect of the duty of disclosure in P&I insurance contracts. It is explained that while Norwegian P&I clubs rely on the insurance contract as the main source of law, the English P&I clubs' contracts are silent on the issue and it is therefore regulated by the pertinent statute. In this part of the text it is discussed what constitutes the relevant background law for the purpose of Norwegian P&I contracts, as this maybe unclear due to an express exclusion of the generally applicable Norwegian Insurance Contracts Act. Chapter 3 provides an introduction and background to the functioning of the

P&I insurance market. For this purpose a presentation of the historical development of P&I clubs and of the framework of international co-operation of P&I clubs is given. The background information also includes a presentation of the risks covered by P&I insurance, the standard manner of concluding P&I insurance contracts as well as the parties to the contract. Chapter 4 explores the principal legal issues within the duty of disclosure. In particular it is explained how the different jurisdictions establish what information is subject to disclosure and what legal tests are applied in establishing this. A presentation of some practical examples of information that has to be disclosed by the shipowner also follows for both jurisdictions. An inherent qualification of every duty are remedies available to the innocent party in case of a breach and therefore these are also presented in Chapter 4. Chapter 5 will conclude the discussion and it will be submitted that the regulation of the duty of disclosure is to a large extent convergent, however could be simplified by a direct regulation in the insurance contract of English clubs.

2 Legal Sources

2.1 English law

2.1.1 Legislation

In the context of English law the most important statute applicable in marine insurance is the Marine Insurance Act 1906 ("MIA"). The MIA provides, *inter alia*, in Section 85 that:

> "(3) The provisions of the Act, insofar as they may be modified by the Agreement of the parties, may in the case of mutual insurance be modified by the terms of the policies issued by the Association, or by the rules and regulations of the Association.

> (4) Subject to the exceptions mentioned in this Section, the provisions of this Act apply to a mutual insurance."

These provisions reflect the tradition of English law to accord wide negotiation freedom to individual contractual parties. As mentioned briefly above, this contractual agreement in P&I insurance will be between the assured, also known as Member, and the legal personality of the insuring P&I club.[2] This means that the provisions of the agreed contract will, as a general rule, form the primary source of the legal relationship between the parties.

The MIA was drafted in the beginning of the 20th century as a codification of the existing common law and did not envisage reforming the law applicable at the time. Bearing this intention in mind, as well as the time of the Act's drafting, one ought to view the Act's individual provisions with caution for three reasons. Firstly, the Act codified the law relating to business practice in marine insurance as exercised at the turn of 19th and 20th century. Since this time significant changes in the daily commercial practice have occurred and it therefore needs to be remembered that the Act refers to superseded concepts and forms of dealing. Secondly, although the Act enshrines the most important and most common legal concepts, it is not full exhaustive. In pursuing correct legal understand one therefore needs to be aware of other legal sources. One ought to remember that principles stemming from predating case law remain applicable. Importantly, one has to look to subsequent judicial opinion clarifying MIA's individual provisions. Thirdly, as explained above, the presumptions laid down in the Act's provisions operate only to the extent that they are not contrary to agreements between the parties.[3]

According to this provision, where a conflict between express provisions of the P&I club rules and the Act occurs, the club rules prevail. However, if the Rules provide no regulation the provisions of the Act

[2] This should be contrasted with the historical functioning of the mutual P&I clubs, where Members concluded contracts with each other as physical persons.

[3] Merking R., Marine Insurance Legislation (4th ed., Lloyd's List Group, Lodnon 2010), p.xliv.

will be applicable to the insurance contract. In other words, the P&I club Rules do not cover the entire ground with regard to cover and exceptions[4], but in absence of contractual regulation the MIA applies between members and the club.[5] In the context of this paper, this is particularly applicable to the regulation of the duty of disclosure and the laws of warranties. These issues are often unregulated in the Rules and the provisions of MIA will therefore be of relevance.

2.1.2 English P&I Contract Rules and Statutes[6]

By purchasing P&I insurance the shipowner contracts with the P&I club under the P&I Rules. This means that the P&I rules form the basis of the contractual relationship and will be the primary legal source. As a general rule, there is a basic division of the legal documents produced by all P&I clubs into two categories, namely statues[7] and rules.
Statutes are in place for the regulation of the P&I club as a mutual association. They serve the purpose, *inter alia*, of governing the relationship between members as the owners of the association.[8] Issues such as voting rights, functioning of the board of directors, membership regulation and the purpose of the mutual association are dealt with in the statutes of a P&I club. An illustration of a statute can be found in Gard's Article 3, which sets out the purpose of the association in the following manner:

> "The purpose of the Association is to offer insurance to Members predominantly on a mutual non-profit making basis. However, this does not restrict the Association from offering, as an adjunct to its

[4] See the reasoning of Lord Denning M.R. in relation the applicability of the Marine Insurance Act 1906 in *Comapnia Maritima San Basilio S.A. v. The Oceanus Mutual Underwriting Assoociation (Bermuda) Ltd. (The "Eurysthenes")* [1976] 2 Lloyd's Rep. 171.

[5] Hazelwood S.J., P&I Clubs Law and Practice (3rd ed. LLP, London 2000), p.59.

[6] For the purpose of this text the P&I contract of the two largest English clubs were scrutinised, namely UK P&I club and North of England P&I club.

[7] These are sometimes referred to as Bye-law or Articles of Association.

[8] Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p.11.

> core business, ancillary insurance on a non-mutual, fixed premium basis to certain categories of assured. In particular, charterers and mobile offshore units are insured on fixed premium basis."[9]

Rules, on the other hand, regulate the rights and obligations of the association members in their position as assureds.[10] Rules govern issues such as the extent of the insurance cover, conditions of cover, termination and cesser of entry, etc. The framework of the Rules is governed by the basic principle of mutuality, i.e. the mutual sharing of all costs of liabilities, losses and costs incurred by each member in connection to the operations of ships entered in the association. Mutuality is reflected in the principle that the Rules as well as terms and extent of cover are decided by the members of the association prior to the inception of each policy year.[11] An example of a practical outcome of the mutuality principle is the classification requirement laid down in Rule 8 of Gard's Rules. In this case the mutually responsible members understood that, in the absence of such a requirement, unclassified vessels would represent unacceptable financial risk.[12]

2.2 Norwegian Law

2.2.1 Legislation

In Norway insurance contracts are in general governed by the Insurance Contracts Act 1989. The general rule laid down in the Insurance Contracts Act is its mandatory application to all insurance contracts[13]. However, section 1-3(c) and (e) stipulates an exception to this general

[9] Article 3, Gard Statutes.

[10] Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p.11.

[11] *Ibid.*

[12] *Ibid.*

[13] Section 1-3. The only section which remains mandatory in all cases, i.e. also for the commercial activities falling into the above named exception, is section 7-8 relating to liability insurance. This section enables a third party to bring a direct action against the insurer when the assured is insolvent and thereby to sidestep the generally applicable "pay to be paid" rule.

rule in relation to commercial activity performed by ships that have to be registered according to the Maritime Code[14] and to commercial activity dealing with the international carriage of goods respectively.

The legislator allowed the exception for shipping insurance based on several reasons[15]. Firstly, marine insurance relates to vessels of high value exposed to high risk and carries highly professional characteristics. Secondly, a strict Norwegian national regulation of insurance contracts would not be suitable for the international field of marine insurance. Thirdly, the actors within marine insurance co-operate on the development of the Norwegian Marine Insurance Plan which is applicable to general marine insurance. As will be discussed below, this standard document carries characteristics of legislation and therefore supplements the traditional position of legislative regulation.

2.2.2 Norwegian P&I Contract Rules and Statutes

In Norway one finds two P&I clubs, namely Assuranceforeningen Skuld in Oslo and Assuranceforeningen Gard in Arendal. Identically to the English P&I clubs the two Norwegian P&I clubs provide their members with Rules and Statutes, which govern the contractual relationship between the two parties. Norwegian P&I clubs provide specific Rules dealing with the issue of jurisdiction and governing law. They stipulate that Norwegian law is applicable, however with the exception of the Insurance Contracts Act, which is not to be applied. Specifically, Gard's Rule 90 provides,

> "The legal relationship between the Association and the Member shall be governed by these Rules and Norwegian law, but the provisions of the Insurance Contracts Act of 16th June 1989 shall not apply."

And Skuld's Rule 47.3 provides:

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14 Norwegian Maritime Code of 24 June 1994 (no 39).

15 Norges Offentlige Utredninger (NOU) 1987: 24 p.40-41, as paraphrased in Wilhelmsen T-L. and Bull H.J., Handbook in Hull Insurance (Gylendal, Oslo 2007), p.27-28.

> "The Rules and any arbitration proceedings shall be governed by Norwegian Law, except that the Insurance Contracts Act of 1989 shall not apply."

The express exclusion of the application of the Insurance Contracts Act is due to the generally wide scope of application of the Act which includes consumer life and property insurances and makes it unsuitable for marine insurance. The Insurance Contracts Act is considered particularly consumer friendly and not particularly suitable for the relationship of two professional commercial parties. The express exclusion ensures that there does not remain any doubt as to the application of the Act.

2.2.3 Background Law to Norwegian P&I Rules

The legal relationship between the Member and the P&I club is governed by the express provisions of the contract they have entered into. In practice this means that the relationship will be governed by the Rules of the P&I club, unless some particular exceptions are specifically agreed between the two parties. The Rules of both Norwegian P&I clubs provide that Norwegian law will govern the insurance contract, yet at the same time they provide that the Insurance Contracts Act will not be applicable. This lead s to the question what one may consider Norwegian law in the absence of Insurance Contracts Act? The following Chapter will discuss this question and submit that the Norwegian Marine Insurance Plan is a suitable document for this purpose.

As a starting point all Norwegian statues, codes, regulations, preparatory works as well as previous court decisions can serve as guidance for Norwegian courts in interpreting the P&I contract. However, upon a closer look one finds that few suitable statutes or regulations are found. This is due to the fact that the Norwegian marine insurance sector has traditionally been regulated by the Norwegian Marine Insurance Plan which supplemented the need for formal legislation. General marine insurances in Norway have traditionally been effected on the conditions of the NMIP and although it does not cover P&I insurance as such, it is submitted that there are strong arguments to consider it as the applica-

ble background law for the purpose of the Norwegian P&I conditions.

The plan is not a statutory document of the Norwegian Parliament, but rather it is a standard document agreed by the Norwegian marine industry. It has a long tradition dating back to 1871, but has since been regularly revised and brought up to date. The NMIP underwent the last major redrafting which included structural changes in 1996. Since it has been amended in regular intervals and the currently applicable version dates back to 2010.[16] The NMIP is a unique document with specific characteristics that need to be carried in mind when considering its legal status.[17]

Firstly, the NMIP is a document negotiated and drafted by a special committee including all stakeholders within the Norwegian marine insurance industry. The committee includes representatives of shipowners, insurers, academics as well as an average adjuster. This is unlike other standard documents applicable in the marine insurance industries, which are traditionally drafted by the insurers only. The representation of different interests as well as the requirement to make concessions ensures that the NMIP is a balanced document and is not perceived as being favourable to a particular party. Secondly, the NMIP has a unique structure and construction compared to standard contracts in other industries. It provides comprehensive regulation of all aspects of marine insurance and is therefore much more similar to ordinary legislation than to other standard contracts. The wide scope of the plan has ensured that it is frequently used by actors across all marine insurance sectors. Thirdly, the NMIP is supplemented by an extensive publicly available commentary providing guidance to the meaning of individual provisions and clauses of the plan.[18] This commentary carries many similarities to preparatory works of parliamentary legislation. It is dis-

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16 This will be superseded by a new Nordic Plan on 1.1.2013. For more info see http://www.nordicplan.org/

17 Wilhelmsen T-L. and Bull H.J., Handbook in Hull Insurance (Gylendal, Oslo 2007), p.28.

18 It "shall ... carry more interpretative weight than is normally the case with preparatory works." This imperative and convincing status of the commentary was also affirmed by the Norwegian courts.

cussed, negotiated and approved by all stakeholders represented in the drafting committee.

The NMIP is a form of privately agreed contract document and not traditional legislation. This means that as a starting point the NMIP is not applicable to insurance policies *per se.* As a general rule, it ought to be expressly provided for by the contractual parties if the NMIP is to be applied. However, there are good arguments in supporting the application of the NMIP as background law for the purpose of interpretation of the P&I contracts.

Firstly, this view is supported by the P&I clubs themselves. Gard's own publication Guidance to the Statutes and Rules provides that Norwegian courts are likely to follow the provisions of the NMIP, as well as its commentary, in interpreting provisions of marine insurance contracts. This is particularly likely where the P&I Rules use expressions that are defined in the NMIP, but which do not have a clearly established meaning under general law.[19] Given the particular characteristics of the NMIP it can be argued that the application of the NMIP to the P&I insurance contract can be implied by the actors in the marine insurance industry. This position is supported by the perception of the NMIP as a well-balanced document with a strong position in the Norwegian marine insurance market.[20]

The application of the NMIP is further supported by the historical development of P&I Rules of the Norwegian clubs. At inception both Norwegian P&I clubs developed their Rules independently. However, the importance and acceptance of the NMIP as a leading document across all marine insurances in Norway was confirmed in 1964 when P&I regulation was integrated into the plan. Here it was also provided that the provisions of general application in the NMIP should apply as background law for P&I insurance.[21] This was confirmed in legal theory

19 Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p. 455.

20 Wilhelmsen T-L. and Bull H.J., Handbook in Hull Insurance (Gylendal, Oslo 2007), p. 29.

21 Commentary to the 1964 NMIP, as quoted in A. Lund, Partsforhold og medforsikringsformer i P&I forsikring, 2010, LLM thesis delivered at University of Oslo. p.13.

when it was stated that there is "not much doubt that NMIP in its entirety should be used as declaratory background law for an agreement on marine insurance for seagoing vessels."[22] The internationalisation of the P&I market and the requirements of the International Group however lead to the P&I insurance separating from the NMIP again in 1996. This separation was due to a requirement of higher flexibility of Rule changes and should not to be interpreted as creating a cessation of the application of the general conditions of the NMIP to P&I insurance. This follows from the understanding of the P&I clubs as described above.

It can therefore be submitted that case of discrepancies, uncertainties and lack of definitions the NMIP will fill the position of background law, despite not being an official statute of the Parliament, and will be applied for interpretation purposes.

2.3 International Legal Sources

2.3.1 The International Group Agreements

Leading international P&I clubs co-operate through the body of the International Group of P&I clubs. The agreements reached by the clubs of the International Group are applicable to all clubs participating in this arrangement. All four clubs analysed in this text are members of the International Group and signatories to the International Group agreements. In relation to the International Group there are two key agreements which impact the individual clubs; namely the International Group Agreement and the Pooling Agreement.

The International Group Agreement sets out the regulations applicable in cases where shipowners wish to switch insurance cover from one club to another as well as how individual clubs ought to quote insurance rates. It furthermore obliges P&I clubs to disclose and share certain information.[23]

[22] Translation of Professor H.J.Bull's quotation as in *Ibid*.

[23] For example ration of their operating costs to their premium and investment income. See the International Group Agreement at www.igpandi.org/downloadables/2150736_v4-International_Group_Agreement.pdf

The Pooling arrangement allows the clubs to provide efficient and economically advantageous insurance. In practice it provides the P&I clubs with the cheapest possible re-insurance. The clubs cover losses of up to the 8 million USD retention level and claims exceeding this amount are shared among all International Group members proportionally to their size. The consequence of sharing losses is that the risks covered by individual clubs should be identical and individual club rules should be consistent. If this was not the case individual clubs would not have incentives to limit their financial exposure. The clubs actively co-operate on the amendments of existing rules and on the development of new provisions. The Pooling Agreement also stipulates that in cases where an individual club has a rule not approved by the other clubs, and this rule grants benefits beyond the ordinary, the club may be deprived of the benefits of the Pooling Agreement.

These agreements are important for the purpose of this paper for two reasons. Firstly, the legal framework stemming from the initiative of the International Group requires the individual P&I clubs to provide insurance on the conditions of identical character and extent. P&I clubs which would wish to provide cover outside of the stipulations of the International Group framework would risk losing re-insurance cover. Secondly, the framework is of interest in the examination of the appropriate interpretation of the P&I contracts of the Norwegian clubs.

2.4 Interpretation of P&I Contracts in Light of the International Group Framework

The issue to be explored in this sub-chapter relates to interpretation of individual P&I Rules and to what extent this ought to be affected by the framework of the International Group. Problems may arise in relation to legal concepts which are traditionally present in English or Norwegian insurance law, but are not found in the other.[24]

[24] A practical example is the Norwegian distinction between "person effecting insurance" and "assured", which is not found in English law. See in A. Lund, Partsforhold og medforsikringsformer i P&I forsikring, 2010, LLM thesis delivered at University of Oslo. p.15

As a starting point it must be stated that general Norwegian rules on the interpretation of contracts are to be applied to the P&I Rules. This follows from the application of Norwegian law to the Rules. However, there are some special features of the P&I Rules which give the contract special characteristics.

As was explained above, both Norwegian P&I clubs have entered the contractual framework set out under the International Group. This was done primarily in order to obtain economically beneficial re-insurance cover. As signatories to the Pooling Agreement the P&I clubs have agreed that their Rules be given identical interpretation to the Rules of other members of the International Group. This follows from the earlier described principle that International Group P&I clubs share loss excess and that therefore they ought to provide identical cover. Hazelwood explains the interpretation issue as follows; "[P&I club) Rules and the scope of the club cover should not only be similar in character but should also receive similar or consistent interpretation by all the clubs of the International Group."[25]

Furthermore, Skuld publishes its Rules exclusively in English language and Gard refers in its Guidance to Statutes and Rules repeatedly to non-Norwegian sources of law. This should be seen as a reflection of the intention to interpret the Rules in accordance to similar international regulations and judicial decisions.[26] In practice this means that the relevant provisions of the International Group framework ought to be given appropriate weight in the interpretation of the Norwegian P&I Rules. The International Group framework and the intention to reach a uniformity of insurance provided within the International Group also allows courts to look at market practice, as well as interpretation practice, which is applied by other members of the International Group. In accord with other writers[27] it is submitted that the Rules of other P&I

[25] Hazelwood S.J. and Semark D., P&I Clubs Law and Practice (4th ed., Lloyd's List, London 2010), p. 371.

[26] A. Lund, Partsforhold og medforsikringsformer i P&I forsikring, 2010, LLM thesis delivered at University of Oslo. P.14

[27] *Ibid*.

clubs should be applied as an interpretation aid in understanding the proper meaning of P&I Rules of Norwegian clubs.

3 P&I Insurance

3.1 Introduction

The following chapter is an introduction to the P&I insurance in more general terms. It will present the historical development of mutual P&I clubs. This historical background serves as an illustration of the risk management applied by shipowners and it underlines the need for a legally enforceable requirement of disclosure in ensuring a sustainable mutual insurance association. Although, modern P&I clubs have access to numerous sophisticated financial instruments to secure financial exposure, they have opted to re-insure their risks through a mutual arrangement. This mutual arrangement of the International Group will therefore also be introduced. Also in this chapter, it will be explained what risks are usually covered under the P&I insurance and how one concludes a contract of P&I insurance.

3.2 Origins and History of P&I Clubs

By its own nature any marine undertaking includes a major element of risk. Vessels are subject to many risk factors including weather and sea conditions, perfidious locations, technical complexity and human error. An accident on the seas, a collision of vessels or any other marine casualty has a potential of developing into tragic consequences with very high costs[28]. Commercial reason leads those participating in shipping and marine undertakings to limit their risk exposure. The earliest examples of risk management and risk-sharing can be found in ancient

[28] For example the costs of the casualty of Costa Concordia have been estimated at around 1 billion USD. http://www.bloomberg.com/news/2012-01-23/concordia-cruise-ship-insurance-costs-may-reach-1-billion-moody-s-says.html

China. Chinese river merchants commonly distributed their cargo over several vessels or alternatively agreed to load half of their cargo on each other's vessel.[29] This practice later developed into organised associations, clubs, guilds and societies.

A particular development was the development of hull clubs. These clubs came into existence in the early 18th century and were mainly set up by shipowners from outlying English ports. The hull clubs had a very local character and were particularly suited for the local commercial network within the shipping industry. These small clubs operated mutual insurance schemes, which were developed by general agreement of the clubs' own members and required minimal operational and administrative expenses. This meant that the clubs provided an economical risk management solution. The cost efficiency and flexibility were the largest advantage of the locally administered hull clubs. However, they also suffered from a range of drawbacks and limitations. The local character of the clubs meant that it was impossible to grow without accepting vessels from unknown shipowners. Acceptances of such ships lead to acceptance of unknown risks that had a real potential of developing into expensive casualties. This problem is an early reflection of the issues associated with acceptance of unpredictable risks.

In 1836 the judgement of the landmark case of *De Vaux v Salvador30* was laid down by the English judiciary. The consequence of this decision was a significantly increased liability exposure of the shipowners. As a result of these developments the first mutual protection club, the Shipowners' Mutual Protection Society, was founded in 1855.[31]

3.3 P&I Clubs in Norway

The mutuality insurance model used by English shipowners was soon discovered by shipowners in Norway. Similarly to the English market, also in Norway the P&I clubs evolved from previously existing hull

[29] Hazelwood S.J., P&I Clubs Law and Practice (3rd ed. LLP, London 2000), p.1.

[30] (1836) 5 L.J. (K.B.) 134.

[31] Historical facts and developments paraphrased from Gold E., Gard Handbook on P&I Insurance (5th ed., Gard, Arendal 2002), p.67.

clubs. Assuranceforeningen Skuld was the first P&I club established in Norway. It was only a few years later that the managing director of the Arendal Hull Club founded Assuranceforeningen Gard. In the early years Norwegian clubs focused on providing mutual cover solely to Norwegian shipowners and their results have therefore mirrored the fortunes of the Norwegian shipping industry. Particularly difficult times came during the Second World War when the membership of both clubs was severely reduced. However, the rapid growth of the Norwegian shipping industry in the period 1950-1975 as well as the opening of the clubs to the international market has secured their strong position in the 20th and 21st century.[32] In respect of the international expansion it became crucial for Norwegian clubs to ensure that their underwriting portfolio remained stable and they did not accept extensive risks from foreign shipowners. Norwegian underwriters did not possess the same extensive knowledge of the international market as they had of the Norwegian market and therefore duty of disclosure rules played a crucial role. These legal rules guaranteed them disclosure of relevant risks as well as protection from unknown and unforeseen risks. Both Norwegian clubs were very successful in their international ventures and at present Gard is the largest P&I club in the world and Skuld is among the fastest growing ones.[33]

3.4 The History of P&I Club Co-Operation

The costs and liabilities to be covered by P&I clubs following serious vessel accidents can amount to extraordinarily high sums.[34] Theoretically the clubs would have two basic options of covering these claims.

One option would be to calculate the risk of an unexpectedly large expense into all insurance policies and charge very high premiums. This would allow the club to build large reserves which would help cover costly casualties. However, such an arrangement would lead to

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32 Gold E., Gard Handbook on P&I Insurance (5th ed., Gard, Arendal 2002), p. 68.

33 http://www.lloydslist.com/ll/sector/Insurance/article405484.ece

34 See footnote 1.

high insurance policy cost without knowing when, if and to what extent the reserves will be required. It would also be uneconomical for the P&I club to "sit" on large capital reserves which would have to be readily available at any given point.[35]

The second option would be to ask all members to make extraordinary emergency contributions and supplementary payments in case of an unpredictably costly accident. This means that at the end of a financial year shipowners may be asked for substantial extraordinary contributions in order to settle the reserves balance of the club. This option has the negative effect of making it impossible for shipowners to predict how much money will be spent on insurance covers any given year. In fact, this was the reason behind the collapse of many hull clubs where members were not able to meet large emergency or supplementary costs.[36]

To avoid the negatives of the two aforementioned options the P&I clubs decided to co-operate together in a system of mutual reinsurance. This means they insure each other for excessive losses. The first reinsurance pool arrangement among P&I clubs was developed in 1899 among 6 British clubs.[37] The currently functioning reinsurance pooling arrangement is the International Group of P&I clubs also known as the "International Group"[38] . The International Group consists of 13 international P&I clubs[39] and covers approximately 93% of the world's registered tonnage of ocean-going vessels. Aside from the reinsurance function the International Group also acts as a common representative of the P&I clubs in relation to international organisations and national governments. The International Group also organises regular meetings of representatives of individual clubs aimed at developing the insurance industry, exchange of information and sharing of underwriting and

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35 Hazelwood S.J. and Semark D., P&I Clubs Law and Practice (4th ed., Lloyd's List, London 2010), p.365.

36 *Ibid.*

37 This pool became known as the "London Group". Hazelwood S.J. and Semark D., P&I Clubs Law and Practice (4th ed., Lloyd's List, London 2010),p.365.

38 www.igpandi.org.

39 See detailed list on www.igpandi.org.

claims handling experience. The members of the International Group have concluded two main contracts, the International Group Agreement and the Pooling agreement, as was mentioned in Chapter 2.

3.5 Risks Covered under P&I Insurance

As can be seen from the historical introduction, the protection and indemnity insurance has been developed in order to give shipowners cover from potential liability exposure, but in certain cases also covers loss, damage and expenses incurred by the assured. The fact that the cover was gradually developed in order to respond to the needs of the shipowners means that P&I insurance is a named risk insurance.[40] This means that as a general rule only those risks identified in the Rules will be covered. The most important categories covered include liability for claims related to persons, liability connected to the transport of cargo, liability in relation to collision and striking, pollution liability and wreck removal liability.

The category of claims related to persons covers liability arising from injury, illness or death of the crew, loading and unloading personnel, passengers or other travelling on board the vessel. This category also includes liability arising due to delays in transport of passengers.[41] The cargo liability category will encompass issues such as delay of cargo as well as cargo damage and loss of cargo that has been transported on the insured vessel.[42] These two categories result in the majority of claims forwarded to P&I insurers.[43] P&I cover will also cover liabilities and losses arising due to collision and striking as long as these are not covered by other insurances.[44] The category which leads to potentially the largest liabilities from a single event is pollution liability. The insu-

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40 As opposed to an All Risk insurance.

41 See Gard Rules 27-33 mainly.

42 Gard Rule 34

43 http://www.swedishclub.com/upload/Loss%20Prevention359/Claims_at_a_Glance_2012.pdf, Graph No.9.

44 Gard Rules 36 and 37. Under the NMIP hull insurers will cover these losses to a certain extent, P&I will therefore cover only excess liability.

rance will cover the liability of the assured for oil and other polluting substances that escape the vessel, as well as expenses incurred to prevent any such escape and minimise loss.[45] Finally, as a general rule, the liability for which cover is claimed must arise in direct connection with the running of the vessel.[46]

3.6 The P&I Insurance Contract and Its Conclusion

As was mentioned several times, an insured shipowner will also be an owner of the P&I clubs and will be required to pay extra payments to balance the clubs finances if necessary, or may receive a part of the redistributed operating profit. Interestingly, in the early years of P&I insurance the legal form of the P&I clubs was much less formalised than it is today. In the early years of P&I insurance the clubs did not possess an independent legal personality and contracts of insurance were really made among the members themselves. The club was only the machinery for collecting and paying various amounts and a meeting point for shipowners.[47] This is no longer the case and contracts of insurance are entered into between the individual members and the body corporate of the association. In general the contents of the contract of insurance between the two parties will be gathered from a perusal of the club's Memorandum and Articles of Association or Statutes, the Certificate of Entry and club Rules, regulations, bye-laws and any other special agreements entered into by the particular member.[48]

This means that P&I clubs generally do not offer tailored insurance policies to their members, but rather upon joining the club the member will be subject to terms stemming from the club's Rules. In the words of the English courts, the P&I Rules constitute "[the] general terms of the

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45 Rule 38 and 46.

46 Gard Rule 2.4 (a)

47 The Barrow-in-Furness Mutual Ship Insurance Company Limited v Ashburner (1885) 5 Asp M L C 527, p.529. as quoted in Hazelwood S.J. and Semark D., P&I Clubs Law and Practice (4th ed., Lloyd's List, London 2010), p.45.

48 Hazelwood S.J. and Semark D., P&I Clubs Law and Practice (4th ed., Lloyd's List, London 2010), p.49.

contract of insurance made between the club and the individual member."[49] This is also formally laid down in Gard's Rule 2.3, which provides:

> "The cover afforded by the Association to a Member shall be subject to the Articles of Association and to these Rules and to any special conditions agreed between the Association and the Member."[50]

Given that this text deals with the duties of disclosure arising in the process of agreeing a P&I insurance contract it will be practical to introduce the general process of concluding this contract. This may differ in detail from P&I club to P&I club, but will generally consist of the same steps and have the same requirements.

Any person eligible to be a Member[51] of a P&I club can make an application for insurance of a ship. As a first step, the P&I club will typically be approached by an insurance broker acting on behalf of a shipowner asking for a price quote in respect of the vessel. This process will be followed by an exchange of information required by the club for their risk assessment process. At the same time discussions in respect of the particulars of the insurance conditions required as well as the premium offered will be on-going. The P&I club will have standard methods in which it will inquire about information that it feels is necessary for its general risk assessment. This was previously done by standardised printed forms with detailed questions. These also left considerable space for any comments from the assured. In the modern times this was replaced by an interactive electronic system. However, the basics remain the same. The completed application will be submitted to the underwriting department of the P&I club. The responsible underwriter and the applicant will further discuss specific information that may be required, as well as the payable insurance premiums and other outstanding issues[52].

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[49] Volkswagenwerk AG. and Wolfsburger Transport Gesellschaft mbH v International Mutual Strike Assurance Co (Bermuda) Ltd [1977] 2 Lloyd's Rep 503. p.514.

[50] Gard Rules 2012, Rule 2.3.

[51] Eligibility is typically governed by a particular Rule, eg Gard Rule 3. This category includes owners, charterers, operators and may also include reinsurers.x

[52] This could include the requirements laid down by the International Group Agreement or specific financial requirements.

Once the risk analysis is concluded and the P&I club decides to accept the vessel then the new Member will be presented an Entry form. Each P&I club will have a set of standard Entry forms differing according to the vessel type insured, e.g. dry cargo ships, passenger ships, Ro-Ro vessels, tankers, etc. The process is completed by an offer made by the P&I club including the proposed premium and insurance terms. In order to conclude the contract the applicant must reply in writing. Normally the contract will be considered completed when the offer is accepted by the assured, a broker acting on behalf of the assured or another agent of the assured. Commonly the contract will be agreed prior to the ship receiving cover. Due to historical reasons the P&I insurance year starts and ends on 20th February each year, but most vessel covers will be concluded or renewed prior to this date.[53]

4 Duty of Disclosure

4.1 Introduction

The following Chapter will build on the above described presentation of the essential features of the P&I insurance contract. The discussion in this part of the text commences with a general introduction to the duty of disclosure, which will explain why there is a need to place the insured shipowner under a legally enforceable duty to disclose all material information. Thereafter the provisions regulating the duty of disclosure will be presented and it will be asserted that the assured is under a duty to actively volunteer all relevant information. The main issue which will be discussed in this Chapter will be the manner of establishing which information is subject to disclosure and which is not. The problem arises due to the fact that it is unmanageable to oblige the insured shipowner to disclose all information he possess. Similarly the variety

[53] On this day the waters if the Baltic Sea became navigable for vessels and they commenced trading.

of shipping undertakings makes it impossible to design a one-fits-all questionnaire addressing all issues which have to be disclosed by any given shipowner. The courts have therefore tried to develop rules which delimit the information which has to be disclosed and tried to design a legal test for this purpose. The discourse will show that this was rather troublesome. Subsequently a presentation of circumstances which must be considered material for disclosure and which can give some guidance will be given. The final part of this chapter discusses the remedies available to the insurer in case of the assureds' failure to comply with his duties of disclosure. As a general rule the issues arising are the same for both jurisdictions and therefore will be discussed together.

The generally applicable principle in contract law is to allow a wide scope of negotiation freedom to individual parties. Yet, in certain circumstances this freedom is undermined by an underlying imbalance of information. The rationale behind the introduction of the duty of disclosure is to institute a balance of information between the parties in such situations. In respect of P&I insurance this imbalance is given by the fact that the shipowner has perfect knowledge about the circumstances pertaining to his vessel, while the insurer has to rely on second-hand information sources. This rationale of balancing information is supported by positive legal and economic arguments. Legally the duty of disclosure can be explained as a rule of equity and fairness. It would be unfair for the assured to benefit from his position as information owner. The assured would be in an unfair position in obtaining an insurance policy which has been calculated on less information than he himself possesses. Such a situation would be creating a contractual inequality between the parties.[54] The fairness argument is further extended to making the duty of disclosure mutually applicable. This means that it is not only the assured who is obliged to disclose material information, but also the insurer carries an identical obligation towards

[54] Wilhelmsen T-L., Issues of Marine Insurance - Duty of Disclosure, Duty of Good Faith, Alteration of Risk and Warranties, p.71.

the assured.[55] However, disputes in relation to a breach by the insurer are uncommon and therefore the issue will not be discussed in this paper.

Economically, the duty of disclosure leads to a cheaper and more efficient insurance market. This follows from the fact that a full disclosure of all facts and risks concerning the vessel allows the underwriter to make a more accurate risk assessment. The basic risk assessment principle is that the more information the underwriter possesses, the more accurate the risk projection and calculation can be. This in turn leads to a more individual insurance policy and a more suitable and economically efficient insurance premium.[56] Furthermore, the duty of disclosure will result in minimising the cost related to the issuance of the insurances in the market. This follows from the fact that in the overwhelming majority of cases the person effecting insurance, typically the shipowner, will have the most accurate information concerning the vessel. There is therefore an inherent imbalance of information between the parties. The assured has full information and the insurer possesses only on the information revealed by the assured. If the assured was not under a duty to disclose all information, the insurer would either set the premiums artificially high in order to cover presumed undisclosed risks and unpredictable losses; or alternatively would be obliged to spend resources on investigating full information. The duty of disclosure will therefore, perhaps contrary to popular belief, lead to a lower premium payments for the assured and be economically beneficial to both contractual parties.[57]

4.2 English P&I Clubs and the Duty of Disclosure

The general English law of contract allows individual contractual parties a wide scope of individual negotiation freedom. This freedom

[55] E.g. The insurer must disclose if in financial trouble, or if he has knowledge about the vessel that the shipowner is not aware of.

[56] Wilhelmsen T-L., Issues of Marine Insurance - Duty of Disclosure, Duty of Good Faith, Alteration of Risk and Warranties, 41-172, in SIMPLY, Scandinavian Institute of Maritime Law Yearbook 2001.(Sjørettsfondet , Oslo 2001), p.71.

[57] *Ibid.*

also extends to the regulation of the duty of disclosure in individual contracts. However, P&I clubs located in England elect not to provide specific regulation of the duty of disclosure within their own Rules. Rather, there will be a Rule stipulating that unless expressly excluded, the Rules are subject to the provisions of MIA. An example of such a provision is Rule 6 of the North of England P&I club, which provides:

> "These Rules and all contracts of the insurance made by the Association shall be subject to and incorporate the provisions of the Marine Insurance Act, 1906 of the United Kingdom and any statutory modifications thereof except insofar as such Act or modifications may have been expressly excluded by these Rules or by any term of such contracts."

This means that the P&I Rules are not more stringent in respect of disclosure requirements than the MIA, which will be the source of regulation. However, the need for an express Rule stipulating the application of the MIA stems from uncertainty over the application of the Act to P&I insurance contracts, which may arise due to the particular nature of P&I insurance.

There are several reasons why the application of the Act may be doubted in respect of P&I club Rules. Firstly, given the mutual nature of P&I insurance the insured shipowner will have a dual role of assured and insurer at the same time. This peculiar position might lead to uncertainties on the suitability of the Act, which presumes a more traditionally assured/insurer role. Secondly, the contract of insurance with a P&I club is concluded in a different matter than what would be normal in other marine insurance markets. The particular problem arises due to the fact that MIA's section 21 assumes that a formation of an insurance contract is concluded by issuance of a customary memorandum of a contract.[58] However in P&I insurance such a formal memorandum, known as "Certificate of Entry", is often issued after the conclusion of

[58] Also an insurance "slip" or "cover note" is mentioned.

the contract.[59] It has also been stated that the express provision stating the application of the MIA in respect of the duty of disclosure clarifies the legal rules, something that will be much appreciated by the very international body of P&I club members.[60]

4.3 Legal Regulation of the Duty of Disclosure in English law

Given that there is no express regulation of the duty of disclosure incorporated within the insurance contract between the P&I club and the individual assured, the issue will be regulated by the appropriate English law provision. As was mentioned above, this will be the Marine Insurance Act 1906.

This act deals with the duty of utmost good faith in general as well as with the duty of disclosure in particular. Section 17 the MIA articulates the general doctrine of utmost good faith, while section 18 deals more specifically with non-disclosure in the presentation of the risk to the insurer.[61] Section 20 dealing with misrepresentation is included for a demonstration of the regulatory framework.

Section 17 establishes that insurance contracts are contracts of utmost good faith. The rationale behind making the insurance contracts subject to the duty of utmost good faith has laid down by Lord Mansfield in the seminal case *Carter v Boehm62* in the following manner:

> "Insurance is a contract upon speculation. The special facts upon which the contingent chance is to be computed rest most commonly in the knowledge of the Insured only; the underwriter trusts to his representation and proceeds upon confidence that he does not keep back any circumstances in his knowledge to mislead the underwriter into a belief that the circumstance does not exist, and

59 Hazelwood S.J. and Semark D., P&I Clubs Law and Practice (4th ed., Lloyd's List, London 2010). p.33.

60 *Ibid*.p.34.

61 Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p.103.

62 Carter v Boehm (1766) 3 Burr 1905.

> to induce him to estimate the risk as if it did not exist.
>
> To keep back such circumstance is a fraud, and therefore the policy is void. Although the suppression should happen through mistake, without any fraudulent intention; yet still the underwriter is deceived, and the policy is void; because the risque run is different from the risqué understood and intended to be run, at the time of the agreement. "

The duty of good faith constitutes a very general and somewhat vague concept which serves an "umbrella" function for other underlying duties. The duty of disclosure is one of the most important duties, if not the most important, encompassed within the duty of good faith.

The respective sections of the MIA provide as follows:

Section 17;

> "A contract of marine insurance is a contract based upon the utmost good faith, and, if the utmost good faith be not observed by either party, the contract may be avoided by the other party."

Section 18(1);

> "Subject to the provisions of this section, the assured must disclose to the insurer, before the contract in concluded, every material circumstance which is known to the assured, and the assured is deemed to know every circumstance which, in the ordinary course of business, ought to be known by him. If the assured fails to make such disclosure, the insurer may avoid the contract."

Section 20 (1);

> "Every material representation made by the assured or his agent to the insurer during the negotiations for the contract, and before the contract is concluded, must be true. If it be untrue the insurer may avoid the contract."

As mentioned above, and as apparent from the wording of these provisions, section 17 is the general rule while sections 18 and 20 are more specific. This does not however mean that the duty of utmost good faith is limited to the provisions of sections 18 and 20. These provisions are not comprehensive and the duty of good faith is wider than the features given in these sections or in the MIA.[63]

4.4 Norwegian P&I Clubs and the Duty of Disclosure

As was explained in Chapter 3, the Norwegian P&I clubs approach the regulation of the duty of disclosure differently than their English competitors. Although the NMIP incorporate the P&I Rules and applied its general regulation also to this type if insurance, the P&I Rules have been taken out of the plan in its 1996 edition. This has lead to the fact that both Norwegian clubs regulate the issue expressly in their Rules.

In this respect the main part of Gard's Rule 6.1 on the Member's Duty of Disclosure provides:

> "The Member shall prior to the conclusion of the contract of insurance make full disclosure to the Association of all circumstances which would be of relevance to the Association in deciding whether and on what conditions to accept the entry. Should the Member subsequently become aware of any such circumstances as are mentioned above, or of any change in such circumstances as previously disclosed, he must without undue delay inform the Association"

The respective Rule within Skuld's Rulebook is Rule 28.1.1 dealing with Conditions Precedent – Disclosure. The basic part of the Rule reads:

> "The member shall make full and correct disclosure to the Association, before the contract of insurance is concluded, of every circumstance,
>
> a) which is known to the member or any agent effecting the insurance on his behalf, or which, in the ordinary course of business,

[63] Baatz Y., Utmost Good Faith in Marine Insurance Contracts, p.16.

ought to be known by the member or agent, and

b) which would influence the Association in deciding whether and on what terms to provide cover, “

4.5 Active vs. Passive Duty of Disclosure

For situations where parties are bound by a duty of disclosure and where information has to be provided to the counter-party, two legal concepts linked to methods of acquiring information have been developed. One method is to allow the insurer to ask all questions which he may consider relevant and which will allow him to obtain all material facts. This is the so-called “passive” duty of disclosure, because the assured does not have to reveal any information that he has not been asked about. The other method imposes a duty on the assured to volunteer all material facts on his own initiative. In this case the assured must assess what information can be considered material to the insurer and reveal all such information. This method of disclosure is referred to as an “active” duty of disclosure. It follows that under the passive duty such information which the insurer does not ask for is not material.[64]

The solution in English and Norwegian P&I Rules is identical and both subject the assured to an active duty of disclosure. The wording “must disclose to the insurer” and “shall […] make full disclosure”[65] as expressed in section 18 of the MIA and Gard Rule 6.1 respectively, indicate that a positive requirement to disclose information. This is also confirmed in commentaries dealing with these clauses.[66] It is interesting to point out in this context that this constitutes a slight departure from the general insurance law applicable in Norway. The starting point in section 4-1 of Insurance Contracts Act 1989 is that the insurer will have

64 Wilhelmsen T-L., Issues of Marine Insurance - Duty of Disclosure, Duty of Good Faith, Alteration of Risk and Warranties. 78.

65 A similar provision is in Skuld Rule 28.1

66 E.g. In Schoeabaum T. J., Key Divergences between English and American Law of Marine Insurance: A Comparative Study (Cornell Maritime Press, Centreville 1999), p. 103, and in Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008),p.92.

to question the assured about the information he considers material. Only if the assured has knowledge of special circumstances that he realizes are material for the insurer will he be under a duty to disclose these circumstances.[67]

Being subject to the active duty of disclosure the assureds will be required to assess what information is material for the insurer and disclose it accordingly. An English judge said of this active obligation that it is not "of itself a good answer to say 'if it was material why did you not ask?'"[68] On a similar note it was stated in the case *C.T.I.* v *Oceanus* that mutual marine insurance was "not a branch of insurance where the insurer shows what he regards as material by submitting questions in a proposal form to the insurer."[69] This means that even if questionnaires are presented, the assured cannot rely on them being exhaustive of all possible information as may be required. The assured will in addition to correctly answering all questions have to assess whether there are any particular outstanding circumstances that require disclosure. It is always the assureds' responsibility to make the correct assessment and disclose all information.

4.6 Disclosure of all material information

It is apparent from the two preceding Chapters that the assured is under an obligation to actively disclose information. The basic rationale behind the duty of disclosure is to give the underwriter access to all relevant information in order to assess the risks connected to the vessel. Risk assessment based on all relevant information will invariably lead to a premium reflecting the actual risks. It is apparent that problems arise in relation to the influence of undisclosed facts on the risk assess-

67 Wilhelmsen T-L., Issues of Marine Insurance - Duty of Disclosure, Duty of Good Faith, Alteration of Risk and Warranties, 41-172, in SIMPLY, Scandinavian Institute of Maritime Law Yearbook 2001.(Sjørettsfondet , Oslo 2001), p. 78.

68 Zurich General Accident & Liability Insurance Co Ltd. v Morrison (1942) 72 Ll L Rep 167, p. 175.

69 Container Transport International Ltd. v Oceanus Mutual Underwriting Association (Bermuda) Ltd [1984] 1 Lloyd's Rep 476. p.529.

ment of the underwriter. Ideally the underwriter would like to have access to all possible information, but it is obvious that it is necessary to delimit the obligations of the assured in respect of disclosure. The central part of the duty of disclosure is the passing of all material and relevant information from the assured to the insurer. This means that the principal questions arising here are: how can a shipowner ascertain what information is material and what test ought to be applied for the ascertaining whether a circumstance is material or of relevance to the insurer?

4.6.1 What information is "Material" under English law?

As noted above, both the disclosure and the avoidance of misrepresentation duties of the assured as developed under English law incorporate the concept of materiality. This is evident from sections 18(2) and 20(2) which provide that:

> "Every circumstance is material which would influence the judgement of a prudent insurer in fixing the premium, or determining whether he will take the risk."

The correct reading of the MIA 1906 and the proper interpretation of the materiality of information has troubled the English courts throughout the 20th century. A particularly significant case where the issue was considered directly in great detail was *Container Transport International Ltd. v Oceanus Mutual Underwriting Association (Bermuda) Ltd70.* Here the court of first instance held that information was material only if the non-disclosure exerted "decisive influence" on the judgement of a prudent underwriter by inducing a "different decision" with respect of the risk.[71]

The decision of the lower court was appealed and reconsidered in the Court of Appeal. Overriding the lower court the appellate court

[70] [1984] 1 Lloyd's Rep 476.

[71] Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p. 110.

held that materiality was a purely objective issue. The Court of Appeal did not consider it necessary to question whether the assured appreciated the materiality of the information nor whether the underwriter was influenced by it. It seemed to have opted for proof merely that the prudent underwriter would want to have been told the information while reaching a decision on the risk. Expert witnesses called could be asked whether they would have wished to direct their minds to the relevant circumstance and not whether it would have made any difference to their eventual decision. [72] This means that the materiality test is a fully objective test considering a prudent underwriter as opposed to a test involving the underwriter in dispute at hand.[73]

However this was not the end of the troubles of the English courts with materiality. It became a contested issue again in the case *Pan Atlantic Insurance Co. Ltd. v. Pine Top Insurance Co. Ltd.74* Here the House of Lords, by a mere majority, dismissed the application of a "decisive influence" test, and confirmed the decision of the Court of Appeal in *CTI* in respect of materiality. The House of Lords held:

> "'Influence the judgement' is not the same as 'change the mind'. Furthermore, if the argument is pursued by a purely verbal analysis, it should be observed that the expression used is 'influence the judgement of a prudent insurer in... determining whether he will take the risk'. To my mind, this expression clearly denotes an effect on the thought process of the insurer in weighing up the risk, quiet different from words which might have been used but were not, such as 'influencing the insurer to take the risk'."75

The materiality test laid down in this judgement can be called the "mere

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[72] Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p. 111.

[73] Further guidance on the prudent underwriter assessment can be found in Associated Oil Carriers Ltd v Union Insurance Society of Canton Ltd. [1917] 2 KB 184.

[74] [1995] 1 AC 501.

[75] [1995] 1 AC 501, p 531.

influence" test[76]. It was held that it applies to all facts, including those which if known to the underwriter, would not make any difference to the contract of insurance at all. What is relevant is whether the thought process of a prudent underwriter would have been influenced by the non-disclosed fact and whether he would have liked to consider the facts in the risk assessment process.[77] The court also held that the materiality of a fact must be tested on the day of the conclusion of the insurance contract. These conclusions are similarly relevant to misrepresentation requirements. Only misrepresentation in respect of material information will lead to a breach of utmost good faith and result in sanctions.

The objective test for ascertaining the materiality of information laid down by the English has been described as "not high"[78] and is considered very favourable to the insurers. However, this objective test of materiality is counter-balanced by the subjective requirements of inducement.

4.6.2 The Inducement Requirement

In order for the breach of the duty of disclosure to lead to legally enforceable sanctions, which are discussed in Chapter 10, it will not be sufficient to establish the objective materiality of the non-disclosed fact. In addition the insurer must establish a causal link between the breach and his agreement to conclude a contract.[79] This subjective requirement is termed "inducement" and is a well-established principle in non-marine contract areas, yet it was unclear to what extent it ought to be

[76] Schoeabaum T. J., Key Divergences between English and American Law of Marine Insurance: A Comparative Study (Cornell Maritime Press, Centreville 1999), p. 110. It can also be referred to as the "awareness" test.

[77] Botes J.H., From Good Faith to Utmost Good Faith in Marine Insurance (Peter Lang, Frankfurt am Main, 2006), p. 158..

[78] Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p.109.

[79] Attwood v Small (1836) 6 Cl & F 232.

applied in marine insurance.[80] The Marine Insurance Act 1906 provides detailed regulation of misrepresentation and non-disclosure issues however it is silent on the application of inducement. This lead to a discussion whether inducement was relevant to marine insurance, and if so, what the extent of the inducement rules ought to be.

The English courts have discussed the application of inducement rules in marine insurance in several important cases. Judgements upholding the inducement requirement and bringing marine insurance in line with rules on general contract law argued that not applying inducement rules would be "absurd"[81]. Contrary judgements held that the wording of the MIA 1906 did not leave space for a reading which included inducement rules.[82] The final conclusion to this discussion came from the House of Lords that "in the *Pine Top* case unanimously held that in order to resort to the remedy of rescission, the underwriter needed to show that he had been induced to conclude the contract by reason of the failure of the assured to disclose material facts."[83] The judgement therefore plainly established a requirement for a subjective element within the objective requirements of the duty of disclosure.

In practical terms including the inducement requirement provides a more just outcome. It will not be possible for an underwriter to annul the insurance contract in cases where although misrepresentation or non-disclosure occurred, it was of such a minimal nature that it would not have affected the contractual conditions accepted by the underwriter. The burden of proof of inducement rests on the party allegedly induced, this will in virtually all cases be the insurer. Although inducement requirements ought to balance the favourable interpretation of materiality, the burden of proof resting with the insurer has been de-

[80] Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p.116.

[81] Berger & Light Diffusers Ltd v Pollock, [1973] 2 Lloyd's Rep 442, p.463.

[82] Container Transport International Ltd. v Oceanus Mutual Underwriting Association (Bermuda) Ltd [1984] 1 Lloyd's Rep 476

[83] Botes J.H., From Good Faith to Utmost Good Faith in Marine Insurance (Peter Lang, Frankfurt am Main, 2006), p. 166.

scribed as “not a heavy one”.[84]

Moreover, in *Pan Atlantic* Lord Mustill stated that “... the assured will have an uphill task in persuading the court that the withholding or misstatement of circumstances satisfying the test of materiality has made no difference. There is ample material both in the general law and in the specialist works on insurance to suggest that there is a presumption in favour of causative effect.”[85] Although the legal foundations of this statement were criticised and its applicability doubted by commentators[86], it appears that the stronger the arguments for materiality the more likely it will be that inducement will be established.

4.6.3 What Information is “Material” under Norwegian law?

As mentioned in the previous chapters, in Norwegian context the rules in respect of duty of disclosure and all its subordinate aspects are found in the individual P&I club Rules. Norwegian P&I clubs are therefore obliged to apply an individualised drafting and structure of the materiality provisions, which must be contrasted with the generally applicable provisions of the English MIA.

P&I club Skuld provides the materiality requirement in Rule 28.1.1.b. This Rule reads:

> “The Member shall make full and correct disclosure to the Association, before the contract of insurance is concluded, of every circumstance, which would influence the Association in deciding whether and on what terms to provide cover.”

The corresponding provision of Gard is found in Rule 6.1 and provides:

84 Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p.120, Wise (Underwriting Agency) Ltd v Grupo Nacional Provincial SA [2004] 2 Lloyd’s Rep 483 at [99].

85 [1994] 2 Lloyd’s Rep. 427, p.551.

86 Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p.121.

> "The Member shall prior to the conclusion of the contract of insurance make full disclosure to the Association of all circumstances which would be of relevance to the Association in deciding whether and on what conditions to accept the entry."

The terminology applied by the two Norwegian clubs is different from the English MIA. Instead of referring to "material circumstance" they refer to "circumstance, which would influence" and "circumstance of relevance" respectively. Closer consideration of the two Rules establishes that the only difference between Skuld's and Gard's provisions is the use of the words "influence" instead of "relevance". It is submitted that this dissimilarity does not have any substantial impact on the meaning of the provisions. This implies that they ought to be interpreted identically and legal sources can be considered to apply to them both.

The question which arises in respect of the two Rules is how to understand their wording. Should one read them as applying the "decisive influence" test or do they rather apply the "mere influence test", or is there some other test that can be applied in this case?

It appears that the more natural reading of the wording would support a "decisive influence" test. This would follow naturally from the inclusion of the words "whether and on what conditions/terms". However, in establishing the proper reading of the provision one should also look to the background law governing the P&I Rules as well as to other relevant legal sources. The legal source most directly tied to the interpretation of Gard's Rulebook will be the in-house publication Gard Guidance to the Rules. This text provides that "[a] circumstance will be 'of relevance' if it is a fact or matter that would influence the judgement of the Association in estimating the risk, particularly if that circumstance tended to increase the risk."[87] This indicates that in order to be "of relevance" a circumstance must have a factual impact on the risk assessment process of the underwriter. This indicates that Gard supports the natural reading of the provision and sets the burden of proving

[87] Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p.92.

materiality in duty of disclosure higher than in the provision of the English MIA.

Further guidance for this position can be taken from the NMIP, which forms the applicable background law to the P&I Rules. NMIP provides in section 3-1 paragraph 1 that "[the] person effecting the insurance shall, at the time the contract is concluded, make full and correct disclosure of all circumstances that are material to the insurer when deciding whether and on what conditions he is prepared to accept the insurance."[88] This section provides the same wording as the two P&I Rules. The most important academic publication dealing with the NMIP sections and their comparison to English law as well as application in case law is the "Handbook on Hull Insurance" by Wilhelmsen and Bull[89]. This text submits that under Norwegian law the insurer will only be able to argue that a circumstance was "material" if the undisclosed circumstance was decisive for the acceptance of the contract, the setting of the premium or the setting of alternative conditions. The combined authority of the natural language interpretation, Gard's own guidance publication, and the Handbook allow concluding that the position under Norwegian law is a "decisive influence" test.

4.7 Illustrations of Material Circumstances in Practice

4.7.1 Practical Illustrations

One of the crucial needs for having clear and predictable rules governing the duty of disclosure is to allow the parties to assess what information needs to be disclosed. It is not an easy task for the lawmaker to set out unequivocal rules. The amount of possible occurring circumstances is almost unlimited and therefore it is impossible to present an exhaustive list of material/relevant circumstance. It has been stated above that the parties to the contract are professionals and that as a general rule they

[88] Norwegian Marine Insurance Plan 1996, Version 2010, s. 3-1.

[89] Wilhelmsen T-L. and Bull H.J., Handbook in Hull Insurance (Gylendal, Oslo 2007)

ought to know what information is considered material and therefore has to be disclosed. Still, it is interesting to look at previous cases and existing P&I insurer practice for an illustration of material information in practice. It ought to be stated at the outset that the Norwegian legal rules have resulted in limited amounts of litigated cases and therefore there is limited legal authority. The lack of litigious disputes relating to the duty of disclosure was also noted in the Handbook on Hull Insurance publication, which says that the "rules concerning duty of disclosure have caused few problems in Norwegian marine insurance."[90]

The circumstances arising in the cases dealing with the duty of disclosure can be divided into three general categories: (1) circumstances which pertain to the vessel; (2) circumstances which pertain to the vessel's operation and trade; and (3) risks related to the assured. It must always be born in mind that regardless of which category a circumstance falls under, if the insurer asks directly about a circumstance the assured must provide truthful information and not breach any duties leading to misrepresentation.

The first category of risks would comprise issues which are related directly to the vessel or the fleet insured with the P&I club. This category includes the obviously material information such as age, type and number of vessels insured. It also includes information on flagging of the vessels and their classification societies. Although this information may appear trivial it will be important for the risk assessment of the insurer. For example some clubs will consider the risk associated with US flagged vessels unacceptable within their portfolio. The same can be said about vessels which are classified by a classification society which is not member of the IACS association of classification societies.[91] The

[90] Wilhelmsen T-L. and Bull H.J., Handbook in Hull Insurance (Gylendal, Oslo 2007), p. 139. This relates primarily to hull insurance. However, no court cases dealing with the issue of P&I insurance have been discovered in the research for this thesis and therefore it is assumed that the same relates to P&I insurance.

[91] This would not apply to particular types of vessels, e.g. Norwegian shipping vessels, local ferries, etc. These can be sometime approved by state maritime authorities. http://www.iacs.org.uk/. This is an association of the most respected classification societies. It provides and umbrella for co-operation and exchange of expertise.

significance of information falling within this group for the risk assessment process is typically of such a degree that most P&I clubs would cover the issues in their formal Entry Forms and the insured would be obliged to answer correctly.

A particularly interesting disclosure issue under English law arises in respect of previous refusals of cover by other underwriters. This is an atypical disclosure requirement because there is a contrasting practice between general insurance and marine insurance law. In general English insurance law it is established practice that refusal of cover is a material circumstance requiring disclosure to the underwriter.[92] In marine insurance previous refusal is not deemed to be material and therefore it does not require disclosure.[93]

The second category of risks has been labelled as risks which pertain to the nature of trade of the insured vessel. This category encompasses issues such as intended cargo of the vessel, trade patterns, particular port risks, etc. Further practical guidance can be found in Gard's Guidance to the Rules publication which provides examples of circumstance that must be disclosed. These include "a Member's intention to trade the Ship substantially outside 'warranty limits', to carry cargo or cargoes on a Ship not constructed, designed or adapted for the carriage of such cargo, ..., or to change substantially the contractual terms under which the Ship is operating..."[94]

Central to this category of risks is the exposure of the vessel to certain areas and ports considered to pose extraordinary risk. This means, for example, that P&I club underwriters will be interested to know the exposure of the insured vessel to US ports, which have high litigation risk. Similarly the underwriter will want to know exposure to trade with West-African states. In this area it is known that receivers

[92] Ewer v National Employers' Mutual General Ins [1937] 2 All ER 193, Roberts v Avon Ins CO [1956] 2 Lloyd's Rep. 240.

[93] Glasgow Assurance v Symonds (1911) 16 Com Cas 109. It should be noted that this is a principle established under hull insurance and it is therefore uncertain to what extent courts would apply it in P&I insurance.

[94] Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p.92.

commonly experience cargo-shortage.[95] Information falling under this category also includes the exposure of the vessel to deep sea and short sea trade, as this may have an impact on wreck removal costs or pollution liabilities. The P&I insurer will also be interested to know what cargo will be traded on the vessel. The liability exposure will be different for vessels carrying scrap metal and those carrying expensive steel products.[96] A practical illustration of a breach falling within this category can be found in the Norwegian case of *MK Anna II 97*, where the assured did not disclose his intentions to use a vessel as a fish cargo carrier rather than as a pure fishing vessel. The court held that this was a breach of the duty of disclosure.

This category will also encompass the requirement of the assured to disclose the technical and crew management arrangements associated with the insured vessel. A highly regarded crewing management company will be a guarantor for highly qualified crew. This will mean that the P&I club will be less likely to incur losses and the shipowner will be offered a better premium. The same can be said of the technical management of the vessel. Although, interestingly, the English courts have held that the qualifications of a master of a vessel are not a material circumstance[98] *per se*, it is common practice of P&I clubs to inquire about these issues in some detail.

The third category comprises risks directly connected to the assured. One can group cases relating to issues such as financial record of the shipowner, previous claims record, criminal convictions of the assured, etc. within this definition. In respect of financial history of the assured the English courts have held it to be generally material in respect of insurance contracts. This is due to the fact that it provides a demonstration

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[95] This is an insured cargo risk. P&I club claims history shows that local security in West Africa is weak and allows theft of cargo.

[96] This follows from much higher risk connected to carriage of valuable steel and its exposure to corrosion.

[97] ND (1953) 376.

[98] 89Eggers P.M., Picken S. and Foss P., Good Faith and Insurance Contracts (3rd ed., Lloyd's List, London 2010), p. 429, footnote 186.

of the risk management capabilities of the assured.[99]

A particularly interesting issue falling within this group is the disclosure requirement of previous criminal convictions of the assured. In English common law it is a well-established principle that this is a material circumstance and must be disclosed.[100] The body of law developed in relation to criminal history is mainly from litigation arising in non-marine disputes but it is considered equally applicable for marine insurance. Although criminal convictions of the assured do not necessarily pose direct risk to the object of insurance, the moral hazard connected to the assured is considered to be material because the chance that a false claim will be made under the policy may be increased.[101]. The requirement to disclose previous criminal history under Norwegian law has been subject of considerable discussion.[102] The discussion seems to conclude that in Norway such information is not subject to a duty of disclosure. If the insurer feels it necessary to obtain this information he should actively pursue it. However, as a rule it is considered somewhat delicate to inquire about the criminal history of business partners and therefore insurance in will be effected without such information. Gard P&I club does not specifically request such information; however it is not uncommon for the insurer to carry out searches of information otherwise available in the public domain.

In respect of previous criminal convictions one must also note the disclosure requirements in respect of vessel crew. English law stipulates that this may be considered material circumstance subject to disclosure. A recent practical example of a marine insurance dispute on this topic can be found in *The Dora* case[103]. Here the assured was held to be in

99 Norwich Union Insurance Ltd. v Meisels [2007] Lloyd's Rep IR 69.

100 Rose F.D., Marine Insurance: Law and Practice (2nd ed., Oxford 2012), Ch. 5.50.

101 Mance J in Insurance Company of the Channel Islands v Royal Hotel Ltd [1998] Lloyd's Rep IR 151. says the criminal conviction "may merely increase the likelihood of it being made to appear (falsely) that loss or damage has occurred falling within the scope of the policy."

102 E.g. Brækhu/Rein: Håndbok i Kaskoforsikring (handbook of Hull Insurance) p.123, and Selmer: Lov, domo g bok (Statute, Judgement and Book) , p. 471-472.These sources are referred to in the Commentary to the NMIP, p.69.

103 Inversiones Manria SA v Sphere Drake Ins Co Plc (The Dora) [1989] 1 Lloyd's Rep 69.

breach of the duty of disclosure requirements for not disclosing a previous conviction of a crew member on a yacht.[104] In relation to risks related to crew particulars one can also receive guidance from the P&I clubs. Gard, for example, stipulates that is a material circumstance that needs to be disclosed if there will be a change of the nationality of the Crew which will result in increased death, disability or contractual liabilities.[105] In respect of the crew it will also be a duty to disclose any changes occurring subsequent to the conclusion of the contract. In this connection it is important to note the Norwegian court decision in the case *Ormlund106*.

The general conclusion is that the practical requirements of the disclosure rules can be uncertain, at times due to lack of clear legal authority and at time due to the particularity of the practical situation. It is advisable that one closely co-operates with the underwriters and it is also advisable to follow Gard's guideline to assureds: "if in doubt, all matters should be disclosed"[107]

4.8 The Time at which the Duty of Disclosure is in Effect

The purpose of this chapter is to analyse the time at which the duty of disclosure applies. Under this heading one can generally discuss two aspects. The first aspect is the time when the factual circumstances that are subject to disclosure must be evident. This question asks at what point factual circumstances should be assessed in order to reflect whether they have been correctly disclosed by the assured? The second

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[104] The conviction was not previously known to the assured. But it was held that the assured ought to have inquired about the criminal history and the court presumed knowledge.

[105] Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008)P.92.

[106] ND 1978.31. In this case the shipowner undertook a flag change, however omitted to disclose to the insurer that there was only one chief officer on board. Later this chief officer was replace with an officer without proper qualifications. This on the other hand, was not a breach of the duty of disclosure, but rather an alteration of risk.

[107] Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p.92.

aspect is the question of good faith. This means at what time the assured must be without knowledge in order to claim that he was acting in good faith.[108]

In regards the first question one can distinguish between circumstances which are or ought to be known at the time when the insurance contract is entered into and circumstance which change while the insurance contract is running. The difference was illustrated in practice in the Norwegian case *Ormlund.109* In this case the shipowner changed the flag state of the vessel at insurance renewal and disclosed this to the insurer, who decided to amend the insurance conditions accordingly. When the flag was changed the vessel's amount of chief engineers was reduced to one. Additionally, while the vessel was on risk the chief engineer position was filled with an unqualified person. In its decision the court held that both changes of circumstances constituted a breach of the duty of disclosure. This is correct in respect of the change of flag and the reduction of the amount of chief engineers to one. However, the filling of the post while the vessel was insured should have been assessed under the rules relating to change od circumstances.[110]

The two Norwegian P&I clubs provide very similar regulation of the issue of timing of the duty of disclosure. Both clubs require disclosure of facts which exist at the time of the conclusion of the insurance contract. The duty relates to facts which are known to the assured or ought to be known to him in the ordinary course of business.[111] Gard obliges their members to make full disclosure "prior to the conclusion of the contract" and Skuld obliges their members to make full disclosure "before the contract of insurance is concluded". These requirements are identical to the provisions set out in section 3-1 of the NMIP. An interesting question arises in cases where the assured provided wrongful information at the conclusion of the contract and realises his mistake

108 Wilhelmsen T-L. and Bull H.J., Handbook in Hull Insurance (Gylendal, Oslo 2007), p.144.

109 Supra. 105

110 Ibid, p.145.

111 Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p.92.

prior to any casualty happening. This situation will be covered within Gard Rule 6.1 second sentence, which provides that if the assured member becomes aware of non-disclosed material circumstances, or a change in the disclosed circumstances, he must without undue delay inform the insurer. Skuld Rules do not provide an express regulation of the problem. However, one can infer a similar solution based on the structure of the Rule 28, in particular from the wording in 28.1.2. This is supported by the regulation set out in the applicable background law, which stipulates that assured must correct wrongful information without undue delay. [112] It also appears that if the assured approached Skuld or Gard prior to any loss occurring with a correction of wrongfully disclosed information, the two parties would be able to reach a pragmatic commercial solution to the problem.

It must be noted that the member's duty of disclosure does not end at the point of conclusion of the contract. Both clubs also oblige their members to disclose changes in circumstances occurring after the insurance contract was formed. Skuld sets out the requirement to "make full, correct and prompt disclosure …, of every change of circumstances which is or ought to be known to the member and which alters the risk covered by the Association."[113] Gard also requires disclosure change in circumstances occurring after the contract was entered into. Gard provides a separate Rule dealing with this issue and Gard Rule 7 reflects the importance of alteration of risk by providing separate sanctions.

The P&I Rules of clubs located in England do not specify the application of these Rules in any detail and therefore one ought to turn to the MIA. Here the provisions of sections 18 and 20 are similar to the application of the Norwegian P&I clubs. Also members of English P&I clubs will be obliged to disclose circumstances in existence at the point

112 Norwegian Marine Insurance Plan 1996, Version 2010. s. 3-1, para. 2.

113 Rule 28.1.2. This is equivalent to Gard's provision of Rule 6.1: "Should the Member subsequently become aware of any such circumstances as are mentioned above, or of any change in such circumstances as previously disclosed, he must without undue delay inform the Association."

of conclusion of the insurance contract.[114] However, the MIA does not contain a similar requirement of correcting wrongfully provided information. Neither can such a clause be found in the P&I Rules. This leads to some uncertainty regarding the application of the MIA. It is unclear to what extent the wide rule of utmost good faith contained within section 17 can be applied to invoke sanctions against the assured.[115]

4.9 Remedies available in case of a Breach of the Duty of Disclosure

The practical significance of a legal duty is equivalent to the power given to the innocent party in case of its breach. In other words, if there is a legally imposed duty, but no sanctions are available in case of a breach, than the impact of that duty will be very limited. This means that the insurer has to be provided with an efficient enforcement and sanctioning mechanism in order to be able to rely on the duty of disclosure. The main question in relation to sanctions is what powers and rights the insurer has in respect of the concluded contractual relationship in case of a breach of the disclosure duties of the assured. The text will also discuss the practical impact of the sanctions on the assured.

4.9.1 Remedies in English P&I Club Rules

It is a common feature for the majority of the English P&I clubs that, similarly to the rules on the duty of disclosure, they do not provide any particulars on the application of remedies in case of non-disclosure. This means that the MIA 1906 will afford the applicable legal framework. The remedy for non-disclosure or misrepresentation contemplated by the MIA is avoidance of the contract. Section 17 provides that "if the utmost good faith be not observed by either party, the contract may

[114] A person is deemed to know every fact which in the course of his business ought to be known to him and these have to be disclosed accordingly. Schoeabaum T. J., Key Divergences between English and American Law of Marine Insurance: A Comparative Study (Cornell Maritime Press, Centreville 1999), p. 103

[115] Wilhelmsen T-L. and Bull H.J., Handbook in Hull Insurance (Gylendal, Oslo 2007), p.146.

be avoided by the other party". Likewise, sections 18(1) and 20(1) provide for avoidance in the event of material non-disclosure or misrepresentation.[116] Misrepresentation of facts can be made with three different degrees of fault; it may be fraudulent, negligent or innocent. However, in marine insurance the classic rule is that they all result in the same sanction. The policy will be voidable regardless of whether the misrepresentation was due to fraud, negligence, accident or mistake.[117] Similarly, English law stipulates that good faith is breached, and sanctions are available, in case of innocent or inadvertent non-disclosure of material facts known to the person.[118] In other words, this means that in respect of material information the insurer may avoid the contract, if the assured knew or ought to have known that the information he passed on to the insurer wass either insufficient or wrong.[119]

This sanction means that the innocent party, typically the insurer, has the right to call the contract void. In such a case the avoidance of contract is *ab initio*. This means that the contract is void from its very commencement and is perceived as if it had never been entered into. Any obligations resulting from the contract are thus terminated retrospectively and, as far as practicable, the parties are returned to the position they were in prior to the conclusion of the contract. The innocent party electing to void the contract, typically the insurer, is viewed as if it had never come on risk. This results in no possibility of future liabilities under the contract. The avoidance of the contract *ab intio* also means that any outstanding liabilities are discharged and any losses

116 Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p160.

117 Schoeabaum T. J., Key Divergences between English and American Law of Marine Insurance: A Comparative Study (Cornell Maritime Press, Centreville 1999), p. 100.

118 Also see footnote 101. Schoeabaum T. J., Key Divergences between English and American Law of Marine Insurance: A Comparative Study (Cornell Maritime Press, Centreville 1999), p. 103.

119 Wilhelmsen T-L., Issues of Marine Insurance - Duty of Disclosure, Duty of Good Faith, Alteration of Risk and Warranties, 41-172, in SIMPLY, Scandinavian Institute of Maritime Law Yearbook 2001.(Sjørettsfondet , Oslo 2001), p.97.

already paid are recoverable.[120]

Importantly this sanction is available in all cases of a breach of the duty of disclosure. This means that the remedy is available even in cases of minor breaches or innocent breaches. It is also available in cases where the undisclosed information is not the cause of the loss. This avoidance of contract *ab inition* has been described as "a powerful weapon"[121] but also as an "drastic"[122] and "draconian"[123] remedy. The impact of the sanction is so severe because in virtually all cases the breach of the duty of disclosure will become known during the claims handling process following a casualty. This means that the assured will not have any options of correcting his mistakes and will be left without insurance coverage.

The best way of demonstrating the practical impact of the "draconian" remedy is by illustration of a practical example. One can take the example[124] of a shipowner who failed to disclose that his vessel will be trading exclusively with high-value steel cargo between Japan and the USA. Given the high value of the steel and its significant exposure to corrosion damage in sea transport this particular trade pattern would include extraordinarily large risks of expensive cargo damage.[125] Furthermore the frequent calls in the USA would pose an extraordinary risk of extensive 3rd party liability claims associate with the US jurisdiction. Given these risks it can therefore be the case that, if the planned trade pattern was disclosed, the insurer would have accepted the insurance contract with the same premium, but subject to a 200% higher deductible. Later the vessel is involved in a casualty and the assured incurs major liabilities covered under P&I insurance. The P&I club gets

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120 Bennett H., The Law of Marine Inusrance (2nd ed., Oxford University Press, Oxford 2006), p. 160.

121 Container Transport International Inc v Oceanus Mutual Underwriting Association (Bermuda) Ltd [1982] 2 Lloyd's Rep 178, p. 188.

122 Kausar v Eagle Start Insurance Co Ltd [1997] CLC 129,p. 132.

123 Drake Insurance plc v Provident Insurance plc [2004] 1 Lloyd's Rep 268. Para. 145.

124 Taken from Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p. 93

125 P&I Clubs provide insurance for cargo damage . E.g Gard Rule 34 or Skuld Rule 5.

involved and during the claims handling process the P&I club discovers the undisclosed facts. This breach of the duty of disclosure will permit the P&I insurer to relieve itself of all liabilities by choosing to void the contract from its start. The insurer be obliged to repay all received premium payments and will be able to walk away from the problem. On the other hand the assured will be left with all liabilities and some "pocket money" in form of returned premiums. It is apparent that the sanction is very severe and does not reflect neither the fault of the assured or the significance of the non-disclosure.

4.9.2 Remedies in the Norwegian P&I Contracts

Remedies in Skuld Rules

Skuld provides the sanctions for the breach of the duty of disclosure in Rule 28.1.4. which reads:

> "In the event of any failure to comply with any of the above [disclosure] requirements, the member shall not be entitled to any recovery from the Association in respect of any event occurring after the time of the failure…"

The sanction for a breach of the duty of disclosure incorporated in Skuld's Rules is very harsh. It provides that the assured will not be indemnified for any liabilities if a breach of the duty of disclosure occurred. As was mentioned above, such a breach will typically be found in the process of claims handling of a casualty and investigation of liabilities. The remedy allows Skuld to deny any coverage of the claims. Coverage can be denied regardless of the causal link between the undisclosed information and the loss, and regardless of the fault attaching to the assured. Furthermore, Skuld's Rule 3.3.2.a) allows termination of the insurance contract in cases of breach of the obligations under Rule 28.1. This will be a termination with immediate effect. Therefore if there are any losses which occur prior to the settling of a new insurance contract, these will also be uninsured.

The practical impact of this sanction is very severe. An illustration can be drawn with help of the above named example of non-disclosure of the intended trading pattern. If the shipowner was insured with Skuld and the club elected to enforce its rights, than no liability payments would be recoverable and Skuld would be in the position to cancel the contract with immediate effect. In this case the shipowner would be left even worse off than under the MIA, because the sanction would not oblige Skuld to return previously received premium payments. This follows from the fact that the contract was actually valid, however with no recovery for the insured. It must be concluded that Skuld's sanction in this respect has an even harsher impact than the "draconian" remedy of the MIA.

The only exception in respect of this sanction can be found in Rule 28.1.4. This exception applies in cases where the member's breach did not relate directly to the pre-contractual duties of disclosure, but rather to disclosure of an alteration of risk. In this case Skuld will not invoke a sanction as long as Skuld would have "provided the cover at the same premium had [it] known of the changed circumstances prior to the conclusion of the contract."[126]

Remedies in Gard Rules

The sanctions for a breach of the duty of disclosure within Gard's Rule book are set-up differently from Skuld and the MIA. Gard provides a more differentiating scope of non-disclosure sanctions than Skuld or MIA. Gard Rule 6.2. provides the following:

> "Where the Member at the conclusion of the contract of insurance has neglected his duty of disclosure and the Association would not have accepted the entry at the Premium Rating agreed if the Member had made such disclosure as it was his duty to make, the Association is free from liability. Where the Association would have accepted the entry at the same Premium Rating but on other conditions, the Association shall only be liable to the extent that it

[126] Skuld Rule 28.1.4.

> is proved that any liability, loss, cost or expense would have been covered under those conditions the Association would have accepted."

From this it follows that while Skuld and MIA are strict in denying any liability compensation whatsoever in case of breach of the duty of disclosure Gard provides an additional distinction within its sanctions. Gard draws a distinction in sanctioning two kind of breaches; firstly, those where the Association would not have accepted the contract either at all or at the agreed premium, and secondly, breaches where the Association would have accepted the contract at the agreed premium but on different terms. This means there is a differentiation of breaches of the duty of disclosure according to their significance to the insurer.

The outcome of the sanction set out in the first sentence of Rule 6.2 is identical to that applied by Skuld. If the assureds' failure is of such a manner that Gard would not have accepted the risk, than the insurer will not cover any of the assureds' liabilities. Similarly to Skuld, and differing from MIA, the assured will not recover any previously paid premiums. This follows from the words "free from liability" which in Norwegian law do not have the meaning of making the contract voidable. Instead according to the NMIP's commentary it means that there will be no liability cover.[127] A practical situation where this could occur would be for example a failure to correctly disclose whether the vessel is classified by an approved classification society.[128] If a breach falls within this category than the insurer will be free from liability attaching to the specific vessel to which the disclosure referred. In order to avoid liability the insurer will be required to carry his burden of proof in demonstrating that the contract would not have been entered into with the same premium. The burden of proof in respect of the insurance conditions is

[127] This follows from the Norwegian Marine Insurance Plan Commentary on s.3-3., p. 72.

[128] It is a condition of both P&I clubs that the insured vessels be classified by approved classification societies. Any misrepresentation or breach of duty of disclosure in this respect will result in "no recovery" for the assured. Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p. 93.

subjective. This means that Gard only has to prove that it would not have accepted the insurance policy, and the attitude of other insurers or P&I clubs can be disregarded.

The second part of the clause, differing from the previously discussed issues, obliges Gard to indemnify the assured in cases where, if full disclosure was made, Gard would have accepted the contract with the same premium but with differing conditions. A practical example of the application could be a situation where a shipowner failed to disclose that his vessel will be trading exclusively with high value steel cargo and the insurer would have accepted the insurance contract with the same premium, but subject to a doubled deductible. In case of a casualty the shipowner would not be denied any coverage of the loss, but instead the coverage will be based on the conditions with the higher deductible.[129] This remedy will be applicable in cases where the breach of the duty of disclosure was less serious and the information that was not provided was not of entirely crucial nature for the premium assessment. It should also be noted that regardless of which sanction for a breach will be applicable, Gard may terminate the insurance contract with a 14 day notice.[130]

In general it ought to be concluded that the sanctions under Gard's Rules are more shipowner friendly than those of Skuld and the MIA. This addition of a remedy for breaches where the insurer would have accepted the contract with different terms eases the "draconian" impact of the first remedy. It appears that Gard retains a closer reflection of the wording applied in the 1964 version of the NMIP, where P&I insurance was an integral part.

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129 Williams R., Gard Guidance to the Statutes and Rules (Gards AS, Arendal 2008), p.93.

130 See Gard Rule 24.2.c.

5 Conclusion

In conclusion some of the main points of discussion can be summarised. Based on the above discussion it is submitted that, as a starting point, the test applied for ascertaining what information is subject to disclosure is more favourable to the insurer in the English jurisdiction than in Norwegian courts. In English courts it will be less troublesome task for the insurer to convince the judge that the he would wish to have known about the undisclosed or misrepresented material circumstance, and at the same time that the withholding or misstating of the facts was any importance to. It will be a relatively easy task for the insurer to demonstrate that he would want to consider a fact, even if the fact would have been dismissed as irrelevant for the insurance contract consideration. This unfavourable position for the assured was demonstrated by a presentation of various commentary and *obiter dicta*. This means that the shipowner should prefer dispute proceeding in Norwegian courts. Here the insurer will carry the burden of proving that the undisclosed circumstance would have had a decisive influence on his consideration.

However, it is also submitted that a closer inspection of circumstances which were in fact considered material by courts, reveals that the convergence of the two jurisdictions is higher than what the theoretical discussion would suggest. The analysis pointed out that there may be details which are not subject to disclosure in one of the jurisdictions. An example was provided in the case of previous criminal convictions in Norway. However, the differences are minor and appear rather insignificant in practice. In this respect the conclusion is in accord with the NMIP Commentary, which provides that the parties to the contract are usually professional and therefore will have knowledge about what is required for disclosure as a matter of business practice.[131]

It appears that the largest difference is to be found in the difference of the sanctioning systems. Interestingly, here the divergence is not

[131] Commentary to the Norwegian Marine Insurance Plan of 1996, Version 2010, p. 68.

found between jurisdictions, but rather between Gard and the rest of the analysed P&I clubs. While Gard applies remedies which consider a differing degree of significance of the undisclosed circumstances, the other clubs are more stringent. This difference may be of practical significance in some individual cases, as demonstrated by the example in the discussion.

It is unclear, and difficult to research, to what extent the sanctioning system is practical. It however appears that it is rather uncommon and applied in a very limited amount of practical scenarios. The overall conclusion therefore is that the clubs rules in respect of the duty of disclosure are provided on the same terms. Given the co-operation of individual clubs on the development of their Rules within the International Group framework this does not come as a surprise, but rather as a confirmation of the active and effective role of the International Group.

A conclusion in respect of more general issues which can be drawn from the discussion points out other issues of interest. Firstly, it is interesting to note the difference in legal source for the regulation of disclosure between the two jurisdictions. While English clubs do not regulate the duty of disclosure and rely on the insurer-friendly MIA as statutory background law, Norwegian clubs have drafted their own provisions which are expressly formulated in clubs Rules. Bearing in mind that one of the motivations for the text was to provide a practical duty of disclosure guide for a potential assured, it is submitted that it is a clearer approach to provide the full regulation of the disclosure requirements directly in the P&I Rules. This allows a clear, concise and approachable understanding of the legal requirements for an individual shipowner untrained in legal research. In this respect it is also to note the requirement of the International Group that all clubs provide insurance under same conditions. The analysis revealed that this was in fact the case in respect of the duty of disclosure. Although, also here it would be practical to have express regulation of the duty in individual insurance contracts, as this would make it easier to ensure compliance.

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Tackling the Resource Curse

Can the Norwegian approach in the Petroleum Industry be applied in Developing Countries?

Synne Hathway

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1 Introduction

The discovery of petroleum resources represents a valuable opportunity to improve a country's development. Sales of oil and gas can generate huge revenues and have the potential to raise living standards and improve economic growth. However, many countries fail to use the wealth that these resources represent. Living standards remain low and the nation is still poor in spite of their resource endowment. This is known as the 'resource curse'. Research has repeatedly shown that resource wealth does not tend to create wealthy nations. On the contrary, there is often a decline in development[1]. This curse represents a missed opportunity to improve the country's economic situation and social well-being.

The resource curse is not inevitable though. Norway used the discovery of petroleum to improve economic development and benefit the country as a whole. It was one of the poorest countries in Europe at the beginning of the 20th Century, but it is now one of the richest[2.] It is ranked as the world's seventh largest oil exporter and the second largest gas exporter[3]. The petroleum sector represents a 26% share of state revenues and 21% of Norway's total value creation[4]. Norway is often cited as one of the best examples of how natural resources can be managed for the benefit of the population[5]. It has succeeded in defying the resource curse.

This thesis will identify whether there are lessons that can be learnt from resource management in Norway and applied to help prevent the resource curse in developing countries. The core strategy in Norway was to channel the oil profits into an oil fund, but other methods were also important. The legal organisation of petroleum activities on the Norwegian continental shelf played a fundamental role. Indeed, the

1 Auty (1993) p1

2 Duruigbo (2005) p9

3 Hansen and Rasen (2012)

4 Norvik et al (2010) Figure 1.2, p14

5 Ryggvik (2010) p5

extent to which *any* country succeeds in using its natural resources to improve development will depend on the application of an appropriate legal framework for exploiting them. It is the starting point of good resource management. The broad focus of this thesis is, therefore, to examine how petroleum law can be used to help prevent the resource curse.

The particular focus is Norway's petroleum law in relation to direct state participation (DSP) in petroleum activities. This is the direct financial investment of the state in a national oil company to perform petroleum activities on the government's behalf. Norway's legislative framework for DSP played a key role in enabling the country to overcome the resource curse. The government used DSP to benefit the population in a number of ways. As an example, it facilitated the integration of the petroleum sector into the wider economy, significantly improving the growth of related Norwegian industries. Ultimately it is these economic benefits that will have a longer life than the petroleum industry itself. Moreover, the experience of directly participating in petroleum operations improved the government's ability to manage the wider petroleum industry in a manner that furthered the national interest. The main objective of this thesis is to identify whether other countries can learn lessons from how DSP was structured in Norwegian petroleum law in order to realise the potential benefits natural resources represent.

1.1 The structure of the text

The structure of this thesis is designed to provide an understanding of the Norwegian system of DSP and whether it could be applied to address the resource curse elsewhere. Thus, in Chapter Two the issues facing resource rich developing countries will be outlined. This provides the background for analysis as it is the problem that DSP needs to address. The legal principle of Permanent Sovereignty over Natural Resources will then be explained to show why it is that natural resources should be managed in a way that benefits the population. Following this is an

outline of the solution proposed by the Natural Resource Charter. Chapter Three describes the system of DSP and its role within the Norwegian petroleum sector. The benefits it gave Norway and how the government structured the system to achieve these benefits will be explained in detail. Chapter Four identifies the features that enabled DSP to function effectively in Norway. This gives an indication as to whether the system has the potential to be applied in other countries. Chapter Five provides an analysis of the lessons that can be learnt by developing countries from the Norwegian legislative structure of DSP. The overall objective is to assess whether this system could be applied to address the resource curse outside of the Norwegian context.

1.2 Legal sources

The starting point is Norwegian petroleum law, which sets out the legislative framework for its petroleum sector. International law will also be used to underpin my analysis. This includes the principle of Permanent Sovereignty over Natural Resources, which formally places the benefit of natural resources in the hands of citizens. It also includes a 'Natural Resource Charter'. This is a document compiled by world experts in politics and economics who have created an ideal legal framework for resource management. These are my primary sources.

In order to evaluate the Norwegian legal framework, I will use evidence from economic and political scientists as my secondary resources. This research provides evidence of the impact of the law and thus provides the critical perspective on Norwegian DSP. These researchers will be used to identify the advantages and disadvantages of using the Norwegian legal structure of DSP. Since laws governing resource management aim to address economic and political issues, indications of its success or otherwise must come from economic and political sources. These sources demonstrate the implications and actual outcomes of the law and are therefore the focus of my research.

Thus the particular methodology used is a literature review. I will use a combination of online resources, journals, books and statistical

research. Evidence will be taken from scholars discussing a range of countries and legislative regimes. They include economists and political scientists such as Al Kasim, Nelsen and Noreng that provide an analysis of the Norwegian petroleum industry, and experts in other models of resource management, such as Victor, Hults and Thurber. Other research focuses on analysing the different methods of resource management, as opposed to specific country analysis. This includes an extensive research project into national oil companies by The World Bank and a study on the effects of privatisation by Wolff and Pollitt. The literature will show the potential economic and political implications of transferring the Norwegian legal system of DSP beyond the Norwegian context.

2 Background

2.1 The problem of 'the resource curse'

The resource curse is a frequently occurring and contradictory economic situation where resource rich countries perform worse than less well-endowed countries. In order to understand whether DSP has the potential to overcome this issue, we must first understand the problem in greater detail.

The resource curse is essentially a failure to use natural resources in a manner that benefits the population. In some countries though, the detrimental effects go well beyond a lack of economic growth. The discovery of natural resources has been blamed for causing corruption, autocracy, high levels of inequality and even civil war[6]. This is most clearly visible in certain African countries: oil resources have contributed to civil strife in The Congo, The Sudan and Angola and endemic

[6] Humphreys (2005), X. Sala-i-Martin and A Subramanian (2003), Tsui [2005]

corruption and extreme poverty in Nigeria[7]. These countries provide a stark illustration of the daunting problem that mismanagement of natural resources represents.

The causes of the resource curse are numerous and include economic, political and social problems[8]. The primary cause is that petroleum resources represent a huge source of income. This creates an incentive for those in power to engage in 'rent-seeking', corrupt, behaviour. This weakens democracy because rulers are not reliant on taxation for revenue and thus do not need the vote of their citizens to stay in power[9]. Rulers are also able to use petroleum revenue to keep themselves in power and repress their opponents. Put simply, high economic rent increases the probability of poor wealth management and oppressive behaviour, which can undermine, rather than enhance, a country's economic and political situation.

There is though great variation in the way countries have responded to the discovery of natural resources. A comparison between Nigeria and Indonesia illustrates this. Approximately thirty years ago Indonesia and Nigeria had similar per capita incomes and both depended heavily on oil sales. Indonesia's per capita income is now four times that of Nigeria[10]. The 2011 UN Human Development Index highlights more broadly how some oil and gas producing countries have performed much better than others. Norway is at the top of the Index and The Netherlands is third, while other petroleum producers such as The Democratic Republic of the Congo, Chad, Equatorial Guinea, The Sudan, Nigeria and Angola all rank at or close to the bottom of well-being statistics[11]. This indicates that developing countries in particular struggle to use natural resources in a manner that benefits, rather than harms,

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7 Nigeria is amongst the fifteen poorest nations in the world and the poverty rate between 1970 and 2000, the share of the population subsisting on less than one dollar a day, increased from close to 30% to just under 70% Sala-i-Martin and A Subramanian (2003) pp 4 and 35 (Figure 1A)

8 Duruigbo (2005) pp13-21

9 Humphreys et al (2007) p4

10 Humphreys et al (2007)p2, and Ross (2003) pp13-15

11 United Nations Development Programme (2011) pp 127-130

the population. However, it also shows that the resource curse is not inevitable since not all petroleum-producing countries suffer from it.

The focus of this thesis is addressing causes of the resource curse in the upstream sector; capturing the value of the resource, as opposed to the downstream sector; how that value is used by government. Corruption, weak state institutions and information asymmetries between government and multinational oil companies have all been blamed for a failure of the state to capture the true value of sub-sea petroleum resources[12]. Any legal framework that could address the problems upstream has the potential to be part of the solution to the resource curse.

2.2 Permanent Sovereignty over Natural Resources

The principle of Permanent Sovereignty over Natural Resources explains *why* it is that government must seek to use natural resources for the good of its citizens and gives this argument legal grounding. Put simply, it means that natural resources belong to the people of the territory in which the resources are found. A logical consequence is that a government, acting on behalf of its people, has a duty to use those resources in a manner that benefits the owners of that resource. Any solution to the resource curse must enable the state to uphold this principle.

Norway used DSP in a manner that benefited its population and thereby complied with the Principle of Permanent Sovereignty. Indeed, the state's founding aim for the petroleum industry was to improve the development of Norwegian society. This is clear from Norway's Petroleum Act 1996 s1-2, which states '*Resource management of petroleum resources shall be carried out in a long-term perspective for the benefit of the Norwegian society as a whole'13*. It was the opinion of the Norwegian government that its petroleum legislation should be designed with this principle at its core.

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12 Humphreys et al (2007) pp xi and 4, Duruigbo (2005) pp18-21

13 The Petroleum Act, Act 29 November 1996 No. 72, s1-2

Permanent Sovereignty over Natural Resources is a key principle of international law, which applies to other countries in the same way as it does to Norway. The General Assembly gave recognition to the principle in Resolution 1803 (XVII) in 1962. The Resolution provides that states shall strictly and conscientiously respect that '*the right of peoples and nations to permanent sovereignty over their natural wealth and resources must be exercised in the interests of their national development and the well-being of the people of the state concerned*'[14]. Further to this, violation of this right was declared to be in breach of the principles of the United Nations Charter. The principle developed out of the colonial period and the political claim of newly independent states to take control over their natural resources. Its reason for being was to improve the economic development of these countries and is a basic constituent of the right to self-determination [15]. Resolution 1803 reflects the sovereign right of a state to control the exploitation of resources on their territory, but additionally imposes an obligation on states to exercise this right in the best interests of its citizens[16].

The principle of Permanent Sovereignty was later consolidated in international law. Further General Assembly Resolutions strengthened its standing and Common Article 1 of the International Covenant on Civil and Political Rights and the International Covenant on Cultural, Economic and Social Rights made it a binding part of international human rights law. The right is also enshrined under Article 21 of the African Charter on Human and People's Rights, proclaiming that '*All peoples shall freely dispose of their wealth and natural resources. This right shall be exercised in the exclusive interest of the people. In no case shall a people be deprived of it*'. In the *East Timor Case* Judges Weeramantry[17] and Skubiszweski[18] referred to the principle as being part of international law with *erga omnes* character. Today it is generally ac-

14 UNGA Res. 1803 (XVII) para 1

15 Kilangi (2008)

16 Elian (1979) p98

17 *East Timor Case* (1995) Separate Opinion of Judge Weeramantry, pp142, 221

18 *East Timor Case* (1995) Separate Opinion of Judge Skubiszweski, pp 127

cepted that Permanent Sovereignty over Natural Resources is a prerequisite for economic development and thereby a fundamental principle of international law[19].

Thus it is not simply a moral obligation that a government manage resources to benefit the nation, but a legal duty with a corresponding right that citizens can expect this to be done[20]. However, while the principle establishes a legal right, it does nothing in and of itself to solve under-development. It is a legal prerequisite to economic development, but requires further expansion for its founding purpose to be fully realised. The issue is whether the Norwegian structure of DSP could be part of a legal solution to this economic problem.

2.3 The Natural Resource Charter

The Natural Resource Charter proposes a universal solution to the resource curse. It is *'a global initiative designed to help governments and societies effectively harness the opportunities created by natural resources'*[21]. It aims to enable the use of natural resources as a 'pathway out of poverty' for developing countries. The Charter constitutes a set of guiding principles identified by leading economists, lawyers and political scientists and has at its core the principle of Permanent Sovereignty as its legal and philosophical underpinning[22]. As such, the Natural Resource Charter is the point of reference for this thesis.

The Natural Resource Charter consists of twelve 'precepts' to inform decision-making from the point of discovering natural resources. Each precept provides guidance on a stage in the decision-making process, from extraction to the use of the revenue generated. The authors see the resource curse as a consequence of misguided and short-sighted choices

[19] Nincic (1970), Perrez (1996)

[20] This duty has been recognised by the African Commission on Human and Peoples' Rights in African Commission on Human Rights in Social and Economic Rights Action Center (SERAC) v. Nigeria (2001)

[21] Collier et al (2010), p20

[22] See, for example, Collier et al (2010) p1: 'governments of resource-rich countries, ... have both the sovereign right and the moral responsibility to harness natural wealth for the benefit of their peoples'

made by those in power. The Charter recognises that resource management is a complex process, but if each 'link' in the decision-making chain is complied with, it can generate economic growth and improve the welfare of the population. The Charter does not dictate a detailed legal structure. It recognises that this depends on the objectives and needs of the particular country in question. Instead it is a framework with which particular decisions should comply to maximise the opportunities provided by resource wealth. These precepts apply to all extractive industries and are presented as being universally applicable.

The preamble to the Charter takes an expansive view of the potential benefits, stating that '*Exploitation of natural resources should be pursued in order to help a country meet its broader social and economic goals*'[23]. It is a development opportunity that can be used to improve the country as a whole, in the long term, and in a comprehensive manner. A successful petroleum sector needs to fit into a country's economic future. This means that government, as the key decision-makers in this process, must recognise their responsibility to manage resources for the benefit of their people. The overall aim of the solution proposed by the Charter is to enable governments to realise this objective. This is also the objective of this thesis.

2.4 The Natural Resource Charter and direct state participation

Precept 6 relates to direct state participation of a nationally owned resource company in developing a resource base. In the oil and gas sector, this is a national oil company (NOC) participating in upstream petroleum activities. Precept 6 outlines how a NOC should be organised. The consensus is that it can be beneficial, but only if managed correctly, since many NOCs have performed poorly24. The guidance can be categorised into the internal and external legal organisation of the NOC:

[23] Collier et al (2010) p1

[24] Collier et al (2010) p10

- Internal organisation: nationally owned resource companies should:
  - Have the ultimate objective of becoming commercially viable;
  - Have a limited functional scope;
  - Avoid engaging in governmental activities, such as social functions and distributing subsidised output;
  - Avoid engaging in regulatory functions to avoid conflicts of interest between public and commercial goals
  - Be professionally managed;
  - Be transparent;
  - Operate as efficient revenue generating operations
  - Be able to adapt to changes in the economic environment

- External organisation: the government should ensure that:
  - The NOC operates in an open and genuinely competitive environment with other companies
  - The NOC is organised as a separate legal entity with clearly established authorities and objectives and by having governing and management boards separate from the government.
  - Independent government entities conduct the licensing, technical and regulatory supervision of the resource sector

The Charter recognises that a well-managed NOC can assist economic development and have other social and political benefits. It *could* be a part of the solution to the resource curse, but only by complying with the principles under Precept 6.

3 The Norwegian petroleum sector: direct state participation in context

Precept 6 of the Natural Resource Charter indicates that Norway's use of DSP has the *potential* to help governments use petroleum resources to benefit the population. However, it also suggests that this depends on the specific organisation of DSP in Norwegian petroleum law. This will be addressed in Chapters Three, Four and Five. Chapter Four addresses *how* DSP worked in Norway and Chapter Five explains *why* it worked in Norway. First though, Chapter Three puts DSP in the context of the Norwegian petroleum sector as a whole. The legal arrangement of Norwegian DSP within this context and the benefits it achieved for Norway will be presented. The description shows that Norway's legal organisation of DSP helped to prevent the resource curse. This indicates that it does indeed have the *potential* to address the resource curse beyond the Norwegian context.

3.1 Direct state participation in context: the Norwegian state's objectives for the petroleum sector

The government's main concern for the future of its petroleum industry was that it would benefit all of Norwegian society. The means to achieve this was good resource management. The '10 Oil Commandments' reflect this overarching objective[25]. This is a White Paper from the Parliamentary Committee on Industry and was unanimously adopted by the Norwegian Parliament in June 1972. In particular, Commandments 1, 4, 7 and 8 reflect the desire for a comprehensive and controlled approach to oil policy:

> 1. National supervision and control must be ensured for all operations on the Norwegian continental shelf.

[25] Innst. S. no. 294 (1970-71)

> 4. The development of an oil industry must take necessary account of existing industrial activities and the protection of nature and the environment.
>
> 7. The state must become involved at all appropriate levels and contribute to a coordination of Norwegian interests in Norway's petroleum industry as well as the creation of an integrated oil community, which sets its sights both nationally and internationally.
>
> 8. A state oil company will be established which can look after the government's commercial interests and pursue appropriate collaboration with domestic and foreign oil interests[26]

These founding principles remain relevant today and are reflected in the Petroleum Act 1996 s1-2 [27]

3.2 Norwegian oil policy

In order to realise these objectives, the Norwegian state considered it of paramount importance to maintain national control over its petroleum sector. The ability to exercise this control derives from the Law of the Sea Convention, Articles 77(1) and 77(2) (UNCLOS). This international convention grants the state ownership of its sub-sea resources located on its continental shelf and the exclusive right to exploit these resources. The system that developed in Norway must be seen in connection with this basic state ownership[28]. The '*exclusive right*' means the state must grant express permission to any outside entity wishing to exploit its sub-sea resources and can impose any conditions it sees fit on the grant of this

[26] Innst. S no. 294 (1970-71)

[27] The Petroleum Act, Act 29 November 1996 No. 72 S 1-2 Resource management of petroleum resources shall be carried out in a long-term perspective for the benefit of the Norwegian society as a whole. In this regard the resource management shall provide revenues to the country and shall contribute to ensuring welfare, employment and an improved environment, as well as to the strengthening of Norwegian trade and industry and industrial development, and at the same time take due regard to regional and local policy considerations and other activities.

[28] Hammar et al (2011) p28

right. This is the legal underpinning of Norwegian oil policy. The characteristic features of Norwegian oil policy include the licence system, state organised licence groups and state participation within these groups[29].

3.2.1 Norwegian petroleum legislation

The main source of current Norwegian petroleum legislation must be outlined at the outset. The Petroleum Act 1996[30] regulates the significant stages of petroleum activities and establishes a framework for state management of petroleum resources. S1-1 reflects Art 77(1) UNCLOS. It vests the property rights to sub-sea resources located on the Norwegian continental shelf in the Norwegian state. S1-2 first paragraph reflects Art 77(2) UNCLOS. It states that resource management is exercised by The King and decisions of The Norwegian Parliament. The King in this context means The Cabinet. Pursuant to these powers, the state established its legal framework to exploit petroleum resources and regulate the companies conducting petroleum activities its continental shelf. The Ministry of Petroleum and Energy (MPE), referred to as 'The Ministry' under the Petroleum Act, has been delegated overall responsibility for resource management in the petroleum sector. It is the MPE that administers the licence system.

3.3 The licence system

The Norwegian state implemented a concessionary system whereby foreign oil companies must apply for a licence to exploit petroleum on the Norwegian continental shelf. The companies own the petroleum they produce, but the state controls how this is done.

This licence system ensured that the government maintained oversight and control at each important stage of petroleum activities. This was emphasised in Parliamentary Report No. 25 by the Ministry of Industry, stating that the organisation of petroleum activities must

[29] Hammar et al (2011) p28

[30] The Petroleum Act, Act 29 November 1996 No. 72

'*provide Norwegian authorities with full control of all stages in the operation: exploration, production, processing, export and marketing*'[31]. No major petroleum activities could be conducted without prior government approval. This is explicit under the Petroleum Act s1-3 '*None other than the State may conduct petroleum activities without the licences, approvals and consents required'*. A separate licence is required for exploration activities, production activities and to install and operate facilities for transportation and utilisation of produced petroleum[32]. The MPE stipulates the terms of each licence and additional approvals may be required for other significant activities.

3.4 State organised licence groups

The MPE selects a group of suitable companies to create a licence group for each licence it grants. This is another feature of Norwegian oil policy: the state considered it better resource management to have several oil companies conducting oil activities rather than one company acting alone. The MPE invites oil companies to apply for a licence to explore or produce petroleum in a defined licence area. On the basis of these individual applications, the MPE organises the licence group. The licensees are chosen on the basis of financial strength and experience in petroleum operations. In the early years the Ministry would also consider whether the applicant would be contributing to the Norwegian economy[33] .The licensees are obliged to enter a Joint Venture Agreement with one another and conduct petroleum operations in partnership. Petroleum is produced jointly, but each licensee owns its proportionate share. This process ensured government discretion over who and how activities were conducted. The NOC would participate in co-operation with

[31] Parliamentary Report No. 25 (1973-1974) Petroleum Industry in Norwegian Society

[32] The Petroleum Act, Act 29 November 1996 No. 72, Chapter 2, Chapter 3 and section 4-3 PA

[33] This could be through marketing in Norway, constructing refineries, using Norwegian ships etc. In addition, a condition for granting the licences was that the applicant would utilise onshore bases in Norway and use Norwegian labour, Al Kasim (2006) pp19-20.

foreign oil companies, but did not need to apply for a licence itself.

3.5 State participation within the licence groups

The eighth 'Oil Commandment' shows that the state aimed to create a NOC to look after its commercial interests within the licence groups. In 1972 an entirely state-owned company, Statoil, was established by decision of the Norwegian Parliament. This entity directly participated as a fully operational oil company in every licence group from the third licensing round in 1974.

According to Noreng there were three main objectives for DSP:

1. Revenue: securing the highest possible share of the earnings from oil, excluding tax and royalties

2. Government control: ensuring more direct control of operations than is possible through the licence system alone

3. Know how: to learn as much as possible about the oil industry through active cooperation with private companies[34]

These aims are clear from the government papers debating the establishment of Statoil, stating that DSP would '*besides the opportunity for greater economic revenues, secure direct state influence in the activities, at the same time as being able to develop more comprehensive Norwegian know-how*'*35.*

The legal structure of Norwegian DSP will first be outlined to show how the Norwegian government set about achieving these aims. The actual contribution of DSP to these stated aims will then be discussed.

3.6 The organisation of direct state participation in Norwegian petroleum law

The 'Norwegian model' of DSP included a 100% state-owned NOC and two independent legal entities to regulate this company: The MPE and the Norwegian Petroleum Directorate (NPD).

[34] Noreng (1980) p121

[35] St.prp.nr.113 1971-1972:8

3.6.1 Statoil: the national oil company

Statoil is Norway's NOC. When created in 1972, it was as an ordinary joint stock company under Norwegian company law[36], but with all the shares held by the Norwegian state[37]. Thus Statoil's legal status was somewhat unclear at this stage, being a business enterprise, but with complete state ownership, which implied a national purpose.

This national purpose was to uphold the government's commercial interests in licence groups and to serve as a vehicle for technology transfer and economic development[38]. Statoil was thus an instrument of the Norwegian state, but unlike most state-run entities, it was structured as a relatively autonomous company. The directors held the main responsibility for fulfilling Statoil's commercial mandate. They were given a large degree of freedom from the government in making these commercial decisions[39]. Furthermore, Statoil's own fortune was formally separated from the state treasury because it was governed by Norwegian company law. Thus it did not need the state's permission to use its own money[40]. It paid taxes, as other oil companies did, and the state earned money through dividends as company shareholder. Thus Statoil was essentially a commercial enterprise, but acted primarily in the state's interest, rather than its own private interests.

Statoil's legal status has been reformed considerably since its creation. These reforms were designed to reflect the state's changing objectives for its NOC and to ensure the company continued to function in an efficient manner. This legal reform is a key part of the Norwegian model for DSP and will be discussed as such in Chapter Four.

3.6.2 The responsible authorities

The legal organisation and mandate of the authorities responsible for

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36 Limited Liability Companies Act (1957)
37 Mestad (1985) pp 65-66
38 Stenvoll (2007) p23
39 Mestad (1985) p67
40 Mestad (1985) p72

the petroleum sector were designed to maximise state control and to promote good resource management. The system is structured in a hierarchical manner. The Norwegian Parliament (The Storting) makes the main decisions and sets the key principles. The government has the overall responsibility to see to it that these principles are followed. The MPE is the delegated government department with specific responsibility to regulate activities on the Norwegian continental shelf. The NPD is subordinate to the MPE and responsible for regulating the day-to-day activities on the Norwegian continental shelf, while Statoil, like the other oil companies, is subject to the decisions of both the NPD and the MPE[41].

The overarching function of Statoil, the NPD and the MPE is to ensure good resource management of petroleum activities. Their relationship to one another was structured in law to enhance this purpose. The key roles were clearly separated between these three, independent, legal entities in what is known as a tripartite system. The MPE has the main policy making function, the NPD is responsible for regulating the oil companies and Statoil was made responsible for the state's commercial interests. This prevented overlap of responsibilities and conflicts of interest between these key functions.

3.6.3 The Ministry of Petroleum and Energy and the Norwegian Petroleum Directorate

The MPE is central to the legal and administrative system for resource management on the Norwegian continental shelf. It took over responsibility for the sector from the Ministry of Industry in 1978. This ensured that the necessary considerations in petroleum activities were safeguarded by a separate sector ministry dedicated to these activities[42]. The MPE was made specifically responsible for the formulation of oil policy and the licensing system. It works with the political leadership to plan the development of the sector and does the preparatory work prior to the Cabinet granting production licences. All other major licences and

[41] Mestad (1985) p47

[42] The Norwegian Petroleum Directorate (2003)

approvals are issued directly by the MPE pursuant to the Petroleum Act 1996[43]. Thus, while the ultimate legislative and executive power rests with the state, the central governing functions rest with the MPE.

The NPD was established simultaneously with Statoil in 1972 as a separate government entity. It was made responsible for technical and regulatory supervision and guidance in the petroleum sector. It compiles data, collects fees, sets regulations within its areas of responsibility, and advises the Ministry on technical matters[44]. It is subordinate to the MPE and, while the MPE has overall responsibility for resource management, the NPD has more day-to-day, technical and regulatory control. It also handles the more detailed approvals and consents[45].

This division of commercial, regulatory and policy functions into three independent legal entities enables the state to have greater control over petroleum activities. This tripartite system is an essential part of the legal framework for Norwegian DSP.

3.7 The contribution of direct state participation to Norwegian oil policy

The state's objectives for DSP were to increase revenue, know how and control. In the following sections, the contribution that Statoil made to these goals will be described.

3.7.1 State revenue

DSP significantly contributed to state revenue. Statoil was granted a 50% participatory interest in each licence from 1974, giving the state a proportionate share of the value of the resource extracted. This was in addition to the revenue received from royalties and taxation of the oil companies in each joint venture. The state optimised government take by mandating further privileges for Statoil. The 'sliding scale' provision

43 The Petroleum Act, Act 29 November 1996 No. 72, see I particular Chapters 2, 3 and S 4-3

44 Thurber et al (2011) p5367

45 Hammar et al (2011) p11

was introduced in the fourth licensing round in 1979. If a field was deemed commercial, Statoil reserved the right to increase its participating interest by up to 85%, depending on the size of the field. In addition, Statoil's exploration costs were 'carried' during the exploration phase, reducing capital investment during this uncertain phase of activities.

The Statfjord Field provides an example of how DSP contributed to state revenue. This field was discovered in a block during the third licence round. This was the first round during which Statoil held a 50% interest. This field would turn out to be one of the biggest reservoirs in the world. By this time the oil price had also risen to four times that of the year prior to the Statfjord find[46]. Had the state not secured Statoil's 50% interest at this early stage, it would have failed to capture significant revenues from this giant field.

3.7.2 Government control

DSP was at the centre of the government's strategy to 'steer' petroleum activities in the national interest. It was the primary tool of direct control over Norwegian resources[47]. The presence of Statoil in each licence group secured government influence at each important phase, during exploration, development and production. The 50% participatory interest gave Statoil a significant degree of influence in each management committee of each joint venture and a veto-right over decisions. This effectively gave the state a controlling interest in virtually every producing field covered under licences awarded after 1973[48]. This enabled the authorities to maintain close control over the direction, tempo and impact of petroleum activities on the Norwegian continental shelf[49].

The importance of this national influence within licence groups was demonstrated at the initial stages of developing the pipeline network. The pipeline network is used to transport oil and gas from the field to

46 Ryggvik (2010) p31

47 Nelsen (1991) p41

48 Nelsen (1991) p59

49 Al Kasim (2006) p242

the European and UK markets. Whoever secures control over access to the pipeline network also, in effect, controls access to the market. Monopoly over the market can develop through strategic ownership of a pipeline network. In the Ekofisk field, the American oil company Philips insisted that as owner of the field it should also own the connecting pipeline. The pipeline from Ekofisk was of particular strategic importance. It had the potential to be a 'trunk pipeline', connecting other fields to the market[50]. The Norwegian state challenged Phillips to gain control over this pipeline and managed to negotiate a 50% share for Statoil. This prevented Phillips from obtaining a decisive ownership position. It also opened the way for Statoil to take over as operator of the pipeline at a later point[51]. The Norwegian state, through DSP, secured this strategic position, ensuring state control over the development of the pipeline transport network.

3.7.3 Know how

DSP gave Norway a 'window to the oil industry'. Through Statoil, Norway developed hands on technical and managerial experience of oil operations. In doing so, it generated expertise that could be used to strengthen its position against the international oil companies. Norway was able to overcome the information asymmetries between oil companies and government authorities. As a result, the balance of power turned in favour of the Norwegian state. The knock on effect was an ability to negotiate more favourable conditions for the state because it knew the true value of its resource base. It could, for example, demand more stringent and favourable terms and higher tax rates over time, to a large extent as a result of the learning process of a fully operational NOC.

3.7.4 Norwegianisation

In addition to increasing revenue, control and know how, the state oil

[50] Ryggvik (2010) p29
[51] Ryggvik (2010) p29

company was also involved in the 'Norwegianisation' process. This policy objective was based on a desire to build up a strong domestic industry with both oil companies and suppliers[52]. It is alluded to under the third Oil Commandment '*that new industry is developed on the basis of petroleum*' and was formally declared in the Royal Decree of 8th December 1972. This objective became another means of using petroleum activities to benefit the Norwegian society as a whole.

According to Corti and Frazer, Norwegianisation consists of three elements:

1. Increased equity shares and operator responsibilities for the three Norwegian oil companies: Statoil, Norsk Hydro and Saga
2. Increased use of Norwegian goods and services in petroleum activities
3. Norwegian industrial development[53]

This process was primarily implemented through regulations and conditions attached to licences, but Statoil also played an important role. It was, as a Norwegian company, both a part of the Norwegianisation process itself and helped to further implement the use of local content[54]. Firstly, Statoil and the two other Norwegian oil companies Hydro (51% state-owned) and Saga (private) were singled out for special treatment by the state to encourage the development of a Norwegian petroleum industry. This preference was clear from the privileges granted to Statoil and the appointment of Norwegian oil companies in licence groups and to the position of operator; the most influential position in a joint venture. In the third licence round Norwegian companies were appointed operator in eight of the twelve licences (four to Statoil). This trend continued in the fourth licence round of the 'Golden Block'[55]. Secondly, designating the role of operator to Statoil increased the use of Norwegian goods and services. Statoil, as operator, had the corresponding responsibilities for procurement, enabling the state to direct the use of

52 Rasen (2102) pp13-14

53 Corti and Frazer (1983) p70

54 Nelsen (1991) pp70-72

55 Nelsen (1991) p71

Norwegian as opposed to foreign industry. This Norwegianisation process was an indirect and broader means of benefiting the Norwegian society through petroleum activities.

These four main outcomes show that DSP furthered the Norwegian state's objectives for its petroleum sector. This in turn indicates that it is desirable to make the system work in other countries rich in natural resources.

4 How the Norwegian state achieved the benefits of direct state participation

The following chapter describes how the state used Statoil to achieve the objectives outlined in Chapter Three. This is the 'story' of the development of Statoil. Chapter Three described the company's role and legal status in Norway. This chapter will show how this changed according to the changing needs of the country. During the early years of the Norwegian petroleum sector, Statoil was legally granted certain privileges to enable it to achieve the government's objectives at this particular stage. Once it became a powerful company and the state changed its objectives for the petroleum sector, Statoil went through major legal reform. This chapter is designed to illustrate the complexities of controlling a NOC so that it acts in the interests of the state and thus does in fact help prevent the symptoms of the resource curse.

4.1 The early years

4.1.1 Statoil's legal privileges

Statoil was granted significant privileges during the early years. This enabled the state to build a strong and competent NOC and rapidly achieve its objectives for DSP. These privileges were a 50% participatory interest in each licence group, the 'carried interest' provision and the

option to increase its participatory interest if a field was deemed commercial. These privileges helped to maximise the government revenue from and control in each licence group.

During the first licensing rounds, prior to the establishment of Statoil, the government agreed to relatively poor conditions for itself, which benefited the foreign oil companies[56]. This included large licensing areas, low royalty levels and tax reductions to encourage the oil companies to invest in the Norwegian continental shelf. The results highlight the importance of Statoil's privileges during the early years. The first concession round was the largest Norway ever offered and Norwegian companies were only given minimal shares in twenty one of the three hundred and forty six blocks allocated. By chance Hydro had a 6.7% interest in the block that was found to contain the Ekofisk field. Had the Norwegian state mandated DSP and an option to increase its share at this stage, the income from the Ekofisk field could have been far greater. The rights of a NOC may need to be less stringent during the initial phase so as not to deter foreign oil companies. However, the experience from the Ekofisk field demonstrates the importance of securing DSP and mandating certain privileges as early in the process as possible.

4.1.1 The role of system operator

A key means of gaining know how and control was to assign the role of operator to Statoil. This is a strategic and influential role sought after by the oil companies. For example, several foreign companies rallied for the position in the giant Statfjord field. Mobil was assigned the role, but on the condition that it train Statoil as operator and hand over the role ten years after the field became commercial. Statoil was assigned the role of operator in several other joint ventures. Operatorship ensured state presence at every important stage, 'conquering the strategic heights' of petroleum activities as the most influential position in a joint venture. The position maximised state influence in each licence group

[56] Ryggvik (2010) p19

and enabled it to gain expertise over and above that of an ordinary licensee.

4.1.2 Control over Statoil

The legal framework governing the relationship between Statoil and the state

How the state controlled Statoil during the early years made an important contribution to the government achieving its objectives for DSP. In the process of creating a NOC, the government emphasised the need to ensure adequate control over its policies and actions[57]. White paper no. 113 to the Storting (1972) stated in this regard '*the Ministry of Industry will underline that the authorities will at all times have control over the companies activities since the state as a 100% owner will have the full instruction right in accordance with the rules of the law on public share holding companies*'.

Statoil was controlled by several state entities; the NPD, MPE, the government and parliament. Each entity had a separate function to prevent a conflict of interest arising that could undermine state control over Statoil. The legal framework for political control aimed to ensure that the new state-owned oil company functioned for the benefit of Norwegian society as opposed to its own, private interests[58]. The methods for controlling Statoil consisted of oversight, reporting and accountability requirements.

Reporting regulations ensured Statoil made sound decisions in managing the state's commercial interests. Under Article 10 of Statoil's articles of association, the board of directors was legally obliged to '*submit to the General Meeting …all matters which are presumed to involve significant political questions or questions of principle which might have important affects on the nation and its economy*'. The Minister for Petroleum and Energy was Statoil's general assembly who called an annual general meeting and had the discretion to call for extraordi-

[57] Al kasim (2006) p179

[58] Nelsen (1991) p37

nary general meetings if required[59]. Article 10 also required an annual plan on all aspects of Statoil's future activities to be submitted to the MPE. Statoil's annual plan was commented upon and amended where necessary by the MPE. It was then submitted to parliament for discussion and approval. Biannual reports were also submitted and quarterly meetings held with the relevant authorities. Article 10 was implemented to ensure that no significant decisions were made without prior approval. It also enabled greater state oversight of the company's activities. This was particularly important considering the significance that oil activity was to have on the Norwegian economy[60].

The integrity of the information submitted by Statoil to the authorities was ensured by legal requirements and institutional checks. Firstly, *all* licensees operating on the Norwegian continental shelf were required to submit large amounts of information to the Ministry. Since each company in every licence group had to submit information, this acted as a check on the reporting of other companies within the same licence group. Secondly, the Minister had rights as an observer in the meetings of the management committee of each joint venture. The MPE could also draw on the independent expertise of the NPD. These checks could be used to verify the information supplied by Statoil and were intended to ensure that it would not conduct its own policy or steer the MPE[61].

In addition, in Norway there is a tradition of informal dialogue and co-operation between government and industry. This supplements and enhances the formal procedures. This is a significant aspect of how the Norwegian petroleum industry functions, but will not be expanded upon in this thesis because it is unrelated to law. Nonetheless, it is important to be aware that it has played a significant role. Considering all formal and informal oversight mechanisms the state had at its disposal, the amount of information passing between the Ministry and Statoil was quite considerable[62].

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[59] Al kasim (2006) p179

[60] Richardson (1981) p39

[61] Noreng (1980) p147

[62] Richardson (1981) p39

4.2 Statoil's changing role as an instrument of the state

The legal framework governing Statoil aimed to allow the company to develop into a powerful instrument for the state, while at the same time control it to ensure that it did indeed act in the state's interest. Throughout the seventies there was political consensus on the need to develop a strong, influential and competent oil company through which the state could pursue its national objectives[63]. The dilemma that emerged was how to reconcile political control with the maximum possible freedom for the state oil company in its commercial operations[64]. By the 1980s it was clear that this balance needed to be re-instated. As the balance of power began to tip in favour of Statoil, important reforms were introduced to adjust both the control and role of Statoil as a policy instrument.

4.3 The problems emerge

4.3.1 Losing control

As Statoil became an increasingly strong oil company, it began to wield some political power. The rising wealth of Statoil, its privileged position in licence groups, combined with its ever-growing expertise, enabled the company to become too influential. The formal mechanisms of controlling the company began to show signs of strain.

Statoil was in a dominant position in relation to other oil companies and, to some extent, in relation to government authorities. The voting rules and guaranteed 50% interest in each licence group meant that the company held a veto right in decision-making procedures. Alternative views could thus be subdued and Statoil could commit licensees, as well as the authorities, to decisions that were difficult to reverse politically[65]. Furthermore, disparities between the government authorities and

[63] Al Kasim (2006) p87

[64] Richardson (1981) p37

[65] Al Kasim (2006) p88

Statoil began to emerge. Statoil was able to develop greater expertise, human capital and financial capacity than the NPD[66]. This is significant because the role of the NPD was to regulate Statoil and unequal capacity undermines this element of governmental oversight. There was concern that the NPD was not able to stay ahead of Statoil and control its activities effectively. Moreover, Richardson suggests that the MPE was also not regulating Statoil as it should. Although difficult to substantiate, the suggestion is that Statoil was granted want it requested with few exceptions[67]. Concerns were raised that Statoil could overwhelm the petroleum policy-making structure[68].

Problems also began to emerge with the formulation of Statoil's reports to the MPE on its business plans. These reports had to be submitted at regular intervals under Article 10 of Statoil's articles of association[69]. They became a point of contention between Statoil and the authorities. The MPE wanted more information on future plans, investment and cost predictions[70]. Statoil was concerned that its business dealings with private companies could be undermined by the constant public scrutiny. Thus for Statoil the goal in writing the Article 10 plans was to reveal as little as possible about the company's forward planning[71]. This lack of information could undermine the government's ability to approve and evaluate its plans and thus control its future activities before irreversible actions were taken. Statoil wanted greater independence, while the state needed to restrain this freedom to remain in control. This issue is also illustrative of the tension between Statoil as an instrument of the state and Statoil as a commercial enterprise.

4.3.2 Policy instrument vs. commercial enterprise

Problems also began to emerge with the commercial efficiency of

66 Nelsen (1991) p78
67 Richardson (1981) p40
68 Nelsen (1991) p78
69 See s 4.1.3, para 3
70 Nelsen (1991) p78
71 Richardson (1981) p42

Statoil's operations. It became increasingly clear that the company needed to be exposed to market forces and that a change in this direction would be in the interests of both Statoil and the state.

4.3.3 The Mongstad scandal

The events of 1979-1985 over the Mongstad refinery would become the biggest industrial scandal in Norwegian history[72]. It gave a stark illustration of the need to expose Statoil to market forces.

The Mongstad project was controversial and met with opposition from the beginning. Statoil wanted to invest downstream and made plans to upgrade and expand the refinery. Norsk Hydro and the conservative party in opposition both argued that such a project would not provide sufficient return on investment[73]. After intense political lobbying by Statoil, the plans were eventually approved in June 1984 and given a budget of NOK 4.920 Billion[74]. The project overran its budget by 100%. Statoil had been aware of cost overruns, but did not inform the authorities until two years had passed. The company was criticised in a report by the MPE for a serious lack of leadership and proper management. Another report by the Auditor General accused Statoil of covering up the costs and criticised the MPE for not obtaining verifiable information from the company throughout the project[75]. The scandal led to the resignation of a number of Statoil's board and Arve Johnsen, the company's CEO[76]. The events highlighted the improvement that exposure to market forces could bring to the performance of the company.

Events internationally and domestically following the Mongstad scandal would strengthen the call for greater commercial efficiency. Statoil again experienced significant cost overruns, this time at the Åsgard Field and the Snøhvit project. Moreover, the oil price crash in 1998 weakened the overall profitability in the oil industry. The lower

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72 Nelsen (1991) p177

73 Gordon and Stenvoll (2007) p28

74 Nelsen (1991) pp176-177

75 Nelsen (1991) p177

76 Nelsen (1991) p177

profit margins resulting from the increased cost of conducting petroleum operations and the lower price of oil changed the priorities of both Statoil and the state. The government was now mainly concerned with maximising oil revenue. Statoil had served its initial purpose and the government wanted to focus on maximising return on its investment. Statoil wanted greater commercial freedom to expand internationally and less state oversight of its actions[77]. Thus it was now in the interests of both Statoil and the state to re-structure the legal framework governing Statoil's role and powers in a manner that increased its commercial efficiency.

4.4 Reform of Statoil: stage one 1984

With effect from 1st January 1985, Statoil was reorganised in what became known as the '1984 Reform'[78]. The government and parliament reached a solution to help normalise Statoil's position to that of a strictly business enterprise, without excessive decision-making or financial advantages[79]. The essential concern was to make Statoil a more useful servant to society[80].

Statoil's privileges were largely removed and a distinction was made between the company's licence shares and those of the state. Three main legislative changes were introduced[81]:

1. To moderate Statoil's economic growth, a distinction was made between the shares that generated revenue for Statoil and those that generated revenue directly for the state; the state direct financial interest (SDFI). This would re-direct some of Statoil's revenue directly to the state and put more of the oil income under the control of parliament.

2. Statoil's financial advantages were removed, including the carried interest and sliding scale provisions. These privileges were only to be exercised in favour of the state's share. This also helped to dampen

[77] Austvik (2007) p211

[78] St meld nr 73 (1983-84) and Innst S nr 321 (1983-84)

[79] Al Kasim (2006) p88

[80] Nelsen (1991) p169

[81] Al Kasim (2006) p88

Statoil's financial strength and equalise its position in relation to other licensees, although it did retain the right to a 50% interest in all licence groups.

3. Statoil's administrative advantages were removed. It no longer had the right to vote the state's entire share in each licence group and now needed one of the other companies to vote with it to block or pass a measure. The general assembly, on approval from parliament, retained the discretion to instruct Statoil to veto a decision in exceptional situations[82].

These changes aimed to put Statoil on a more level playing field with other companies operating on the Norwegian continental shelf and force it to act more like a private enterprise. Statoil's role as a policy instrument continued, but greater emphasis was now placed on Statoil as a commercial enterprise[83].

4.5 Reform of Statoil: stage two 2001

The 1984 reform was only the first step in Statoil becoming a more commercially oriented company. In light of the cost overruns at Mongstad and other projects, the declining price of oil and the desires of Statoil itself to expand its operations, a second major reform was implemented in 2001[84]

Statoil was partly privatised and shares were floated on the New York and Oslo stock exchanges in June 2001. Statoil was now organised as an ordinary, limited liability company as opposed to a state-owned company. The state maintained a majority stake in the company at 81.7%[85] and thereby reserved a degree of influence. In spite of this large majority shareholding, the main effect of partial privatisation on the state's relationship with its NOC was to put it on an equal footing with other sharehol-

[82] Nelsen (1991) p95

[83] Nelsen (1991) pp170-171

[84] St prp nr 36 (2000 - 2001) Ownership of Statoil and Future Management of the SDFI and Innst S nr 198 (2000-2001)

[85] In 2012 the state owns a 67% share of Statoil and thus remains its largest shareholder, Statoil (2012)

ders[86]. The MPE was prohibited from consulting Statoil on commercial issues and meetings with the MPE were now the same as meetings with other investors. A more business-oriented relationship was thereby created with Statoil and a clearer distinction was made between government authorities and the now partly private state oil company.

The Norwegian constitution does not allow a partly privatised Statoil to manage the SDFI. Thus, the second part of this reform was to transfer responsibility for managing the SDFI to a new government entity: Petoro[87]. Petoro is formally a licensee and takes part in the decision-making process in joint ventures, but it was not designed to be another oil company. It is structured as a 100% state-owned, non-operating company and does not generate its own income. All of its operating funds come from the state treasury[88]. Its internal relationship to the state is essentially the same as Statoil's was prior to privatisation. However, unlike Statoil, it does not apply for licences, perform any operator responsibilities or sell the state's shares of produced petroleum[89]. Statoil continues to sell the SDFI, but Petoro supervises this. Statoil was now structured as a purely commercial enterprise and Petoro a purely regulatory body.

The 2001 reform meant that Statoil was removed from managing the state's business interests and was no longer a vehicle for the Norwegian state. This is how the structure of state participation on the Norwegian continental shelf stands today. It has enabled Statoil to focus on maximising profit and expand its operations internationally. It continues to bring in significant revenues to the state, but is no longer a policy instrument as it was during the early years.

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86 Thurber and Istad (2012) p623

87 Petoro is governed by Chapter 11, The Petroleum Act, Act 29 November 1996 No. 72

88 Thurber and Istad (2012) p623

89 Hamar et al (2011) p24

5 Distinctive features of Norwegian direct state participation: the key factors contributing to its success

DSP was part of the reason that Norway avoided the resource curse and managed to use its natural resource endowment to benefit the population[90]. This success can be attributed to certain legal and non-legal factors that were either implemented as part of the petroleum sector, or existed prior to the discovery of petroleum. This chapter identifies these factors and how they contributed to the success of Norwegian DSP. They have been taken from a range of sources and compiled to show the most salient and commonly cited aspects of the Norwegian system that enabled Statoil and the principle of DSP to work effectively for the benefit of the population[91]

5.1 Legal factors

Certain aspects of Norway's legislative framework for its petroleum sector made an important contribution to the success of DSP. Norwegian petroleum law laid down the model system of separating functions between government entities, the rules for ensuring transparency and accountability in the petroleum sector and a licence system that created competition between Statoil and foreign oil companies. Each of these legal factors will be discussed in turn.

5.2 The separation of functions model

A key principle of the Norwegian system of governance is to separate functions between government entities. In the petroleum sector this has meant separating three state-controlled institutions, each with its

[90] See section 3.7

[91] These factors largely correspond to those identified under Precept 6 Natural Resource Charter, see section 2.4

own distinct role: the regulatory (NPD), policy-making (MPE) and commercial (Statoil). Each of these bodies is independent and has an arms length relationship with the other entities. This tripartite separation between commercial, policy, and regulatory functions has become known as the "Norwegian model" of oil sector governance[92].

This administrative structure has a number of advantages. Firstly, it avoids any conflict of interest arising between the regulatory/policy-making bodies and the commercial entity. Each function entails a different set of interests, which may conflict in certain situations. The regulator must consider the long-term interests of the population as a whole, while the commercial entity focuses on maximising profits[93]. If the same institution were responsible for both roles, the drive to increase profit could compromise the need to regulate certain actions that generate profit, but harm broader interests. Maximising the revenue of a NOC should not be at the expense of other important interests. In the Norwegian context, the main non-commercial interests are protecting the environment, other industries such as fishing, and the principle of extraction at a moderate tempo. These interests need to be balanced with the profit motive[94]. Thus it is important that the regulator and the policy-makers are formally separated into two entities, distinct from the commercial objectives of the NOC.

Separating responsibilities into three distinct entities also enables each role to be performed more effectively. Firstly, the government and the MPE are able to maintain a much higher degree of control over Statoil. Where a NOC performs both the regulatory and commercial functions it can quickly grow to become a very powerful entity, undermining government influence over its actions. In the Norwegian system, the government always maintained the full right of instruction through the Cabinet, the MPE and the NPD[95]. Secondly, it also improves the commercial role of the NOC. Where the NOC carries out both com-

92 Al-Kasim (2006) p242

93 Noreng (1980) p26

94 Al-Kasim (2006) pp132-133

95 Al-Kasim (2006) p179

mercial and regulatory functions, this can lead to business distrust between the international oil companies and the NOC[96]. This can undermine the relationship of the NOC and international oil companies and thereby the state's commercial interests. The NPD emphasises its objectivity in regulating petroleum activities to reassure the international oil companies that this is done in a neutral manner. In contrast to Statoil, the NPD is able to perform this task without bias to Norwegian commercial interests and acts as a 'faithful guardian of the public interest'[97]. Thus the separation of functions model also improves the standard to which each function is carried out.

Separating functions also had the advantage of focusing Statoil more clearly on the state's business interests. This contrasts to other NOCs, which often have pressure to perform non-commercially. Sonangol, the NOC of Angola, runs an airline, bank and telecoms company and NNPC, the NOC of Nigeria, runs social programmes, in addition to its core activities. Statoil's more specific function helped it to focus on its key purpose and to avoid becoming embroiled in politics. According to Stenvoll, this independence from politics was critical in Statoil's development as a successful commercial entity and its ability to take on necessary, but risky investments[98].

5.3 An accountable and transparent petroleum sector

Statoil was governed by legal norms that ensured its decisions were transparent and public sector agencies were accountable for their actions. This prevented corruption and fostered good practice within the petroleum sector. There was a clear set of internal regulations for Statoil and the other entities, such as the reporting requirements discussed above and laws that limited and clarified the powers of each entity[99]. The legal system in Norway was able to enforce transparency and accountability

[96] Al-Kasim (2006) p175
[97] Al-Kasim (2006) p180
[98] Stenvoll et al (2007) p51
[99] s 4.1.3

and thereby upheld these principles. This instilled confidence in the sector from international oil companies. For example, licensees could appeal decisions of government agencies, reassuring the foreign companies that they would not be unfairly treated, despite the presence of Norwegian commercial interests in joint ventures. In addition to the legal norms, Norway had an existing tradition of transparency, openness and integrity in its civil service[100]. As a result of this transparent system, the Norwegian petroleum sector has thus far been free from corruption and the licensees and authorities are able to cooperate effectively.

5.4 Competition between oil companies

A criticism often made of public enterprises is under-performance because of the lack of incentives generated by commercial competition. Due to the joint venture system, Statoil, to a certain extent, conducted its petroleum activities in a competitive environment. This is regarded as having improved Statoil's performance. Participating as a licensee in joint ventures meant that the NOC's performance would be benchmarked against other oil companies[101]. The presence of more than one Norwegian oil company was of particular importance. According to Al Kasim the presence of both Statoil and Norsk Hydro improved efficiency and prevented a monopolistic dominance by one company[102]. This indigenous competition for assets between Hydro, Saga and Statoil is a distinguishing factor between the Norwegian and other NOCs because it faced more pressure to perform financially[103]. This feature has been termed a 'value adding force' because it is seen as having increased the revenue generated by Statoil[104]. Parliament recognised this, stating that, '*active competition between several competent companies helps to ensure the best possible use of resources. In this way we ensure that they sharpen*

[100] Al-Kasim (2006) p241

[101] Thurber et al (2011) p5371

[102] Al-Kasim (2006) p187

[103] Stenvoll (2007) p22

[104] Stenvoll (2007) p51

themselves against each other'[105]. Having Statoil operate in a competitive commercial environment thus improved its ability to generate revenue for the government.

5.5 Non-legal factors: Norway's privileged starting point

The following features are independent from law and were already present in Norway prior to discovering petroleum resources. They include a well-functioning civil service, possessing the tools to quickly and competently establish a NOC, and the ability to attract foreign oil companies relatively easily. These factors enhanced the success of DSP and the formal legal framework. They put Norway in a privileged position to achieve success in the petroleum industry, but are often lacking in developing countries. Isolating these factors will indicate whether lessons could be learnt in developing countries or if DSP is too specific to Norway to be workable elsewhere.

5.5.1 A competent bureaucracy

The administration of DSP depended on a well-functioning bureaucracy. The separation of functions model can only be an effective framework if those who work within it are competent. Petroleum activities are highly expensive, thus swift and accurate management by government agencies is needed[106]. Furthermore, the success of DSP also depended on the MPE and the government being able to adapt the system to changing national and international conditions. For Statoil, the ability of the state to reform its structure, legal status and privileges was particularly important as the need for greater commercial efficiency increased. This involved a significant reassessment of the links between Statoil and the state. The legal solution that the Norwegian bureaucracy created has been termed a

[105] St prp nr 36 (2000 - 2001) Ownership of Statoil and Future Management of the SDFI p10
[106] Al Kasim (2006) p177

'Norwegian Innovation'[107]. Norway was able to create a more profit-oriented company and avoid the poor-performance often associated with NOCs. Thus the Norwegian civil service were important both in effectively carrying out the roles of regulator and policy maker, and in having the necessary knowledge and foresight to change policy and reform institutions when good resource management required it.

5.5.2 Enterprise capacity

Norway was fortunate to have the necessary tools in place to mobilise its own petroleum operations. Al Kasim has termed this 'enterprise capacity' and states that '*the high level of enterprise capacity in Norway before the oil age was one of the most important factors contributing to its success as a petroleum nation*'[108]. The building blocks for developing its own oil company were already in place at the time of the first oil discoveries. The main factors relevant to DSP included: technological expertise in related industries, a developed institutional framework, available infrastructure, a high level of education and relevant skills, a stable economy, experience in state participation in other industries, traditions of transparency and competence in the civil service[109]. For example, Norwegian universities were able to quickly develop the relevant research institutions and educate new personnel with specific knowledge of petroleum activities. Norway's stable economy and efficient administration ensured that the necessary expertise and technology could be adapted to petroleum activities in an efficient and reliable manner. This enabled the state to successfully implement DSP and for Statoil to become a competent oil company in a relatively short space of time.

5.5.3 The Norwegian continental shelf: an attractive and stable investment

Statoil's success was dependent on foreign oil companies; they were its

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107 Clauss (2002) p8

108 Al Kasim (2006) p128

109 Al Kasim (2006) p127-128

source of know how and revenue. Thus the success of the Norwegian state's own investment was reliant upon attracting competent and financially strong international oil companies to enter into joint ventures with Statoil. These companies provided the experience necessary for Statoil itself to become a competent oil company. They also 'carried' Statoil's exploration costs and made the resource discoveries, which enabled Statoil to produce and generate revenue for the state. Thus Norway had to ensure it remained an attractive investment prospect.

A stable political and legal system

Norway's political system meant the country was more able to attract foreign investment. Norwegian oil was located in a politically stable democracy, which re-assured international oil companies that their investments would be secure[110]. All binding agreements, such as licences, fiscal and royalty terms and joint ventures with Statoil, were almost certain to be respected. This secure and predictable system has meant that oil companies are more willing to make large investments and enter into joint ventures on the Norwegian continental shelf[111]. The Norwegian legal system also reassured oil companies that if issues did arise with the state, there would be recourse to justice. Thus Norway's status as a stable democracy gave foreign oil companies confidence and encouraged them to invest from the early stages of petroleum activities. Since Statoil relied upon foreign companies, the political situation in Norway contributed significantly to the success of Norwegian DSP.

Resource base and geographic location

Norway's proximity to the European market and the high value of its resource base also made it an attractive investment prospect. The estimated ultimate petroleum potential of the Norwegian continental shelf is 13.1 billion standard cubic meters of oil equivalents, making the

[110] Noreng (1981) p74
[111] Al Kasim (2006) p129

country very rich in petroleum[112]. The timing of the first discoveries also coincided with high oil prices following the first dramatic rise in prices from 1973[113]. Norway also had relatively easy access to the European market, with discoveries in close proximity to the continent[114]. This guaranteed the sale of produced petroleum to offset exploration, production and transportation costs. This is of particular significance for gas. Norway's geographical location made it possible to sell the gas without excessive investment in pipelines to transport it to the continent. Thus investment in the Norwegian continental shelf was more likely to be profitable than in a country with a less valuable resource base and high transportation costs to a distant market.

6 Lessons that can be learnt by developing countries from the Norwegian model of direct state participation

This thesis has shown that DSP helped the Norwegian government to realise the benefits of its petroleum resources and thereby avoid the resource curse. This suggests that the system has at least the *potential* to address the resource curse elsewhere. The problem for developing countries is that they do not have the same advantageous starting point as Norway when establishing their petroleum sectors. They lack many of the 'building blocks' identified in Chapter Four that facilitated the legal framework for DSP to function effectively. The question is what lessons can be learnt by countries that lack these 'building blocks' from the legislative design Norway used for structuring and regulating its NOC. Which features should be transferred to developing countries to give DSP the best chance of preventing the resource curse?

Firstly, it will be demonstrated that DSP *should* be used by develo-

[112] Hansen and Rasen (2012) p26

[113] Al Kasim (2006) p137

[114] Noreng (1980) p74

ping countries because it is more appropriate than the alternative system: a liberalised petroleum sector. A liberalised sector has its advantages, but these advantages do not necessarily benefit the citizens and, moreover, certain fundamental benefits of using a NOC are lost. This focuses the question because it is no longer an issue over *whether* developing countries should use a NOC, but *how best* to manage that NOC. This leads to the second point of analysis: which legal features of Norwegian DSP could enable the system to work in developing countries? Each legal aspect of Norwegian DSP will be assessed to understand whether it could in fact assist developing countries in preventing the resource curse. Thirdly, the Norwegian model will be analysed in comparison with Precept 6 of the Natural Resource Charter. While the Norwegian model complies on the whole, certain legal norms are not in line with the Norwegian system. This suggests that the universally applicable principles of Precept 6 could be adjusted to take account of the fact that these legal norms did function effectively in Norway and thus may also function effectively elsewhere.

6.1 The use of national oil companies: Statoil in context

Many resource-rich countries have chosen to use a NOC. Norway is far from unique in this sense. According to a 2007 study, nine of the top ten oil companies in terms of oil reserves, and all top ten in terms of gas reserves, are NOCs[115]. Of world proven oil reserves of 1,148 billion barrels, approximately 77% of these resources are under the control of NOCs with no equity participation by foreign oil companies[116]. Moreover, most of these companies are located in developing countries. Thus DSP is already a central part of many domestic oil sectors and fundamental to resource management on a global scale.

The popularity of NOCs in the petroleum sector grew out of a desire to establish greater national control over this strategic resource. Initi-

[115] Kyepa (2012), Pirog (2007)

[116] Jaffe et al (2007) p3

ally, private oil companies had dominated the industry, but, after World War II, the prevailing view was that states could and should take control over their own resources. This was articulated in the emergence of the principle of Permanent Sovereignty over Natural Resources in international law and direct participation through ownership was seen as a key part of this[117]. For example, in 1968 the Organisation of the Petroleum Exporting Countries (OPEC), issued a 'Declaration of Petroleum Policy in Member Countries', which encouraged its member states to develop their petroleum directly, resulting in the establishment of a number of NOCs in these countries. Statoil was established in this context, along with several other NOCs throughout the late 1960s and 1970s.

However, these state-owned enterprises were criticised as being commercially inefficient and, following a decline in the price of oil, many chose to privatise their NOCs during the 1980s and into the 2000s[118]. While Norway chose to partially privatise its NOC, others fully liberalised the industry, most famously Great Britain. While there has been a resurgence in the popularity of NOCs, this criticism remains relevant today. It is concerns over finance that are the key arguments against deciding to directly participate in petroleum activities.

6.2 A national oil company vs. a liberalised petroleum sector

Petroleum operations are highly expensive and return on investments cannot be guaranteed. Where return is generated, it can take many years before a field becomes commercial. The main issue in petroleum operation is that resources cannot be directly seen - they can only be inferred from data and surveys during the exploration phase[119]. Thus, petroleum activities involve a high degree of financial uncertainty. As a result, using state funds and taxpayers money to participate directly as an investor is a high-risk activity. This is exacerbated in developing co-

117 Mcpherson (2003) p1

118 Warshaw (2012) figure 2.2 p45

119 Al Kasim (2006) p130

untries that lack financial security and the technological and managerial skills to create a well-functioning NOC. Leaving this risk to the private oil companies by liberalising the petroleum sector and taxing their income could, in terms of revenue, benefit the country more than using a state-owned company.

6.2.1 The problems associated with using a national oil company

Commercial inefficiency

State-owned oil companies are considered costly and commercially inefficient in comparison to private oil companies[120]. This is confirmed by research and empirical evidence[121]. Moreover, NOCs that are privatised have shown significant improvements in their performance[122]. Indonesia's NOC, Pertimina, is illustrative of this lack of operational efficiency. A management audit of Pertimina by PwC in July 1998 exposed losses of over $2 billion per year. Figures also show a significant efficiency gap: Pertimina's direct production costs were US$ 5.50, whereas the industry average is US$ 1.20[123]. The Nigerian NOC, NNPC, also shows significant wastage, with estimated losses at between US$ 800 million and US$ 1 billion annually[124]. This begs the question whether private oil companies are in fact a more appropriate solution to the resource curse in developing countries.

A key cause of this efficiency gap is the different incentive structures of private and public enterprises. The objective of a private oil company is to maximise shareholder value, to ensure profitability in the short and long term. There is a motive to achieve productive efficiency to hold down costs to enhance profitability[125]. This requires sound technical,

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120 Mcpherson (2003) p2

121 Pirog (2007) p10, C. Wolf (2008) p19, Eller et al (2007)

122 Wolf and Pollitt (2008)

123 Mcpherson (2003) p4

124 World Bank Group, NNPC Management Audit, December 2000, see Mcpherson (2003) p4

125 Pirog (2007) p5

financial and labour management. NOCs, on the other hand, are not subject to market forces to the same degree. Efficiency suffers because there is an absence of the spur of competition[126]. NOCs tend to be overstaffed and paid more than market wages, are prone to corruption and patronage and show poor financial management[127].

Cost requirements

The government must provide the funds to establish and run the NOC. If the company is to have a chance of functioning well, this will require significant capital investment in its initial set up, administration and operational activities. A developing country may be unable to afford this monetary burden. For instance, Nigeria has consistently defaulted on its contributory payments to its NOC in joint ventures over the years[128]. Moreover, in comparison to the requirements of other sectors, such as education, health and infrastructure, the budgetary demands of a NOC are very large[129]. It may be difficult to justify such a capital-intensive investment in countries where citizens see that their government is unable to fulfil other fundamental needs.

Statoil was a costly, but relatively efficient NOC. In countries that lack the skills, institutions and knowledge necessary to ensure commercial efficiency, state ownership could result in financial losses. Moreover Statoil, being entirely not partly state-owned and a fully operational company not just a holding company, is a particularly capital intensive and challenging model to replicate. Thus, the risks may outweigh the benefits in creating a NOC modelled on Statoil in less developed countries.

6.3 A liberalised petroleum sector: could this be a more appropriate solution?

In a liberalised petroleum sector, all oil companies are privately owned

126 Stevens (2003) p15

127 Stevens (2003) p16, Humphreys et al (2007) p27, Tordo et al (2011) p37-39

128 Ogunlade (2010) p6

129 Mcpherson (2003) p7

and the government generates revenue via taxation and royalties alone. This both avoids the financial risk of direct participation and could increase government-take if the oil profits can be channelled into the state treasury.

6.3.1 The advantages

Commercial efficiency

According to efficiency rankings in a study by Eller et al, the largest, privately owned, international oil companies are the most efficient, in terms of revenue per employee and revenue per unit reserves, while NOCs tend to be in the bottom 20% of efficiency rankings. The average technical efficiency rankings of private oil companies were also significantly higher than NOCs[130]. It follows that a private oil company will tend to generate a higher return on capital than a state oil company of a similar size and operations[131]. These findings are also reflected in a study by Wolf, which suggests that preference for state oil will come at an economic cost[132]. This means that government take from a given resource base could be higher in developing countries if all oil companies operating on its continental shelf are private enterprises.

Lower financial risk

In a liberalised sector the state avoids the costs of establishing and running oil operations itself and receives a steady and fairly predictable source of income. Effective fiscal policy can be used to maximise the government's share of oil rents. Neutral taxes and tax incentives can also help stimulate and sustain further petroleum development projects. Tax deductions mitigate high tax rates and encourage further exploration activities[133]. Focussing on enforcing well-designed tax laws could

[130] Eller et al (2007) pp 11-14
[131] Jaffe et al (2007) p3
[132] Wolf (2008)
[133] Ogunlade (2010) pp15-16

be a more appropriate use of public funds in developing countries[134]. The state could capitalise on the commercial efficiency of the private sector and focus on channelling these reserves into more pressing obligations to its citizenry[135].

6.3.2 The disadvantages

The problem of institutional capacity

A liberalised sector requires strong institutional capacity and good governance in order for the state to receive the financial benefits of using this model. The government must be able to formulate and execute an effective fiscal policy and enforce its petroleum regulations. This can be particularly challenging in countries with weak institutions and little experience of dealing with powerful, multinational oil corporations. Thus it may not in fact offer a better solution for developing countries. Private oil companies generate more profit, but unless the government has a fiscal policy and institutions that capture an optimum share of this profit, the commercial efficiency of private oil companies does not benefit the country in question.

Tax administration and imposition are highly demanding tasks for state institutions. Assessing the tax liabilities of each oil company is complex and there is a risk of tax evasion. For example, in Nigeria, the lack of strong and independent regulations through the Federal Inland Revenue Service and Department of Petroleum Resources, allows the international oil companies to interpret tax rules in an aggressive manner without being challenged[136]. Even in countries that have the necessary capacity, tax avoidance is still a problem. In the case of *State of Alabama v Exxon Mobil Corp* (no. Cv-99-2368) Exxon was found guilty of illegally deducting production costs from royalty payments, resulting in $63.6 million in unpaid royalties. In developing countries the risk of tax evasion is more acute because they do not have experien-

[134] Mcpherson (2003) p 8, Ogunlade (2010) p14

[135] Ogunlade (2010) p14

[136] Emelife et al (2012) p720

ced bureaucrats to administer the complex tax structures[137]. This could amount to significant losses in state revenue.

Thus, as with DSP, for a liberalised petroleum industry to benefit the state, it requires strong administrative capacity to regulate the private oil companies, oversee operations and take a fair value of the produced petroleum. Without this capacity, the asymmetries between the international oil companies and government are likely to be exploited, to the detriment of the wider population.

The lack of a broader purpose: profit making or policy instrument?

A liberalised sector also leaves a gap in achieving any wider purpose with a country's oil industry. Profit making is only one argument in assessing the appropriate legal structure for resource extraction and fails to capture the broader purpose of a NOC[138]. The fundamental reason for state ownership of an oil company is to achieve aspirations that might not otherwise be attainable through taxation and regulation alone[139]. Without a NOC, the state loses its 'window to the industry' and the opportunity to achieve wider benefits related to preventing the resource curse.

Statoil made a significant contribution to the government's objectives for its petroleum sector. These benefits have been explained in Chapter Three and are likely also to be important for developing countries. These benefits are also reflected in the Natural Resource Charter, Precept 6. They include:

- Exerting direct control over the pace of resource development, securing supply, or achieving other national objectives
- Providing a viable vehicle for the country to build its own expertise and professionalism in the resource sector
- Developing domestic capacity and supporting development of domestic linkages between the resource and other sectors

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137 Humphreys (2007) p25
138 Tordo et al (2011) pp39-40
139 Ogunlade (2010) p18

These outcomes of DSP are based on research from natural resource sectors worldwide, which indicates that other countries also use a NOC to achieve broader objectives. For example, under-developed economies will be looking to build up related domestic sectors and increase employment through their NOC. Generating know how is likely to be of particular importance. Direct experience through a NOC helps to overcome the information asymmetries that exist between the state and the oil companies[140]. With little oil expertise, these countries are vulnerable to agreeing poor terms that undervalue the worth of their resources. It is also considered important by many developing countries to assert their sovereignty over natural resources and a NOC facilitates this sense of ownership[141]. The popularity of NOCs in developing countries suggests that the priority of governments in these countries will continue to be more in line with the opportunities offered by using a NOC than relying on private companies. Thus, it is perhaps unrealistic to suggest that a developing country should not directly participate in petroleum activities. The analysis is not so much *if* a country should chose to use a NOC, but how it should be structured and regulated in order to realise the potential benefits.

6.4 Lessons that can be learnt form the Norwegian legal framework for its national oil company

This section will identify and analyse the key features of Norway's legal framework governing Statoil that could be transferred to resource-rich developing countries to help prevent the resource curse. The analysis will build on the factors that were identified in Chapter Four as being key to Statoil's success. The general finding is that the framework Norway used helped to mitigate the risks of using a NOC by structuring the internal and external legal framework in a manner that mimicked certain aspects of a liberalised sector. DSP does have the potential to help overcome the resource curse in developing countries and the fol-

140 Humphreys et al (2007) p4

141 Ogunlade (2010) p21

lowing legal features should be used as part of this solution.

6.4.1 Internal legal framework

Reform of Statoil: 100% state-ownership to part-privatisation

Statoil was fully state-owned in the infant years of Norway's petroleum industry, but during the mature phase it was partly privatised. This reflected the changing interests of the government. It was important to first build up a strong NOC, and then partly privatise it when the new priority was to maintain control and efficiency. In effect, the government restructured the law and legal status of Statoil according to the role it was to play for the country. This provides a useful template for developing countries.

The priority of the early years was to exploit petroleum resources, but simultaneously ensure that the petroleum industry worked for the benefit of the Norwegian people. The state had to ensure that national interests were the guiding principles that prevailed in the industry[142]. A 100% state-owned NOC was the best means of ensuring this because it gave more direct influence in petroleum operations than regulations alone could bring. Complete state-ownership is the most appropriate solution at the outset when direct national control is the priority.

When circumstances changed, however, the role of Statoil and consequently its legal foundations also had to be reconsidered. From the late 1980s, maintaining outside investment and optimising the commercial efficiency of Statoil became the priority. Statoil was seen as having served its initial purpose; it now needed to focus on maximising return on the state's investment. As a result the government introduced two main reforms. Firstly, Statoil's financial privileges were removed because they were seen as a hindrance to the state's current economic priorities. Mandating certain privileges for a NOC is important during the early years to build up a strong company and mitigate the investment risks for the state. It must though be recognised when these privi-

[142] Vik (2007)

leges are no longer appropriate and reforms introduced to bring the NOC in line with private oil companies. However, this reform alone is unlikely to be sufficient to truly improve the commercial efficiency of a NOC.

Partial privatisation was the government's second solution to make a more significant impact on the commercial efficiency of Statoil. The result was greater productivity as a result of being guided by market forces, rather than bureaucratic logic. For the state it meant increased revenue as the company's biggest shareholder. Wolf and Pollitt studied the results of partial privatisation and found that Statoil improved its internal efficiency and financial performance significantly. Moreover, a calculation of the net present value of social benefits from part-privatisation came to between NOK 165.8 and 182.4 billion in 2001 money, 11% of Norway's 2001 GDP. Wolf and Pollitt conclude that '*oil privatisation, if implemented appropriately within a competitive petroleum sector, can generate substantial improvements in corporate performance and efficiency, as well as in social welfare'143*. This clearly implies that other countries would be wise to follow this example of building up a competent NOC, then privatising at the appropriate time.

The advantages of privatisation have also been demonstrated outside the Norwegian context. Brazil provides a useful example. Like Norway it partly privatised it NOC, Petrobras, and the state maintained a majority of shares. This was implemented during a period of reforms to liberalise its petroleum industry in order to improve economic efficiency, increase revenue and attract foreign investment. Although it is difficult to attribute one cause, following liberalisation and part privatisation, Petrobras has improved its financial performance and increased its operations overseas[144]. This indicates that the Norwegian strategy of building up an oil company and then reducing state participation is replicable elsewhere.

Following part privatisation, the Norwegian system more closely resembled a liberalised petroleum sector. The financial and political

[143] Wolf and Pollitt (2009) pp 34, 41-42

[144] Adilson (2012) p539

interests of the state were implemented solely through taxation and concession rules, laws and regulations[145]. Yet it was only after twenty years of direct experience in petroleum activities that the government decided it could rely on its laws and institutions alone to influence the industry. This process was, in a sense, the completion of the separation of functions model. Statoil became a *purely* commercial enterprise, with no role in furthering the state's interests in licence groups, while the regulatory role of the state increased. New, entirely state-owned institutions were created in management positions. Petoro took over responsibility for the SDFI and Gassco took over as operator of the pipeline network. Regulations and corresponding institutions were now highly competent and experienced in managing the petroleum sector. It is only after direct, hands-on experience that a government will be able to rely on its regulations and fiscal policy alone to manage the petroleum sector.

Norway's particular method of managing DSP, by first building up a strong NOC to serve national interests, then privatising when circumstances are appropriate, provides a useful model for developing countries. By directly participating, a government can develop the necessary expertise to be able to rely solely on regulations and fiscal policy at a later stage.

Limited commercial function

The Natural Resource Charter strongly endorses a limited, commercially oriented mandate for a NOC. This has worked well for Norway because it focussed Statoil on its responsibility for the state's commercial interests. It should be considered though whether this is in fact 'best practice' for all NOCs. It could be argued that granting a broader mandate to a NOC would simultaneously increase the benefits of using a NOC.

A state oil company is clearly tied to national interests, but what is in the 'national interest' for a developing country may differ from that of a

145 Vik (2007) p32, Austvik (2012) p319

developed country. It could be more appropriate for a NOC to pursue non-commercial functions where government institutions fail to fulfil their welfare duties. NOCs are often used to pursue a broad range of national, social and political objectives that go well beyond the original purpose of generating revenue for the government[146]. Examples include the provision of infrastructure, such as schools, hospitals, roads and water supply, social programmes and subsidising energy prices[147]. This would appear to accommodate a broader range of needs and benefit a greater section of the population than a limited commercial mandate.

However, research has shown that imposing a variety of objectives on a NOC conflicts with value creation and hampers profits[148]. Non-commercial functions impose additional costs and tasks that are unrelated to generating revenue. A number of these social programmes have themselves been criticised for being ineffective, inefficient or sources of patronage[149]. Venezuela's NOC, PDVSA, provides a useful example of the effects that social objectives can have on the performance of an oil company. Between 1976 and the early 2000s, PDVSA was a capable, high performance enterprise. In 2003 President Chavez increased state influence over the company and converted it from a commercially oriented NOC to pursue social objectives. These included funding and managing social programmes, known as Bolivarian missions, such as improving inner city health care, literacy and food distribution networks. Although there is some indication that these social programmes contributed to a decline in poverty, the unpredictability and weight of these obligations reduced PDVSA's capacity to maintain operations and investments[150]. Partly as a consequence of this, PDVSA's performance has weakened[151]. It is generally agreed that government is better placed to perform these social duties.

146 Tordo et al (2011) p37
147 Tordo et al (2011) p37
148 Grayson (1981) p14
149 Stevens (2003) pp15-17
150 Hults (2012) p455
151 Tordo et al (2011) pp36-40

While it may be tempting for developing countries to broaden the mandate of their NOC, they would be wise to only introduce commercial functions. The government is best placed to decide how to use the revenue generated from oil companies and this revenue is likely to be greater where the NOC is not involved in these political decisions.

Transparency rules

Norway had a clear and strict set of transparency laws governing Statoil. In addition, Norway's legal system meant public institutions could be held accountable for their actions. These laws helped to prevent corruption within the petroleum sector and enhanced the confidence of those investing on the Norwegian continental shelf. The separation of functions between government agencies also complemented these transparency rules because it acted as a system of checks and balances, with each separate institution providing oversight of another. The tripartite system mitigates against opportunities for corruption within public institutions. It should be replicated in resource rich developing countries where the petroleum industry is frequently marred by 'rent seeking' behaviour. While the success of any system will ultimately depend on the integrity and competence of the individuals employed within the framework, laws that aim to ensure accountability and transparency should always be implemented.

6.4.2 External legal framework

Hybrid governance: Norway's joint venture system

Statoil entered into joint venture agreements with private oil companies. This represents a hybrid legal framework, half way between liberalisation and nationalisation. The oil companies were taxed and regulated independently, while Statoil co-operated with these companies to achieve a broader mandate on behalf of the state. This helped to improve Statoil's efficiency by introducing an element of competition. It also mitigated against the financial risk involved for the state in establishing

a NOC and investing directly in petroleum activities.

The joint venture system improved Statoil's efficiency. Working in partnership with private oil companies simulated an environment of competition. It provided the ability to benchmark the performance of Statoil by comparing its financial and operating performance with that of the international oil companies. Furthermore, these companies took the role of operator in joint ventures during the early years, which helped to ensure that efficiency standards were close to international oil company levels[152]. Although Statoil was not truly in competition with the other companies because it was guaranteed an interest in each licence group, it was still able to learn from their experience in the industry and faced pressure to perform at a similar level.

By way of comparison, where a NOC operates in an entirely nationalised petroleum sector, it is not exposed to any element of competition. This has been identified as a key reason for the low levels of commercial efficiency in some NOCs[153]. For example, Mexico is the only major Latin American country that doesn't allow international oil companies to participate in oil activities with its NOC, Pemex. This has contributed to the commercial inefficiency and poor financial performance of Pemex[154]. In contrast, Brazil's NOC, Petrorbras, began with a monopoly over the oil sector, until 1997 when its petroleum industry was opened to foreign investment. Private sector companies can now compete against Petrobras for exploration and production licences This opened Petrorbras to competition and induced the company to reorganise itself to improve its operational and financial performance[155]. This contributed to its reputation as a particularly successful NOC. These two cases illustrate that it is important for a country's laws to allow foreign investment and some element of competition with the NOC.

The presence of private oil companies in joint ventures reduced the amount the state had to contribute to exploit its petroleum reserves.

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152 Mcpherson (2003) p4

153 Mcpherson (2003) p4

154 Tordo et al (2011) p42

155 Adilson (2012) p517

These companies had to pay both a substantial sum for their licences and high rate of tax on their profits. This revenue could then be used by the state to finance its own operations. The carried interest and sliding scale provisions additionally helped to reduce the cost required to run Statoil. These fiscal and licensing laws can be implemented outside the Norwegian system, provided they are not so excessive as to outweigh the rewards for the international oil companies' investment.

In countries that lack financial capital but want the petroleum industry to benefit the broader economic development of their country, a joint venture system can reduce the risk of investing while potentially improving efficiency.

Separation of functions

The Norwegian model of separating commercial, regulatory and policy-making functions in to separate legal entities is a distinctive feature of how DSP is structured. It is regarded as best practice in resource management and endorsed by the Natural Resource Charter. The legal features and advantages of this system have been described in section 5.2. In summary, it removes conflicts of interest, increases state control of the NOC, enables the NOC to focus on commercial functions and the regulator to focus on moderating petroleum activities[156]. However, the model requires significant expenditure and capable civil servants. In countries that lack human capital and revenue this model may not be appropriate.

Thurber et al suggest that attempts at this 'ideal' model in countries that lack the requisite building blocks are fruitless and even counter-productive[157]. For example, Nigeria has attempted a tripartite system during reforms in both the 1980s and 1990s, with the Department of Petroleum Resources as the independent regulator. These periods of regulatory independence rapidly deteriorated and the Department of Petroleum Resources was eventually abolished. Nigeria is again plan-

[156] Thurber et al (2011) p7

[157] Thurber et al (2011) p19

ning to adopt a model that mimics the Norwegian system in its 2008 Petroleum Industry Bill, which is yet to become law. There is little hope of its success considering the extent of corruption, political meddling and resistance to providing a regulatory body with sufficient funding. The Department was always unable to procure sufficient resources to oversee and control the oil industry[158]. In countries where the factors that enabled the tripartite model to function in Norway are missing, there may be little prospect that implementing this legal structure will be worthwhile.

It may be more economical to consolidate limited employees and revenue into one entity. For example, Angola has never attempted to create an independent regulator and has succeeded in the absence of checks and balances. Sonangol, Angola's NOC, is the sector manager, regulator and operator. It has primary responsibility for building the oil sector, policy-making and implementation in the petroleum industry, providing government revenue, issuing licences and conducting negotiations with the oil companies[159]. In spite of these conflicting interests, Sonangol has developed a successful petroleum sector, which contrasts sharply with the rest of the struggling Angolan economy. Rather than undermine the development of the sector, the choice to consolidate the little talent and revenue it did have in to one entity seems to have contributed to its success[160]. Foreign oil companies invested in Angola and the petroleum sector grew, even through a civil war. This suggests that creating separate entities may not be necessary to create a well-functioning petroleum sector. The question remains however whether Angola's system would have functioned better using the Norwegian model.

A system of DSP where commercial, regulatory and policy-making functions are all consolidated into one legal entity is, however, much more vulnerable than a tripartite system. The success of a single entity is highly dependent on the competence of decision-makers with authority over the NOC. A system without checks and balances risks those

[158] Thurber et al (2011) p19

[159] Heller (2012) pp836-838

[160] Thurber et al (2011) p17

with power making unwise decisions that are not monitored independently, which is a fundamental purpose of separating functions: no particular interest is allowed to dominate. In Angola the risk remains that the leaders of Sonangol fail to adequately discharge both the regulatory and commercial functions. Moreover, with the lack of an arms length relationship between the government and the NOC, government leaders may also come to abuse their power over the company. The state oil company is liable to become politicised. This can be seen in Malaysia, where the NOC is sole regulator and manager of the sector, under the direct and binding control of the prime minister. It did have a reputation as one of the best-managed NOCs, but has become increasingly subject to political meddling and used as a 'cash cow' as it became more profitable[161]. An independent regulator helps to prevent these problems from developing.

Perhaps the solution for countries that lack revenue and human capital initially is to implement a structure that represents a middle way between the tripartite and one-entity systems. Brazil's petroleum industry began with a NOC that combined commercial and regulator functions into one entity. The tripartite system was introduced once Brazil gained the revenue, capacity and expertise to do so. It now has a highly successful petroleum industry and NOC, which has, in part, been attributed to implementing this new system[162]. Thus, while the separation of functions model used in Norway should not be recommended as the only option for all countries, it is a more robust system that ought to be used once the necessary 'building blocks' have been developed.

6.5 Precept 6 of the Natural Resource Charter: does the legal structure of Norwegian direct state participation comply?

Section 2.4 above clarified the rules under Precept 6. They are promoted as universally applicable principles to ensure good resource manage-

[161] Lopez (2012) p811
[162] Tordo et al (2011) p62

ment of a nationally owned resource company. While the legal organisation of Norwegian DSP is in line with the majority of these principles, there is some discrepancy in the legal relationship between Statoil and the state. Furthermore, Statoil's relationship with other oil companies was not one of genuine competition in the early years, again suggesting some difference in the way Statoil was managed compared to the ideal that the Charter promotes.

Precept 6 states that the NOC should be organised as a '*separate legal entity*' and with '*governing and management boards separate from the government*'. Statoil's legal status between 1972 and 2001 as a 100% state-owned company, with the state as the only shareholder, inevitably meant that it was not truly 'separate' from the government: it was part state entity and part commercial entity. The government was able to direct Statoil's major decisions as its only shareholder and with the Minister for Petroleum and Energy its general assembly. Furthermore, the Article 10 reporting requirements meant that the government had the opportunity to scrutinise and perhaps adjust the company's future plans. This was intended to ensure political oversight, with transparency being ensured via a formal and visible process that had to be followed by the state when providing directions to Statoil. This formalised link was supplemented by informal ties between the leaders of Statoil and the Norwegian government. For example, Arve Johnsen, Statoil's first CEO, was a former deputy minister in the labour government. He was known for being politically astute with strong personal ties to those in power. These informal links to power reached a point where many considered that the company's actions could not truly be challenged, culminating in the Mongstad scandal and Arve Johnsen's resignation. This meant there was not a true division of functions between government and NOC. Until Statoil was partly privatised in 2001, the arms length relationship that the Natural Resource Charter promotes did not truly exist in Norway.

Secondly, Precept 6 states that the NOC should be '*in open and genuine competition with other companies*'163. While Statoil did operate

[163] Collier et el (2010) p11

alongside other oil companies in a competitive environment, it was not truly on level playing field with them. Statoil's privileges during the early years gave it certain competitive advantages over and above its foreign counterparts. The company was guaranteed a 50% interest in all licence groups and had the option to increase this interest if a field was deemed commercial. This gave the company a clear advantage in licensing and access to acreage. It was also given a priority in the sought-after and influential role of operator, again giving Statoil priority over foreign oil companies. Thus, until these privileges were removed, it was part of Norwegian petroleum law that Statoil was *not* in genuine and open competition with other oil companies.

These issues mean that the management of Statoil was not totally in line with the recommendations of the Natural Resource Charter. However, they were implemented for good reason. During the early years of Norway's petroleum industry, the state did not have the necessary finance or expertise to establish a strong NOC. The privileges were necessary because Statoil was a weak company relative to the international oil companies and needed to become competent in a relatively short space of time. Once this had been achieved, Statoil's privileges were removed and it operated in a more genuinely competitive environment with other oil companies.

Statoil's formal links to the state were also necessary during the early years. The objective in establishing a NOC was to uphold national interests in petroleum operations. To ensure this, the government needed to maintain a degree of political influence over the company. Once the objectives had been achieved, the formal links were removed by partly privatising Statoil. Even the informal ties served a purpose: it was Arve Johnsen that lobbied hard to secure Statoil's privileges and other advantages during Statoil's formative years.

Thus, while the Natural Resource Charter mandates certain universally applicable principles that are, on the whole, in line with the Norwegian experience, these two concepts may need to be revised. It is unrealistic to expect a complete separation between NOC and government. The state *must* exercise a degree of influence to ensure the

company upholds the state's objectives. It is also necessary to grant certain advantages to the NOC, since it must be enabled to catch up to the strength and competence of the international oil companies in order to achieve the government's objectives. Both of these aspects of a NOC's legal organisation will need to be reformed in line with Precept 6 once their purpose has been served, but during the early years at least, it may be more astute to follow Norway's example.

6.6 Conclusion

In conclusion, the Norwegian model of DSP should be used in resource-rich developing countries as part of the solution to the resource curse, but only where there is a genuine attempt to abide by the key legal features of this model. The main features include a limited commercial function, transparency requirements, separating functions between government entities and operating in partnership with foreign oil companies. Furthermore, for the company to remain effective and efficient, legal reforms must be implemented as circumstances in the oil sector change. Although this model would be a challenge to replicate in a developing country, its particular design would help to limit the problems often associated with state-owned companies and capture some of the benefits of a liberalised model. It must though be tailored to the specific needs and political, economic and cultural realities of the country in question. Few countries will possess the same initial advantages as Norway and must make the system work in the context of limited funds, expertise and weak institutions. Moreover, to succeed DSP must also be complemented by good resource management at each stage in the decision-making chain, from extraction to the use of revenue. After all, DSP is only *part* of the solution to the resource curse.

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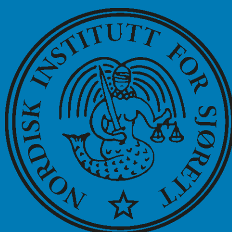

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