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Editor's preface

This issue contains two theses selected among those written by our LLM students who graduated in the autumn 2014. Jolanta Zabityte's thesis deals with a central English law topic, namely the legal categorization of a time charterer's obligation to pay time charter hire timely, by analyzing the Commercial Court case, *the Astra*. As it happened, shortly after Jolanta's thesis was completed, another Commercial Court case, the *Spar Shipping*, came down with a differing conclusion from *the Astra*, which renders the legal position unsettled. Jolanta has subsequently added a chapter setting out the essence of the *Spar Shipping*. The other thesis by Kyle Ritter adopts an approach of law & economics to classic maritime law topics of non-contractual liability norms; negligence, vicarious liability and strict liability.

Finally, two other students from the same LLM class, Martin Starberg and Tommy Bruun, already have had their thesis published as a separate MarIus no. 441, entitled State Intervention and Claim for Reimbursement.

Trond Solvang

Overview of content

The Obligation to Pay Hire in Time Charterparties: *The Astra*

Analysis of the legal grounds for the classification of the obligation to pay hire as a condition

Jolanta Zabityte

Content

Foreword

Commercial Court's judge Mr. Justice Flaux in his judgement as of 18 April 2013 in *The Astra* purpoted to solve the long-standing controversial issue of classification of the obligation to pay hire in time charterparties as a contractual term by holding that the obligation to pay hire on time in clause 5 of the New York Produce Exchange (NYPE) 1946 form is a condition, any breach of which will give rise to a claim for damages for loss of bargain following termination.

The Astra induced a lot of discussion in the shipping market and was not, however, seen as settling the final position on the issue. It may be explained by the fact that the conclusion reached by Flaux J in *The Astra* that the obligation to pay hire punctually is a condition was in contrast to the generally accepted position of both legal practitioners and scholars.

However, after almost 2 years of discussions in the shipping market the issue of classification of the obligation to pay hire on time as a contractual term was reconsidered by another Commercial Court's judge Mr. Justice Popplewell, who handed down a recent judgement as of 18 March 2015 in *Spar Shipping* case, in which it was declined to follow *The Astra* and the obligation to pay hire punctually in clause 11 of the NYPE 1993 form was held to be not a condition.

Although practitioners have already labelled the adoption of the Popplewell J's judgment as indicating the end of *The Astra*, the legal discussion in respect of the legal grounds on which Flaux J based his conclusion that the obligation to pay hire is a condition, which is presented in this thesis, is considered to be of an interest for readers, especially in the light of a recent decsion in *Spar Shipping*. It is noted that this thesis was written prior to the Popplewell J's judgment in *Spar Shipping* case and for this reason the thesis has been updated by including a separate chapter in respect of a recently adopted Popplewell J's judgement in *Spar Shipping*.

1 Introduction

The obligation to pay hire in time charterparties is one of the most important charterers' obligations vis-à-vis the ship-owners. Hire functions as remuneration for ship-owners' services under time charterparty and covers ship-owners' expenses which they incur in relation to the services they provide. Charterers' default in payment of hire may therefore cause problems in ship-owners' everyday financial operations and expose them to serious liquidity problems.

The importance of both charterers' obligation to pay hire and corresponding ship-owners' right to timeous hire payment explains the significance of remedies for charterers' payment default. The ship-owners need protection of their right to timeous hire payment, whereas the charterers need certainty in their legal position in case they are found to be in payment default. Thus, the available remedies are important for both the ship-owners and the charterers.

The system of available remedies for charterers' default in payment of hire in time charterparties under English law is dual. There are legal remedies available at common law and contractual remedies available according to certain contractual terms.

Legal literature suggests that legal remedies for defaults in payment of hire under English law are surprisingly uncertain and on occasions may also be considered by the shipping industry as inadequate[1].

Uncertainty in available legal remedies for defaults in payment of hire under English law stems, at least partially, from controversial construction of the contractual obligation to pay hire. Both legal literature[2] and practitioners[3] – until the recent decision in *The Astra* case – were more

[1] Thomas, §7.7.

[2] *Time Charters*, §16.132: "… the better view is that obligation to pay hire is by nature an intermediate term …"; Thomas, §7.69: "… parties are resigned to its status [status of obligation to pay hire] as a warranty …".

[3] Reed Smith report *Is payment of hire a condition? A long standing controversy resolved* http://www.reedsmith.com/Is-payment-of-hire-a-condition-a-long-standing-controversy-resolved-04-18-2013/; INCE&CO report *The Astra: Single Hire Default Entitles Owners to Withdraw and Claim Loss of Profit for Remaining Charter Period*

likely to say that the obligation to pay hire under English law is characterized as an intermediate (or innominate) term or even a warranty rather than a condition. The position that the obligation to pay hire is an intermediate term, however, due to the absence of clear judicial authority was uncertain and there were indeed suggestions to the contrary[4].

Intermediate term implies that the innocent party's right to terminate a contract at common law and to claim damages for loss of bargain (i.e. losses which accrue as a result of a premature determination of a contract) arises only in case of a serious breach, which deprives the innocent party not in default of substantially the whole benefit of the contract (as opposed to conditions, any breach of which entitles the innocent party to the same). In the context of the obligation to pay hire, this means that in order for the ship-owners to be entitled to the above-mentioned remedies the ship-owners must assess the gravity of charterers' default in payment of hire (i.e. whether it constitutes charterers' repudiatory breach[5] or not). This is, however, not an easy assessment to make, since situations of charterers' payment defaults are highly fact dependent and two missed hire payments may suffice in one case, but not necessarily in another. Furthermore, the ship-owners must exercise their right to terminate at common law at the right time. Too early as well as too late exercise may lead to the ship-owners themselves being in repudiatory breach. The subtlety of ship-owners' slippery election between acceptance of charterers' repudiatory breach with subsequent termination of time charterparty and affirmation of time charterparty is reflected in a recent *Fortune Plum* case.

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http://incelaw.com/en/knowledge-bank/publications/single-hire-default-entitles-owners-to-withdraw-and-claim-loss-of-profit-for-remaining-charter-period Steamship Mutual report *Non-payment of Hire – Right to Withdraw* http://www.steamshipmutual.com/publications/Articles/Astra0613.htm.

4 Comments that the obligation to pay hire is a condition are found in *Contractual Duties: Performance, Breach, Termination and Remedies*, §11-014; McMeel, §23.10.

5 For the sake of clarity it is submitted that in the thesis (i) any breach of a condition; (ii) serious breach of an intermediate term, which deprives the innocent party of substantially the whole benefit of the contract, and (iii) evincing an inability (incapacity) to perform or intention not to perform or to perform inconsistently with the contract are referred as "repudiatory breach".

Legal literature suggests that the uncertainty and limitations of legal remedies for charterers' payment default contributed, at least in part, to the emergence of contractual remedies[6]. It is indeed common practice to have an express right of withdrawal for charterers' payment default drafted into standard time charterparties[7]. The withdrawal clause by its very nature grants an express termination right for the ship-owners and entitles them to withdraw the vessel upon non-payment of hire irrespective of any further factual circumstances, provided the procedure stipulated in the contract is strictly complied with[8]. Simultaneously, the ship-owners are entitled to claim unpaid hire due as at the date of withdrawal.

It is submitted that in a rising market the withdrawal clause is indeed capable to eliminate ship-owners' difficulties associated with the construction of the obligation to pay hire as an intermediate term, because it provides the ship-owners with a tool to get the vessel back by terminating the charterparty upon non-payment of hire and because the question of damages for loss of bargain in a rising market simply does not arise (as the withdrawn vessel is normally subsequently employed at a more profitable hire rates).

But this is not the same when the market is falling. In a falling market, the withdrawal clause only grants the express termination right for the ship-owners and in the absence of charterers' repudiatory breach damages for loss of bargain are not available. Since the damages for loss of bargain in such situation equals to the difference between the charterparty hire rate and the hire rate of a subsequent charterparty, which in a falling market would normally be substantially lower (or there may be no substitute charterparty at all due to the hardship in the market), the availability of damages for loss of bargain is important, but, however, dependent on charterers being in repudiatory breach.

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6 Thomas, §7.11.

7 Cf. New York Produce Exchange (NYPE form) 1946 form clause 5, "Shelltime 4" issued December 1984 amended 2003 lines 196–199, Baltime form 1939 as revised 2001 lines 86–92.

8 Notably, the withdrawal clause may be drafted as giving the right to withdraw the vessel only after expiry of a certain grace period.

Given the fact that nowadays standard time charterparties normally include withdrawal clauses[9] it is namely on the point of damages for loss of bargain the discussion whether the obligation to pay hire is an intermediate term or a condition is legally and commercially significant.

Relatively recent case law – the Commercial Court's judge Flaux J's judgment in *The Astra* – purports to provide an answer and to eliminate the uncertainty related to the construction of the obligation to pay hire by labeling the obligation to pay hire punctually in clause 5 of the NYPE form as a condition.

Since the NYPE form, which is commonly used by the market, has wider application to other charterparty forms that contain similar hire payment clauses, it is submitted that Flaux J's decision concerns not only those time charterparties, which are/will be concluded on the NYPE form, but also those on other standard time charterparty forms. For this reason Flaux J's decision in *The Astra* case is not only one of the most discussed recent decisions among those working in shipping, but it has been appraised as "one of the most controversial"[10] and "potentially ground-breaking"[11] judgments in recent years.

This thesis thus has two major objectives:

1) to analyze the legal grounds on which it was found in *The Astra* that the obligation to pay hire in clause 5 of the NYPE form is a condition, and

2) to analyze the legal effects and commercial implications of *The Astra*.

The thesis consists of four parts. In the first part the short introduction into the research question and the aim of the research was presented. The following two parts are devoted for the above listed objectives of the thesis. The first of the two parts comprises of three main sections. In the first one (2.1) the nature of time charterparties as well as brief characte-

9 Cf. supra note 7.

10 Shirley, §56.

11 Butler, Kouzoupis.

ristics of the obligation to pay hire are presented. It is noted that this section aims to present only those aspects of both time charterparties and the obligation to pay hire which are important for the purposes of the thesis and thus is limited in its scope. In the second section (2.2) the classification of contractual terms is analyzed with the particular focus on conditions. In addition, the construction of the obligation to pay hire in time charterparties as a contractual term prior to *The Astra* is presented, including presentation of the general legal position in situations of charterers' default in payment of hire. The third section (2.3) is devoted for *The Astra* case and the analysis of the legal grounds on which it is based. The third part aims to fulfill the tasks of the second objective and to present analysis of the legal effects and commercial implications of *The Astra*. The last part summarizes the findings and presents concluding remarks on the research question.

2 The obligation to pay hire in time charter parties

2.1 The nature of time charterparties and the obligation to pay hire

The significance and characteristics of the obligation to pay hire are first and foremost determined by the nature of time charterparty.

A time charterparty may be defined as a contract for a period or for a trip under which, in return for the payment of hire, the vessel's employment is put under the orders of the charterers, while possession remains with the ship-owners who provide the crew and pay the ordinary running costs, characteristically excluding specific voyage costs such as fuel and cargo handling and port charges which are paid for by the charterers[12]. Although the exact allocation of costs and responsibilities

[12] *Voyage Charters*, §1.1.

between the ship-owners and the charterers is subject to time charterparty clauses, the distinctive feature of time charterparty is that it is a contract of services, according to which ship-owners, in exchange of charterers' obligation to pay hire, undertake to make services of a ship and her crew, i.e. earning capacity of a ship, available to the charterers[13]. It follows from the definition of a time charterparty as a contract of services that no right of possession of a ship under time charterparty is transferred to the charterers[14]. Namely on this point time charterparties are to be contrasted with demise charterparties which are contracts for the leasing of a ship under which the charterers take possession of the ship and also provide their own crew and ship management to operate her[15].

In functional terms, the charterers get the right to manage the vessel in terms of commercial employment, i.e. the charterers get the right to give orders as to cargoes to be loaded and voyages to be undertaken, and undertake to pay the agreed rate of hire, whereas the ship-owners undertake to perform services in accordance with charterers' orders, provided they are given in conformity with time charterparty. In legal terms, however, it is an exchange of promises that takes place – ship-owners' promise to put services of a ship and her crew at charterers' disposal is given in exchange of charterers' promise to pay hire. In this respect, hire operates as consideration given by the charterers to the ship-owners for the services of a ship and her crew made available[16].

It follows from the allocation of functions between the ship-owners and the charterers in a time charterparty that it is the charterers who bear all the risks associated with the commercial operation of the ship, which means that the charterers enjoy the full benefit of the earnings of the vessel or, conversely, they bear all the detriment if trading of the vessel turns out to be unprofitable due to adverse market conditions. For this reason hire as remuneration for ship-owners' services in time

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13 *The Scaptrade* at 256 per Lord Diplock; *The Laconia* at 319 per Lord Wilberforce.

14 *The Tankexpress* at 50 per Lord Porter.

15 *Time Charters*, §I.6.

16 *The Tankexpress* at 53 per Lord Wright.

charterparty is typically calculated per time unit (per day, semi-monthly, per month etc.), regardless of actual earnings of the vessel, and is paid in advance[17]. In this way ship-owners by virtue of hire payable periodically under time charterparty avoid commercial risks associated with trading of the vessel and receive the benefit of regular and defined cash flow[18], whereas the charterers by way of payment of hire get the right to exploit the vessel as a revenue-generating chattel[19].

Thus, from an economic perspective, payment of hire functions as remuneration for ship-owners' services under a time charterparty and covers ship-owners' expenses in relation to the services they provide[20]. In this respect charterers' obligation to pay hire plays an important role in terms of ship-owners' liquidity and their ability to perform contractual services[21]. However, there is no firm and definite answer in the authorities as to whether charterers' payment of hire and ship-owners' services are interdependent so that the former is a condition precedent to the latter[22].

From a legal perspective, however, hire is to be paid irrespective of both actual services being provided (actual use of the ship by the charterers) and actual expenses being incurred by the ship-owners[23]. This is explained by the very nature of time charterparty, the allocation of risks between the ship-owners and the charterers in time charterparty[24] and

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17 Cf. NYPE 1946 form clause 5, "Shelltime 4" issued December 1984 amended December 2003 line 185, Baltime 1939 as revised 2001 lines 80–92.

18 *Time Charters*, §I.45.

19 Ibid., §I.39.

20 The ship-owners typically bear fixed costs, associated with the services they provide, which normally do not depend on the voyages being performed by the vessel or ports being called at (e.g. insurance, ship maintenance costs, provisions, crew wages, stores et al.), cf. NYPE form 1946 clause 1, "Shelltime 4" issued December 1984 amended December 2003 lines 148–159, Baltime 1939 as revised 2001 lines 37–47. However, hire may also be used to cover other ship-owners' expenses, such as interest and principal on ship-owners' mortgage loan, cf. *Scandinavian Maritime Law: The Norwegian Perspective*, p.435.

21 *The Scaptrade* at 257-258 per Lord Diplock.

22 This issue will be addressed later in the thesis, cf. sections 2.2.1.3 and 2.3.5.2.

23 Actual expenses may be of interest in time charterparties containing the so-called "escalation clauses".

24 *The Gregos* at 4 per Lord Mustill.

the fact that hire in time charterparties is earned upon services of a ship and her crew being made available to the charterers[25]. This also means that unless certain exceptions apply, hire is to be paid for the whole contractual period between delivery and redelivery of the ship[26]. In this respect the obligation to pay hire is often characterized as continuous and unconditional[27].

Another important legal characteristic of the obligation to pay hire is that it is an absolute obligation. It means that in case hire is not paid when due, the charterers are in default of payment of hire, i.e. in breach of time charterparty, irrespective of fault[28] (unless qualifications of the obligation are provided in time charterparties which is not the case with standard charterparty forms).

Given the characteristics above it follows that charterers' obligation to pay hire is one of the most basic charterers' obligations in time charterparties.

2.2 Classification of the obligation to pay hire as a contractual term

2.2.1 Classification of contractual terms: conditions, warranties, intermediate terms

2.2.1.1 General on classification of contractual terms

Historically, contractual terms under English law were classified as conditions and warranties, the dichotomy of which is referred to as orthodox[29]. In the 1960's after the decision of the Court of Appeal in

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25 *The Aquafaith* at 68 per Cooke J.

26 *Time Charters*, §I.45; *Scrutton on Charterparties and Bills of Lading,* §16-009.

27 Thomas, §7.5; *Time Charters,* §I.45.

28 Thomas, §7.4; *Time Charters,* §16.73.

29 Legal literature suggests that conditions and warranties have evolved from the rules of pleading rather than substantive law, namely, from the distinction of dependent and independent promises, terminology of which was employed by the courts since 16th century. It was towards the end of the 19th century when terms "dependent" and "independent" were often replaced by the terms "condition" and "warranty" (cf.

Hongkong Fir case, however, it was recognized that there is a third category of intermediate (or innominate) terms[30]. It is generally accepted therefore that contractual terms under English law currently fall into three main categories – conditions, warranties and intermediate terms[31].

"Condition" as a term has many meanings and is used in a variety of senses[32]. However, when a term "condition" is used to refer to a contractual undertaking , it means a contractual duty, a breach of which entitles the innocent party, if he so chooses, to treat himself as discharged from further performance under the contract, and to claim damages for loss sustained by the breach[33]. Conversely, a "warranty"[34] is a contractual undertaking, a breach of which does not entitle the innocent party to treat himself as discharged, but to claim damages only[35].

An intermediate term is neither a condition, nor a warranty. A breach of an intermediate term may entitle the innocent party to treat himself as discharged, but this will depend on the nature and consequences of

Carter, Hodgekiss, p.31–42).

30 Legal literature suggests that although the third category of intermediate terms is often seen as the modern doctrine, it has older roots (*Anson's Law of Contract*, p.140). Treitel refers to intermediate terms as to "the invention or perhaps more accurately [as] the rediscovery of a third type of contract term" (Treitel (2002), p.113). However, it does not depreciate the significance of Diplock LJ's judgment in *Hongkong Fir*, which is claimed to be the most important judicial contribution to English contract law in the 20th century (Ibid.).

31 Legal literature is not entirely uniform concerning the question of how many categories of contractual terms there are under English law. Some scholars list "fundamental term" as fourth category (cf. Treitel (2002), p. 127–138); some suggest that the better way of classification is the dichotomy of conditions and non-conditions (cf. Poole, p.302). However, majority of authorities support the threefold division of conditions, warranties and intermediate terms (e.g. *Chitty on Contracts*, §§12-019–12-024; *Treitel on The Law of Contract*, §18-048; *Contractual Duties: Performance, Breach, Termination and Remedies*, §10-001).

32 *Chitty on Contracts*, §§12-025–12-030; McMeel, §§20.01–20.07.

33 *Chitty on Contracts*, §12-019; *Atiyah's Introduction to The Law of Contract*, p.193–194.

34 As in case of conditions, "warranty" as a term may also be used in a variety of senses (cf. *Chitty on Contracts*, §12-031–12-033, McMeel, §§20.26–20.32).

35 *Chitty on Contracts*, §12-019. Notably, certain exceptions exist and a breach of warranty may entitle the innocent party to terminate the contract, but this is true only in certain contexts where warranty has its specific "archaic" usage, e.g. in insurance (cf. *Contractual Duties: Performance, Breach, Termination and Remedies*, §10-007).

the breach[36]. As Lord Diplock stated in *Hongkong Fir* case:

> "There are, however, many contractual undertakings of a more complex character which cannot be categorized as being "conditions" or "warranties"….Of such undertakings all that can be predicated is that some breaches will and others will not give rise to an event which will deprive the party not in default of substantially the whole benefit which it was intended that he should obtain from the contract; and the legal consequences of a breach of such an undertaking, unless provided for expressly in the contract, depend upon the nature of the event to which the breach gives rise and do not follow automatically from a prior classification of the undertaking as a "condition" or "warranty".

It follows that a breach of an intermediate term which deprives the innocent party from substantially the whole benefit of the contract entitles the innocent party to treat himself as discharged, whereas any other less serious breach sounds in damages only.

It may be summarized thus that contractual terms are classified into conditions, warranties and intermediate terms by way of available remedies at common law upon the breach of each contractual term. It is namely the availability of the remedy of the right to terminate the contract, which distinguishes the types of contractual terms.

As regards damages, successful termination at common law entitles the innocent party to claim damages for loss of bargain (damages for future loss, which accrue as a result of premature determination of a contract, or post-termination damages)[37], which are not possible to claim when there is no successful termination at common law merely for the reason that there is no future loss as the contract is not terminated and thus stands. For the sake of clarity and consistency, however, it should be noted that the legal basis of damages for loss of bargain is not the act of termination, but the breach itself which is treated in law as repudiatory[38].

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36 Ibid., §12-020.

37 McMeel, §20.10, §23.31.

38 Peel, p.523. It is suggested that if the legal basis of loss of bargain damages were the act of termination, the loss of bargain damages would be also available for the act of

Thus, from the common law position, the legal consequences of any breach of a condition and a serious breach of an intermediate term which deprives the innocent party from substantially the whole benefit of the contract, are the same – the innocent party may treat the contract *as repudiated*[39], i.e. the innocent party may, at his election, exercise the common law right to terminate the contract and claim damages for loss of bargain. Likewise, the legal consequences of any breach of a warranty and a breach of an intermediate term which does not deprive the innocent party from substantially the whole benefit of the contract are the same in the sense that the innocent party is not entitled to terminate the contract at common law and will claim damages assessed in the normal way, i.e. the amounts required so far as possible to put the innocent party back to the position he would have been in but for the breach.

The difference in the available remedies upon breach of contractual terms and especially the uncertainty of determining a repudiatory breach of an intermediate term manifests the significance of classification of contractual terms into particular categories.

2.2.1.2 The two-stage classification test

Prior to *Hongkong Fir* decision the test for distinguishing conditions and warranties was one of construction (the term-analysis test). With *Hongkong Fir* decision a test which requires analysis of the breach was introduced (the breach-analysis test). The two different tests which brought some confusion to the law of contractual terms were reconciled in *Bunge v. Tradax* decided by House of Lords and it is now settled that in order to construe a condition it is not necessary to show that every breach of a particular term deprives the innocent party from a substantially whole benefit of the contract[40].

It is suggested thus that unless a particular contractual term falls into statutory or judicial classification the test of classification of a particular

termination pursuant to the express termination clause in a contract, which is not the case.

39 McMeel, §§20.08–20.11.

40 Cf. Carter, Hodgekiss, p.31–32, 50; McMeel, §20.14.

contractual term is two-stage: the one of construction and the one of the effect of breach[41]. As Lord Scarman put it in *Bunge v. Tradax* case[42]:

> "The first question is always, therefore, weather, upon true construction of a stipulation and the contract of which it is part, it is a condition, an innominate term, or only a warranty. If the stipulation is one, which upon the true construction of the contract the parties have not made a condition, and breach of which may be attended by trivial, minor, or very grave consequences, it is innominate…. Unless the contract makes it clear, either by express provision or by necessary implication arising from its nature, purpose, and circumstances…, that a particular term is a condition or only a warranty, it is an innominate term, the remedy for a breach of which depends upon the nature, consequences, and effect of the breach".

Legal literature suggests that in practice, since it is very rare for a term to be classified by courts as a warranty, the aforementioned two-stage test is a contest between conditions and intermediate terms[43]. It is submitted therefore that the practical application of the test is as follows: first, the question whether upon the true construction of the contract a particular contractual term is a condition must be examined; second, if the answer to the first question is negative, the term is an intermediate term, and at this point the analysis of the effect of the breach is to be employed in order to determine the applicable remedy. Since the latter stage of the test deals with the effect of the breach, which is employed for the purpose of determination of applicable remedy, the essential question to be answered is such: when is a contractual term a condition?

2.2.1.3 When is a contractual term a condition?

It is stipulated in *Chitty on Contracts* that a contractual term generally

41 McMeel, §20.13.

42 *Bunge v. Tradax* at 7.

43 McMeel, §20.14.

will be held to be a condition[44]:

i) if it is expressly so provided by statute;

ii) if it has been so categorized as the result of previous judicial decision;

iii) if it is so designated in the contract or if the consequences of its breach, that is, the right of the innocent party to treat himself as discharged, are provided for expressly in the contract; or

iv) if the nature of the contract or the subject-matter or the circumstances of the case lead to the conclusion that the parties must, by necessary implication, have intended that the innocent party would be discharged from further performance of his obligations in the event that the term was not fully and precisely complied with.

It may be added that a contractual term will be held to be a condition if it is a stipulation as to time of performance and if such stipulation is of the essence of the contract[45]. As a matter of fact, time stipulations as an instance of a condition fall either under (iii) or (iv) in the aforementioned *Chitty's* list, because the stipulations as to time may be construed as being of the essence either if it is expressly stated as such by the parties, or if the court infers from the nature of the subject-matter of the contract or surrounding circumstances that the parties intended them to have that effect[46]. Nevertheless, it is suggested that stipulations as to time has its own history and terminology which justifies, although perhaps not very satisfactorily, a separate discussion[47]. Indeed, time stipulations are often discussed as a separate ground for classification of a contractual term as

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44 *Chitty on Contracts*, §12-040. The *Chitty's* list of instances when a contractual term will be held to be a condition is not only used by other scholars (e.g. *Contractual Duties: Performance, Breach, Termination and Remedies*, §§10-009–10-010; *Anson's Law of Contract*, p.146–149), but was also approved by the Court of Appeal in *The Seaflower*.

45 *Chitty on Contracts*, §12-039.

46 Ibid., §12-037.

47 *Treitel on The Law of Contract*, §18-089.

a condition by the courts, as happened also in *The Astra*. Thus, for the purposes of the thesis, time stipulations are indicated as a separate case of when a term might be found to be a condition, provided such stipulation is of the essence of the contract.

Taking into account the above-mentioned *Chitty's* list and since the cases of (i) statutory and (ii) judicial classification of terms are relatively simple, it is submitted that the cases belonging to (iii) and (iv) of the *Chitty's* list deserve further elaboration.

With regard to (iii) it must be noted that generally usage of the phrase "of the essence" in a contract will be considered as an indicator that a term is a condition, whereas usage of the word "condition" might not suffice[48]. It is also noted that the express provision of the innocent party's right to treat himself as discharged, taken in isolation and by its own, does not necessarily give the effect of the clause, upon breach of which such right is granted, being a condition[49].

Classification (iv) involves the question of how to apply the first limb of a two-stage test[50] which is the so-called term-analysis test. It is suggested[51] that the explanation given by Lord Kerr in the Court of Appeal's *The Golodetz* case[52] in orthodox language is instructive when he, citing Fletcher Moulton J in *Wallace v. Pratt* case, stated that conditions are terms

> "...which go so directly to the substance of the contract or, in other words, are so essential to its very nature that their non-performance may fairly be considered by the other party as a substantial failure to perform the contract at all",

and continued that in situations where the commercial necessity for the characterization of a contractual term as a condition is not self-evident

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48 McMeel, §20.19.

49 This issue is an important one in terms of this thesis and is addressed later in the thesis, cf. section 2.3.5.1.

50 Cf. section 2.2.1.2.

51 Treitel (1990), p.188.

52 *The Golodetz* at 282–283.

> "…the issue whether or not a particular term of a contract is to be characterized as a condition must inevitably involve a value judgment about the commercial significance of the term in question..."[53].

Notably, Lord Kerr's approach in *The Golodetz* was accepted by the House of Lords in *The Naxos*[54].

Thus, it is the evaluation of the significance of a particular contractual term in a given commercial setting and "general scheme and tenor of the contract"[55] which serves as a test for the identification of a contractual term as a condition. This approach does reflect the position under English law as it is in line with *dicta* in the House of Lords in *Bunge v. Tradax* and in *The Gregos*. In the former the construction of a contractual term in the light of the surrounding circumstances[56] as well as the importance of considering the factual matrix – the nature, purpose and circumstances of the contract[57] – was emphasized, whereas in the latter the evaluation of the practical importance of a particular contractual term in question in the scheme of the contract was highlighted[58].

Admittedly, Lord Kerr in *The Golodetz* held that, if a contractual term is a condition precedent to the performance of other terms by the other party, the commercial necessity for such contractual term to be characterized as a condition is self-evident[59]. However, it is not always the case and the last argument against or in favour for construction of a particular contractual term as a condition is found in the arsenal of policy considerations[60].

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53 It is noted that Lord Kerr uses term "characterization". Indeed, once commercial background is taken into account for considering whether or not a term is a condition, the exercise is one of characterization, rather than pure construction (interpretation), cf. McMeel, §20.25.

54 *The Naxos* at 36 per Lord Ackner.

55 Ibid. at 31 per Lord Brandon of Oakbrook.

56 *Bunge v. Tradax* at 8 per Lord Lowry.

57 *Bunge v. Tradax* at 7 per Lord Scarman.

58 *The Gregos* at 9 per Lord Mustill.

59 More on the effect of conditions precedent see section 2.3.5.2.

60 Treitel (1990), p.189.

2.2.1.4 Why is a term construed as a condition?

The underlying policy consideration for contractual terms to be classified as conditions is certainty (as parties to a contract know exactly where they stand and what the results of even a trivial breach of a particular term would be).[61] However, there are situations when certainty is traded for flexibility and promotion of interests of justice – these are the underlying policy considerations of intermediate terms[62]. Intermediate terms restrict the innocent party's right to terminate a contract for breaches which do not deprive the innocent party of substantially the whole benefit of the contract, and thus prevent the innocent party from terminating for uterior motives, such as escaping from a bargain which turned out to be unprofitable or snatching the more profitable opportunity[63]. As Lord Roskill put it in *The Hansa Nord*

> "…contracts are made to be performed and not to be avoided according to the whims of market fluctuations and where there is a free choice between two possible constructions I think the Court should tend to prefer that construction which will ensure performance…"[64].

However, certainty is still of considerable importance. The famous statement of Lord Bridge in *The Chikuma* reads as follows:

> "The ideal at which the courts should aim, in construing such [withdrawal of a vessel] clauses, is to produce a result that in any given situation both parties seeking legal advice…can expect the same clear and confident answer from their advisers and neither will be tempted to embark on long and expensive litigation in the belief that victory depends on winning the sympathy of the court"[65].

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61 *Chitty on Contracts*, §12-034, *Treitel on the Law of Contract*, §18-050.

62 Ibid.

63 *Treitel on the Law of Contract*, §18-050.

64 *The Hansa Nord* at 457 per Lord Roskill. The policy argument was accepted also in *The Gregos* at 9 per Lord Mustill.

65 *The Chikuma* at 377. For the sake of consistency, it is noted that this part of Lord's

Generally, it may be said that the contest between conditions and intermediate terms is a contest between certainty and predictability on the one side, and flexibility and interests of justice on the other. Nevertheless, this does not imply that courts classify contractual terms on the grounds of whichever underlying values they consider to be just in a particular case – the policy considerations are not *per se* a ground for classification. As famously put by Lord Wilberforce in *Bunge v. Tradax:*

> "…the Courts should not be reluctant, *if the intentions of the parties as shown by the contract so indicate*, to hold that an obligation has the force of condition…"[66] (emphasis added).

Thus, it is ultimately the parties' intentions that are decisive.

2.2.2 Construction of the obligation to pay hire prior to *The Astra*

As indicated in the Introduction, the obligation to pay hire prior to *The Astra* was generally seen as not a condition of a contract. This general understanding, however, had no firm judicial authority. Very few cases had indeed touched upon a question whether the obligation to pay hire in clause 5 of the NYPE form or any other standard charterparty was a condition or not as well as whether default in payment of hire leading to withdrawal of a vessel entitled the ship-owners to claim damages for loss of bargain.

One of the main authorities supporting the construction that the obligation to pay hire is not a condition, is the [then] Admiralty Court's decision in *The Brimnes* rendered by Brandon J. *The Brimnes* case concerned the withdrawal of a vessel upon the exercise of a ship-owners' right in clause 5 of the NYPE form (dated 22 November 1968) as a result of the charterers late payment of hire which was due on 1 April, 1970.

Bridge speech has not gone unchallenged as Lord Denning has expressed critical views about it in his last book *The Closing Chapter* in support to Dr. F. A. Mann's critical comments about the same in his article *Uncertain Certainty* (cf. Reynolds, p.189).

66 *Bunge v. Tradax* at 6.

The vessel was withdrawn on 2 April, 1970, being the same day as charterers' belated payment of hire was made. It should be noted that almost over the whole period of the charterparty (from December, 1968, until April, 1970) the charterers were invariably late in paying hire and the ship-owners complained about that as from January, 1970[67].

Brandon J. decided that the ship-owners were entitled pursuant to clause 5 of the NYPE form to withdraw the ship on the ground of charterers' failure to pay hire punctually. However, Brandon J. also decided that the ship-owners were not entitled to withdraw the ship on the ground of breach of an essential term (i.e. a condition of a contract) or of repudiation. Brandon J said in the judgment that "there is nothing in the clause 5 [of the NYPE form] which shows clearly that the parties intended the obligation to pay hire punctually to be an essential term of a contract, as distinct from being a term, for breach of which an express right to withdraw was given"[68]. However, the latter part of the judgment is considered to be *obiter* since the Brandon J's finding that the withdrawal pursuant to clause 5 was lawful was upheld by the Court of Appeal and, notably, the Court of Appeal did not address the condition point directly.

Another case to be mentioned in support of Brandon J's findings in *The Brimnes*, is *The Kos* in which Andrew Smith J's made an *obiter* statement that "the general view is…that the failure to pay hire when it is due is a breach of an intermediate term, and not necessarily repudiatory"[69].

At the same time however, there were other, albeit *obiter*, pronouncements by the courts to the contrary[70], as a result of which, it is suggested, the classification of the obligation to pay hire has always been subject to

[67] *The Brimnes* also concerned an extensive discussion, since there was uncertainty as to the facts, whether the notice of withdrawal preceded belated payment of hire or not – in the light of *The Georgios C* this was an important issue to be considered and will be, however, addressed later in the thesis, cf. section 2.3.5.4.

[68] *The Brimnes* at 482.

[69] *The Kos* at 95.

[70] E.g. the *dicta* of the House of Lords in *The Tankexpress, The Laconia, The Mihalios Xilas*, *United Scientifics Holdings*, *The Afovos,* which will be addressed in section 2.3.5.2.

conflicting opinions[71]. It seems that the uncertainty surrounding the authorities has influenced the market players, their legal advisers and even scholars to opt for the relatively "safer" construction of the obligation to pay hire as an intermediate term[72].

It is submitted that due to uncertainty in the authorities, a substitution of one of the essential characteristics of a condition – the innocent party's right to treat himself as discharged from further performance upon any breach with a subsequent right to terminate the contract at common law – has therefore as a rule been included in standard time charterparties by way of the express ship-owners' right to withdraw the vessel upon charterers' default of punctual payment of hire, i.e. by way of express termination provision (the so-called withdrawal clause)[73]. Given the fact that most of the withdrawal cases prior to *The Astra* were those in a rising market, where the withdrawn vessel was subsequently employed at a more profitable rate, – the question of another essential characteristic of a condition – the innocent party's right to claim damages for loss of bargain – naturally did not arise[74]. It may be said thus that the cautiousness of the market by way of including express termination provisions in standard time charterparties combined with favourable market conditions are those reasons why the question whether the obligation to pay hire is a condition or not finds no firm answer in case law.

As mentioned in the Introduction, the obligation to pay hire considered as an intermediate term implies that, provided as is the rule that a standard time charterparty contains a withdrawal clause (express termination provision), ship-owners' right to claim damages for loss of bargain arises only when charterers' default in payment of hire constitutes

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71 Carter (2012), p.290.

72 Cf. supra notes 2,3. The preferred construction is referred to as "safer", since, given the uncertainties in judicial authorities and if the obligation to pay hire would not be held to be a condition, non-repudiatory charterers' breach of the obligation to pay hire would not suffice for the ship-owners to get loss of bargain damages. Thus, in order to get damages the ship-owners would need to wait until it would be "safe" to claim charterers being in repudiatory breach.

73 Cf. supra note 6.

74 Cf. an overview of withdrawal cases by Meng.

a repudiatory breach[75]. Thus, the generally accepted position prior to *The Astra* was that in order for the ship-owners to treat themselves as discharged from further performance (in case there was no withdrawal clause in a contract) and in any event (whether in the absence of the withdrawal clause or not) claim damages for loss of bargain it was necessary to show that the charterers were in repudiatory breach.

It was suggested that damages for loss of bargain are not available solely upon exercise of an express termination provision[76] (when there is no repudiatory breach), because the ship-owners by exercise of an express right to withdraw the vessel "breaks the chain of causation"[77] and the loss of bargain is not therefore "effectively caused"[78] by charterers' failure to pay hire on time. In this respect, it is stated that the party, exercising its express right to terminate, becomes "the author of his own misfortune", because the party gives up voluntarily its right to insist on future performance and accordingly any substitutionary relief in lieu thereof[79]. In other words, the legal basis of damages for loss of bargain was namely a repudiatory breach, which entitles the innocent party to treat himself as discharged from further performance. In this case it was not the innocent party's decision to terminate the contract, but the breach itself, which destroyed the bargain[80].

Demonstrating repudiatory breach, however, is not without difficulties.

75 Cf. also section 2.2.1.1.

76 Here and later in the thesis the "express termination provision" or "express right to terminate" refers to express termination provision in a contract when express right to terminate is granted upon breach of a certain term of a contract (as opposed to other possible formulations of express termination provisions where express right to terminate may be granted upon occurrence of a certain event and not a breach of a contractual term).

77 *The Kos* at 95.

78 Ibid.

79 McMeel, §23.31.

80 Peel, p.523. Alternatively to the causation theory, it is explained that damages for loss of bargain are not available upon mere exercise of express termination right because the party at the time of termination has not been discharged which is the necessary legal basis for damages of loss of bargain – cf. Carter (2012), p.291, where the author states that the reasoning that the cause of the loss of the bargain is the promisee's decision to terminate "seems a commercially naive application of the causation concept".

What kind of charterers' default in payment of hire and when does it indeed constitute charterers' repudiatory breach? – were the questions that the ship-owners and their legal advisers found not easy to answer.

Case law demonstrates that what default constitutes charterers' repudiatory breach and when is very much fact-dependent. In *The Brimnes* one missed hire payment, even in the context of relatively long history of multiple charterers' defaults in payment of hire (almost constant late hire payment), did not suffice to find charterers in repudiatory breach. It seems that the court put weight on the fact that the ship-owners did not complain about the first 13 out of 14 payments being late and thus one hire payment being late did not amount to the evinced intention by the charterers not to be bound by the terms of the charterparty[81]. Similarly, in the *Fortune Plum,* the arbitration tribunal did not consider a pattern of persistent late hire payments (six hire payments being few days late and three hire payments being a week or more late) to be "seriously worrying"[82], most probably because the ship-owners did not complain about hire payments being late. In *The Afovos* one missed half-monthly hire payment was held not to have the effect of depriving the ship-owners of substantially the whole benefit of the charterparty[83] and thus charterers' default was not repudiatory. In *Leslie Shipping* charterers' repudiatory breach was found on the ground of two missed hire payments (the first non-payment of hire was by agreement covered by 2 bills of exchange, issued by the ship-owners, accepted by the charterers and then later dishonoured by them. In addition, the following hire payment was not paid)[84]. In *Merlin* case Greer J decided that "con-

[81] *The Brimnes* at 483.

[82] *Fortune Plum* at 620. Notably, the tribunal's approach was different with respect to subsequent hire payments, one of which was paid in three installments, the last of which was paid more than a month late.

[83] *The Afovos* per Lord Diplock at 341.

[84] Although it is argued that Greer J's language with respect to repudiation is not that clear, it is submitted that damages for loss of bargain were awarded in that case on the ground of charterers' repudiatory breach. Greer J, referring to the non-payment of two hire payments, stated "Would not any shipowner be entitled to suppose from conduct of that sort that the charterer was not going to pay the hire for the subsequent months of the charter?…that would amount to repudiation of a fundamental part of

tinuous non-payment" [85] of hire, which in fact consisted of three missed payments of hire, was a valid ground to award damages for loss of bargain.

It followed from the case law that one missed hire payment rarely satisfied the repudiation test[86] nor was it possible to guarantee that two missed payments would. It was more likely that charterers' behavior and evinced intentions as well as ship-owners' attitude and behavior in respect of the late payments of hire were weightier considerations than simply the number of missed hire payments. For this reason it was very often difficult to establish with certainty whether charterers were in repudiatory breach or not.

Another difficulty in addition to determination whether the charterers were in repudiatory breach on particular facts, was the need for the ship-owners to exercise their right to terminate at common law at the right time. If termination of a contract (on the grounds of charterers' repudiatory breach) was exercised too early – the ship-owners were at risk that the charterers would not be found to be in repudiatory breach, whereas if termination was too late – the ship-owners were at risk to be found to have affirmed the contract. Both situations would have lead to the ship-owners themselves being in repudiatory breach[87]. As indicated in the Introduction, the subtlety of timeous ship-owners' election between acceptance of charterers' repudiatory breach with subsequent termination of time charterparty and affirmation of time charterparty is reflected in *Fortune Plum* case. In this case ship-owners terminated a time charterparty on the grounds that charterers were in repudiatory breach (on the basis of several missed hire payments and dishonoured promises to pay). However, the arbitration tribunal found the ship-owners having affirmed

this contract".

85 *Merlin* at 186.

86 *Time Charters* at §16.75.

87 However, provided the termination of a charterparty was exercised pursuant to an express withdrawal clause, which is normally included in most time charterparties, the former situation – when the charterers are not found to be in repudiatory breach – would result in ship-owners being deprived of loss of bargain damages and not being in repudiatory breach.

the charterparty by conduct and being in repudiatory breach themselves. It turned out that the ship-owners unreasonably delayed their decision to accept charterers' repudiatory breach (the tribunal held that reasonable ship-owners were entitled to conclude that charterers were in repudiatory breach on 7 November 2011 and the reasonable time to decide whether to accept it as per facts expired on 11 November 2011 and thus termination on 14 November 2011 was late). The ship-owners' appeal, however, succeeded on continued renunciation point (weather the ship-owners were entitled to accept continuing charterers' renunciation) in respect of which the case was remitted to the tribunal.

2.3 Construction of the obligation to pay hire in *The Astra*: the obligation to pay hire is a condition

2.3.1 Introductory remarks

As indicated in the Introduction, *The Astra*, a recent judgment rendered by the Commercial Court's judge Flaux J, holding that the obligation to pay hire punctually under clause 5 of the NYPE form (whether on its own or in conjunction with the anti-technicality clause) is a condition, induced a lot of discussion among legal practitioners and is largely seen as debatable. This section aims to analyze *The Astra*, namely the legal grounds on which the decision is based, and discuss if there is room for contrary conclusion that the obligation to pay hire under clause 5 of the NYPE form is not a condition, but an intermediate term. Before the analysis, the background facts, the arbitrators' decision and the legal grounds on which the Commercial Court's judgment is based are presented.

2.3.2 The background facts

The vessel Astra was chartered on an amended NYPE form 1946 form dated 6 October 2008 for a period of five years. Clause 5 of the NYPE form required the charterers Kuwait Rocks Co to make punctual and regular payment of hire 30 days in advance, breach of which would give

the ship-owners AMN Bulkcarriers Inc an option to withdraw the vessel and terminate the charterparty. The charterparty also contained an anti-technicality clause incorporated in clause 31 which required the ship-owners to give the charterers two banking days' notice of a failure to make a hire payment before they could exercise their right to terminate.

After the charterparty was concluded hire rates fell and the agreed hire rate (US$28,600 per day) was soon above market. The charterers therefore were unable to trade the vessel profitably and thus sought reductions in hire. Several times the charterers came up with various proposals of a reduction in the hire rate and threatened repeatedly that, if the ship-owners did not agree, they would declare bankruptcy. In July 2009 the ship-owners agreed to reduce the hire rate (the newly agreed rate being of US$21,500 per day) for one year and the parties concluded an addendum clause 4 of which (in the judgment referred to as the Compensation Clause) *inter alia* stipulated that

> "[i]n the event of the termination or cancelation of the Charter by reason of any breach by or failure of the Charterers to perform their obligations, Charterers shall…pay the Owners compensation for future loss of earnings…".

The re-negotiated charterparty, however, did not put an end to charterers' requests for further reductions in the hire rate and threats that, unless the hire rate was further reduced, the charterers would declare bankruptcy. In July 2010, upon expiry of the one year period of the reduced hire rate, the parties reached a compromise agreement, which the charterers failed to comply with by non-payment of hire. The ship-owners subsequently served an anti-technicality notice and on 3 August 2010 withdrew the vessel, terminated the charterparty and claimed that the charterers were in repudiatory breach.

Within one month the ship-owners mitigated their loss by fixing the vessel on a substitute charter (at the rate of US$17,500 per day) and, faced with a very substantial loss of hire, commenced arbitration proceedings against the charterers.

2.3.3 The arbitrators' decision

In the arbitration proceedings the ship-owners claimed that they were entitled to recover damages for future loss of earnings for the remainder period of the charterparty on the basis that (i) the charterers were in breach of a condition in not paying hire and/or (ii) in repudiatory/ renunciatory breach of the charterparty.

As to (i), the arbitrators rejected ship-owners' argument that the obligation under clause 5 of the NYPE form to pay hire was a condition on the basis that, whilst their instinct as commercial arbitrators would be to treat the obligation to pay hire pursuant to clause 5 of the NYPE form as a condition, they were not persuaded that was the current state of English law[88].

As to (ii), the arbitrators upheld ship-owners' argument that the charterers were in repudiatory/renunciatory breach on the basis that the totality of the evidence (namely, the repeated threats by the charterers that they would declare bankruptcy compounded by a failure to comply with the compromise agreement reached in July 2010) could only be interpreted as an intention by the charterers to perform at the very least the forthcoming part of the charterparty in a manner that was not consistent with it[89].

The charterers appealed on two questions of law contending that the arbitrators erred in law (i) by applying the wrong test for repudiation/ renunciation and (ii) by failing to find that the Compensation Clause was a penalty clause. The ship-owners in their respondents' notice also challenged the arbitrators' finding that (iii) the obligation to pay hire under clause 5 of the NYPE form was not a condition.

2.3.4 The Commercial Court's decision: the obligation to pay hire is a condition

Flaux J in his judgment dismissed charterers' appeal on both grounds, although noted that the second question whether the Compensation

88 *The Astra* at 73(§14).

89 Ibid. at 75(§19).

Clause was a penalty clause is academic, because having dismissed the appeal on the repudiation/renunciation point, the ship-owners were entitled to recover damages for loss of bargain pursuant to normal principles of the law of contract[90].

As to the issue raised by the ship-owners that the arbitrators erred in law when they found that the obligation to pay hire under clause 5 of the NYPE form was not a condition, Flaux J found in favour of the ship-owners and concluded that clause 5 of the NYPE form is a condition (whether on its own or in conjunction with the anti-technicality clause). This conclusion was supported by extensive and detailed review of the authorities which nearly over the last 100 years touched upon the question whether the obligation to pay hire is a condition and was based on the following four essential reasons:

i) clause 5 of the NYPE form provides a right to withdraw the vessel whenever there is a failure to make punctual payment of hire, i.e. the right of withdrawal pursuant to clause 5 exists irrespective of the gravity of the breach of the obligation to pay hire, and "this is a strong indication that it was intended that failure to pay hire promptly would go to the root of the contract and thus that the provision was a condition"[91];

ii) the general rule in commercial contracts is that time stipulations are considered of the essence and thus conditions – according to the *obiter dicta* statements of the House of Lords, except for *The Brimnes* case, which was not followed, the obligation to pay hire punctually is a provision where time is of the essence[92];

iii) the importance to businessmen of certainty in commercial transactions[93];

iv) *obiter* statements in *Stocznia v. Latco* and *Stocznia v Gearbulk*

[90] Ibid. at 77(§29).

[91] Ibid. at 95(§109).

[92] Ibid. at 95–96(§§110–114).

[93] Ibid. at 96(§§115–116).

supported the conclusion that the obligation to pay hire is a condition.

Alternatively, Flaux J held that even if his conclusion that the obligation to pay hire punctually under clause 5 of the NYPE form (whether on its own or in conjunction with the anti-technicality clause) is a condition was wrong, the Compensation Clause elevated the obligation to pay hire to the status of a condition.

2.3.5 The analysis of the legal grounds on which *The Astra* is based

2.3.5.1 The express right of withdrawal as an indication of parties' intentions

As already indicated above, one of the essential reasons for the conclusion that clause 5 of the NYPE form is a condition given by Flaux J in *The Astra* was the fact that clause 5 of the NYPE form provides a right to withdraw the vessel whenever there is a failure to make punctual payment of hire. According to the learned judge the contractual right to terminate the charterparty irrespective of the gravity of the breach of the obligation to pay hire "is a strong indication" of the parties' intention that any failure to pay hire punctually goes to the root of the contract and thus that the provision is a condition.

To support this conclusion Flaux J relied on Moore-Bick LJ reasoning in *Stocznia v Gearbulk* and dismissed the suggestion in *Time Charters* that the right to withdraw only adds to the obligation to pay hire a characteristic of a condition[94] stating that the argument is "somewhat heretical" as an "obligation either is a condition or it is not"[95].

As to the reasoning in *Stocznia v Gearbulk* Flaux J stated that

[94] *Time Charters* §16.13 reads as follows "It may be that the judicial remarks recorded above should not be understood as meaning that Clause 5 is a condition, but only that its draftsman, by adding an option to withdraw to the obligation to pay hire, has given to that obligation one characteristic of a condition, namely that any breach gives a right of termination".

[95] *The Astra* at 96(§118).

> "…there are obvious differences between the structure of that contract and the charterparty in the present case…and there are no terms of the charterparty which provide a remedy of liquidated damages. Nonetheless, it does seem to me that the reasoning of Moore-Bick LJ is of some assistance, particularly because *it makes clear that where the right to terminate for a particular breach indicates that, on the true construction of the contract in question, the breach goes to the root of the contract, in other words the term is a condition or essential term, upon termination, the innocent party will be entitled to claim damages for loss of bargain*"[96] (emphasis added).

It is submitted that what in fact Flaux J is stating is that if, upon true construction of the contract, the clause, upon breach of which the express termination right arises, is a condition, the innocent party is entitled to claim damages for loss of bargain. With respect, such a conclusion only mirrors what is indeed settled law. It is submitted that, according to the current state of English law, an express contractual right to terminate the contract co-exists alongside its common law rights (unless there is an express and clear agreement to the contrary)[97]. Besides that, it is not clear how Flaux J's conclusion does support the later Flaux J's finding that contractual right to terminate the charterparty irrespective of the gravity of the breach of the obligation to pay hire "is a strong indication" that the provision in question is a condition. It seems that Flaux J fails to read the Moore-Brick LJ speech in *Stocznia v. Gearbulk* in the light of the particular facts of the case where it was found that, contrasted with the provisions of liquidated damages, the express contractual right to terminate was construed as arising only in cases of repudiatory breaches. It is submitted that the above cited Flaux J's sum up of Moore-Brick's LJ speech in *Stocznia v. Gearbulk* thus only takes us that far that the question whether clause 5 of the NYPE form is a condition is indeed a question of construction.

It is also suggested that Flaux J was too dismissive of the argument

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[96] *The Astra* at 92(§99).

[97] This is clearly stated by Peel (at p.536) with references to cases including *Stocznia v. Gearbulk* and, in addition, also confirmed in a recent *Newland Shipping* case.

in *Time Charters*, because "it is hard to see why it should be heretical to suggest that a contractual obligation, albeit classified by the common law (or indeed by the parties) as an intermediate term, can, if the parties so choose, be supported by a right to terminate on any breach, leaving only the right to claim damages for loss of bargain to be dependent on the seriousness of the breach"[98].

While it is generally true, as indicated in the *Chitty's* list in sub-section 2.2.1.2., that a contractual term "will be held to be a condition…if the consequences of its breach, that is, the right of the innocent party to treat himself as discharged, are provided for expressly in the contract"[99], the law on this point is not that straightforward.

It is submitted that there may be situations when parties to a contract expressly provide in the contract that one party shall be entitled to terminate in the event of a specified breach of the contract by the other, but do not intend the obligation upon breach of which the right to terminate arises to elevate to the status of a condition. Indeed, there is case law which is in line with the submission.

In the Court of Appeal's case *Financings Ltd v. Baldock* a hire-purchase agreement for a truck was terminated under an express provision allowing termination for non-payment of hire, since the hirer was two instalments in arrears. The hire-purchase agreement also contained an express right to repossess and a minimum payment clause, entitling the ship-owners to two-thirds of the total cost of hiring in the event of termination. Since the agreement did not make time of payment of the essence and there was no express agreement that hire payment clause was a condition, the Court of Appeal held that as the hirer's default was not sufficient to constitute a repudiatory breach and the minimum payment clause was a penalty, the finance company was not entitled to damages for loss of bargain.

In contrast, in the Court of Appeal's case the *Lombard* which, as admitted by Nicholls LJ, had no practical difference from *Financings Ltd v. Baldock* case it was decided that the plaintiff finance company which

98 Shirley, §25.

99 *Chitty on Contracts*, §12-040.

terminated a contract for hire-purchase of a computer for failure of hire payment was entitled to damages for loss of bargain. The decision which the Court of Appeal reached with unease differed from the *Financings Ltd v. Baldock* case only on one point which "skilled draftsman can easily sidestep"[100], that is because a punctual hire payment was expressly made of the essence in the contract and thus a condition. Notably, the Court of Appeal did not consider *Financings Ltd v. Baldock* not to be good law and indeed noted that *Financings Ltd v. Baldock* was followed in a number of cases[101].

It is explained that the real basis for the decision in *Financings Ltd v. Baldock* is the legal ground of damages for loss of bargain. It is suggested that the legal basis of damages for loss of bargain is a repudiatory breach which has the forward-looking aspect that a non-repudiatory breach lacks and this is most obvious when the repudiatory breach takes the form of renunciation, i.e. the defendant evinces an intention not to perform the contract, but substantial failure to perform and breach of a condition are treated in law in the same way[102]. Although these logics of damages for loss of bargain were attempted to criticize[103], it is compelling that this is namely the current state of English law.

Financings Ltd v. Baldock thus has its critics[104] and supporters[105] but for the purposes of this thesis it adequately illustrates that there may be contractual terms which are given a characteristic of a condition, namely a right to terminate upon any breach, but do not confer automatically upon the innocent party damages for loss of bargain and thus are not conditions in its classic sense[106].

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100 *Lombard* per Nicholls LJ.

101 Ibid. per Nicholls LJ.

102 Cf. analysis in Peel, p.523. For alternative, but compelling explanation see Carter (2012), where he *inter alia* explains why an express right to terminate a contract for breach does not of itself classify the obligations to which it applies as conditions, warranties or intermediate terms as well as why exercise of an express right to terminate for breach is not a sufficient basis for recovery of loss of bargain damages.

103 Opeskin, p.317.

104 Ibid. p.293-326; McMeel, §23.38; McKendrick, *Contract Law: Text, Cases and Materials*, p.773.

105 Bojczuk (1987); *Treitel on The Law of Contract*, §18-069.

106 As eloquently it is said by Carter: "Although it is true to say that if a term is a

As Peel puts it in *Treitel on the Law of Contract* the rationale of express termination clauses is to prevent disputes from arising as to often difficult question whether the failure in performance is sufficiently serious to justify termination and those clauses take effect even though there is no substantial failure[107]. This indeed corresponds with the Thomas' view that uncertainty and limitations of legal remedies for charterers' payment default contributed to emergence of contractual remedies, e.g. the right to withdraw upon failure of punctual hire payment[108].

On the other hand, an indirect support for the proposition that express termination right upon a breach of a contractual term does not inevitably mean that a term breached is a condition rests in *The Antaios* case. The House of Lords in *The Antaios* held that the withdrawal clause (express termination right) may not be invoked upon *any* breach of the charterparty (unless a breach amounts to repudiation). It must be noticed, however, that in cases where a court has to deal with an express termination right granted upon *any* breach of a contract, courts incline into the analysis of commercial reasonableness and business commonsense as indicators of the parties' intentions and only when it is found that upon true construction of the contract the parties did intend that express termination right shall be invoked upon any breach, termination is held to be valid[109].

As has been demonstrated, the express contractual right of termination solely on its own cannot be validly regarded as a strong indicator that the contractual clause upon breach of which the express right of termination may be exercised is a condition.

It is therefore submitted that an express termination right in clause 5 of the NYPE form (i.e. withdrawal clause) solely on its own does not necessarily indicate that the parties did intend that every failure of punctual payment of hire would go to the root of the charterparty. It is

condition any breach entitles the promisee to terminate the contract, the converse proposition is not correct" (Carter (2012), p.288).

107 *Treitel on The Law of Contract*, §18-061.

108 Thomas, §7.11.

109 *Contractual Duties: Performance, Breach, Termination and Remedies,* §§10-031–10-046.

parties' intentions that matter, but they are not to be deduced solely from the express contractual right of termination. Whether the clause in a contract upon breach of which express contractual right to terminate is granted is a condition therefore is a question of construction, which has to be answered by use of construction techniques. The fact that there is an express contractual right to terminate may support the conclusion that the clause is a condition, but not vice versa.

2.3.5.2 The obligation to pay hire punctually is of the essence of the charterparty

Another essential reason for the conclusion that clause 5 of the NYPE form is a condition given by Flaux J in *The Astra* was that the obligation to pay hire punctually is a provision where time is of the essence and thus a condition.

In support of the proposition that the obligation to pay hire is a provision where time is of the essence, Flaux J largely relied on *Bunge v. Tradax* which he reads as giving a firm ground for the proposition that "the general rule in mercantile contracts, where there is a "time" provision requiring something to be done by a certain time or payment to be made by a certain time, is that time is considered of the essence"[110]. While it is generally true that stipulations as to time in commercial setting are treated differently from those in non-commercial contracts, it is respectfully submitted that there is no presumption of fact or rule of law that time is of the essence in mercantile contracts such that stipulation as to time in such a contract may, on its true construction, be found not of the essence and thus an intermediate term[111].

In the light of post-*Bunge v. Tradax* cases[112] it is suggested that the

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[110] *The Astra* at 95(§110).

[111] *Chitty on Contracts*, §12-037; *Treitel on the Law of Contract*, §18-091; *Contractual Duties: Performance, Breach, Termination and Remedies*, §11-008–11-009.

[112] E.g. *The Golodetz* (a term as to opening a letter of credit was not a condition precedent and thus not a condition), *The Naxos* (a term requiring sellers to have goods ready to be delivered to buyers at any time within contract period so that the buyer's ship was not held longer than necessary was held to be a condition); *Universal Bulk Carriers Ltd* (a term relating to laytime notice was not a condition, because it was not a condi-

Bunge v. Tradax case, where the interdependence between the buyers' obligation to give 15 consecutive days loading notice and the sellers' obligation to nominate a port was examined, should be read not as formulating a general rule, but as stating that a term as to time will be treated as a condition when a term is a condition precedent to the ability of the other party to perform its obligation pursuant to another term[113]. It is indicated[114] that such a limited reading of *Bunge v. Tradax* case may be found in a more recent *Aktor*[115] case.

As to the obligation to pay hire, there is no firm authority whether the obligation to pay hire is a condition precedent to the provision of services by the ship-owners to the charterers. Nevertheless, in *The Agios Giorgis* Mocatta J commented that there was force in the argument, based on *The Brimnes* and *Leslie Shipping,* that the obligation to pay hire under clause 5 of the NYPE form is not a condition precedent to immediate further performance by the ship-owners[116]. Flaux J, however, dismissed the relevance of *The Agios Giorgis* because of the different factual situation and, implicitly, because of its reliance on *The Brimnes*[117]. Notably, Flaux J did not address the *dicta* in *The Tankexpress* by Lord Porter where he commented on the interdependence of the payment of hire and provision of the services of the ship and, albeit tended to, but did not conclude that there is no interdependence between the two[118]. However, since there is no firm authority that the obligation to pay hire is a condition precedent to ship-owners' ability to provide services agreed under a time charter-party, the hard and fast *Bunge v. Tradax* rule of stipulations as to time it is submitted is inapplicable.

tion precedent to performance of the other party's obligations).

113 Clarke, p.31. Attention is drawn to the Lord Roskill's speech in *Bunge v. Tradax* at 15.

114 Shirley, §38.

115 *The Aktor* decided by Christopher Clarke J: "Lord Roskill accepted that in a mercantile contract when a term has to be performed by one party as a condition precedent to the liability of the other party to perform another term…the term as to time of performance of the former obligation would in general be treated as a condition".

116 *The Agios Giorgis* at 202.

117 *The Astra* at 86(§§73–74).

118 *The Tankexpress* at 50.

Given the limited reading of *Bunge v. Tradax*, it is suggested that time stipulations are little different from other stipulations in commercial contracts[119]. It follows from case law that in the absence of express agreement courts will construe time stipulations in commercial contracts as of the essence by making a value judgment about the commercial significance of the term in question in its factual and contractual setting[120]. Courts tend to find time stipulations to be of the essence in cases where non-/late performance may prejudice existing contractual strings[121] or undermine commercial certainty[122], but in any event the importance of a term in question will be judged in the light of the whole contractual context[123].

Notably, payment obligations in sale contracts are not treated to be of the essence, unless there are facts or circumstances which attach the fundamental importance to them, e.g. in case of perishable goods or if the buyer fails to pay deposit on time[124]. No similar parallel may be drawn from cases of deposits with the payments of hire as deposits establish buyer's seriousness about completing the contract of sale[125] and no such crucial importance may be attached to periodical payments of hire.

It is submitted that there is no support in the authorities, apart from *obiter* statements, that the obligation to pay hire in time charterparties is an exception to the rule that performance on time is not of the essence. To support the contrary view Flaux J referred[126] to the *dicta* of the House of Lords in *The Tankexpress, The Laconia, The Mihalios Xilas*, *United Scientifics Holdings*, and *The Afovos*.

The first three cases are concerned with the interpretation of express withdrawal clause where courts have supported the literal application of

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119 Clarke, p.31.

120 Lawson, p.21.

121 E.g. in cases of sale-chains or "string" contracts, cf. *The Naxos*; *The Mavro Vetranic*.

122 E.g. in cases of stipulations as to time of ship's expected readiness to load, cf. *The Mihalis Angelos*.

123 *Contractual Duties: Performance, Breach, Termination and Remedies*, §11-003.

124 *Treitel on The Law of Contract*, §18-093.

125 Shirley, §43.

126 *The Astra* at 95(§110).

the clause and elaborated on the obligation to pay hire as absolute obligation[127], stating that if payment of hire is not made on time there is default in payment irrespective of any reason that the charterers may have and regardless if late payment is tendered before withdrawal or not[128]. Namely in this respect the argumentation of commercial certainty was employed in these cases and not, with respect, as suggested by Flaux J[129], to support that the obligation to pay hire is a condition.

The fourth case, namely, *United Scientific Holdings* is a case concerned with rent review clauses in tenancy contracts (thus not a time charterparty case at all) and the only *obiter* statement in that case that "in a charterparty a stipulated time of payment of hire is of the essence"[130] was made without reference to authorities and thus is of little help.

The only case that "presents difficulty…that clause 5 is not a condition"[131] is indeed *The Afovos,* the statements of Lord Diplock in which give an impression that clause 5 of the NYPE form is construed as a condition. However, the „difficulty" is not irresolvable. For this it is necessary to look at the case as a whole, not only to the extract of Lord Diplock's speech, which, as is suggested, has muddied the waters[132].

The Afovos case concerned withdrawal under clause 5 of the NYPE form, where ship-owners gave a premature notice of withdrawal and thus it was ineffective with the consequence that withdrawal was held to be unlawful. However, on the assumption that when the ship-owners gave their notice it was clear that charterers' payment would not be received on time, the ship-owners argued that they could invoke the doctrine of anticipatory breach. Since no repudiatory breach was found (one single missed hire payment did not amount to a repudiatory breach), the

127 Cf. section 2.1.

128 *The Tankexpress* at 51 per Lord Porter, at 53 per Lord Wright, at 56 per Lord Uthwatt, *The Laconia* at 317–318 per Lord Wilberforce; *The Mihalios Xilas* at 312–313 per Lord Scarman;

129 *The Astra* at 86(§78) per Flaux J: „I agree...that the emphasis on the importance of certainty where punctual payment of hire is required tends to point to the clause being a condition".

130 *The Astra* at 87(§81).

131 *The Astra* at 90(§91).

132 Carter (2012), p.289.

doctrine of anticipatory breach was inapplicable[133].

It is suggested that ship-owners' "argument was misconceived", because clause 5 was not a condition and the charterparty simply conferred an express right to give a notice on the occurrence of a specified event which had not occurred[134]. In other words, had the clause 5 of the NYPE form been considered to be a condition in *The Afovos*, the ship-owners' argument of anticipatory breach most probably would have succeeded (because the failure to pay hire on time would have been held by definition to be a repudiatory breach). Namely for this reason Lord Diplock's speech is suggested to add some complication to the case[135].

In the light of the aforementioned, it is possible to see that Lord Diplock was treating clause 5 of the NYPE form as *Time Charters* suggest having one characteristic of a condition when he said

> "The owners are to be at liberty to withdraw the vessel from the service of the charterers; in other words they are entitled *to treat the breach* when it occurs *as a breach of condition* and so giving them the right to elect to *treat it as putting an end to all their own primary obligations* under the charterparty then remaining unperformed"[136] (emphasis added).

And most probably misapplying the term "condition" when he stated that

> "But although failure by the charterers in punctual payment of any installment, however brief the delay involved may be, *is made a breach of condition* it is not also thereby converted into a fundamental breach; and it is to fundamental breaches alone that the doctrine of anticipatory breach is applicable"[137] (emphasis added).

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133 The doctrine of anticipatory breach is only applicable to repudiatory breaches and as suggested by Poole (at p. 308): "the doctrine should more properly be referred to as "breach by anticipatory repudiation".

134 Carter (2012), p.289.

135 Ibid.

136 *The Afovos* at 341.

137 Ibid.

Given the analysis above, it is doubtful whether the authorities support that clause 5 of the NYPE form is to be considered of the essence of the charterparty and thus a condition.

In contrast, in *The Gregos*, decided by the House of Lords, the redelivery clause as to time was not held to be a condition although given the commercial setting of chartering business the exact redelivery time may be and very often is very important, failure to comply with which may result in the ship-owners losing subsequent time charterparties and thus being exposed to substantial loss. Thus, it is far from being straightforward that time stipulations in time charterparties are of the essence and therefore conditions.

2.3.5.3 *The Brimnes* distinguished – the anti-technicality clause

As indicated above, Flaux J held that time of payment in clause 5 of the NYPE form was of the essence of the charterparty and supported this conclusion with reference to the *dicta* of the House of Lords, although Flaux J conceded that *The Brimnes* was of the contrary effect. To overcome the difficulty of *The Brimnes*, Flaux J stated that the anti-technicality clause in clause 31 distinguished *The Brimnes* from the present case.

Flaux J concluded that the anti-technicality clause made time of the essence if otherwise time was not of the essence. To support this conclusion Flaux J relied on *Stocznia v. Latco*, a shipbuilding case where Lord Rix held:

"*In a contract where a vessel is to be built with funds provided by the purchaser in stages*, an installment notice is to be given requiring payment within 5 banking days, and a further 21 days of grace are then allowed, I do not see why provision for what is then called default entitling rescission should not be regarded as setting a condition of the contract"[138] (emphasis added).

It is submitted that *Stocznia v. Latco* does not suggest that the 21 days grace period made time of payment of the essence and thus a condition

[138] *The Astra* at 90(§93).

– it is most probably the contract itself "where a vessel is to be built with funds provided by the purchaser in stages" suggests the significance of payment within the agreed period. Indeed, time charterparties and shipbuilding contracts are by their very nature different and periodical hire payments cannot be simply equated with keel-laying instalments, which are not necessarily condition precedent to the performance of the yard but are milestone payments in a way that hire payments are not[139].

Similarly, Flaux J's reference to *The Mahakam* case to support his reasoning that the existence of the anti-technicality clause makes the obligation to pay hire a condition is of little persuasive value. *The Mahakam* case differs from the situation in *The Astra*, first, because the case concerned bareboat charterers' obligation to pay hire and, second, bareboat charterers' obligation to pay hire on time was expressly made *of the essence* in the contract. Notably, in *The Mahakam* parties' intentions to consider charterer's payment obligation as a condition were deduced from express stipulation that time is of the essence and the general commercial setting and the scheme of the bareboat charterparty was not addressed in the judgment[140].

2.3.5.4 The Brimnes wrongly decided

However, Flaux J went even further and stated that he would, even in the absence of the anti-technicality clause, albeit with some hesitation, decline to follow *The Brimnes*[141]. Flaux J gave three reasons. First, *The Brimnes*, according to Flaux J, cannot be reconciled with the *dicta* of the House of Lords in *The Tankexpress, The Laconia, Mihalios Xilas, United Scientific Holdings, Bunge v Tradax,* and *The Afovos*. Second, *The Brimnes* was based on *The Georgios C* which was subsequently overruled by the House

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139 Shirley §41.

140 Hypothetically, it would not be easy to escape considerable force of the argument in the context of time charterparties if there was no express stipulation "of the essence" in *The Mahakam* case and if it was held that the obligation to pay hire in bareboat charterparties is a condition as per its importance in the contract scheme and commercial setting. However, this is not the case and thus *The Mahakam* cannot be accepted as instructive *dicta*.

141 *The Astra* at 96(§114).

of Lords in *The Laconia*. Third, Brandon J's conclusion in *The Brimnes* involved acceptance of the argument that the word "punctual" added little or nothing to the word "payment" standing alone, an argument the validity of which depended on the correctness of *The Georgios C.*

While it is suggested that there is uncertainty on authorities and *The Brimnes* might not represent the current state of English law[142], there are points to be made in favour of *The Brimnes*.

First, as demonstrated above it is not that straightforward that the *dicta* of the House of Lords points to the obligation to pay hire punctually being of the essence and thus a condition.

Second, it is debatable whether Brandon J's judgment was indeed made by extensive reliance on *The Georgios C.* Although *The Georgios C* was cited quite extensively in *The Brimnes*, it must not be overlooked that *The Georgios C* at the time *The Brimnes* was decided represented the law and thus could not be ignored. But most importantly it is the fact that *The Georgios C* was distinguished in *The Brimnes* and namely on the point which subsequently was overruled by the House of Lords in *The Laconia*. It is suggested that Brandon J was not satisfied with the reasoning of the Court of Appeal in *The Georgios C* and being unable to overrule it distinguished it[143]. In any event it is difficult not to notice the acceptance of *The Brimnes* expressed by the House of Lords in *The Laconia*[144], even though not directly on the condition point.

And finally, it is difficult to follow Flaux J's argument that Brandon J in *The Brimnes* accepted that word "punctual" added little or nothing to the word "payment" and for this reason *The Brimnes* should not be followed. It indeed seems implicit that Brandon J did not consider word "punctual" being capable of making the obligation an essential term of the contract when he decided that the obligation to pay hire in clause 5

142 Shirley §50.

143 Indirect support for the proposition may be found in *The Laconia* at 323–324 per Lord Salmon: "In *The Brimnes, The Georgios C* was distinguished since it could not be overruled".

144 *The Laconia* at 318 per Lord Wilberforce, at 323–324 per Lord Salmon, at 332 per Lord Russell.

of the NYPE form was not a condition[145]. However, is there any authority indicating that word "punctual" in a contract does have the same effect as words "of the essence"[146]? It is submitted that if the word "punctual" would equate to the words "time of the essence" the decision in *The Astra* as well as other cases prior to *The Astra* concerning the construction of withdrawal clauses would have had much less complication. It seems that Flaux J does not pay enough attention to the fact that Brandon J in *The Brimnes,* opting for different construction of withdrawal clause than that in *The Georgios C,* did indeed attribute importance to the word "punctual" (and its meaning that once hire is not paid before or on the due date the payment of hire is not punctual and therefore the right of withdrawal is not lost by mere tender of payment after the due date). Namely on this aspect *The Brimnes* was expressly accepted by the House of Lords in *The Laconia* and later applied in *The Chikuma.*

2.3.5.5 The need for certainty upon failure to make punctual payment of hire

The third essential reason for the conclusion that clause 5 of the NYPE form is a condition given by Flaux J in *The Astra* was the importance to businessmen of certainty in commercial transactions.

The situation, where the ship-owners, faced with non-payment of hire in a falling market would be left with no remedy in damages at all (except the cases where the charterers would be in repudiatory breach) and in order to claim damages they would need to "wait and see" until they were in a position to say that the charterers were in repudiatory breach, according to Flaux J, "is inimical to certainty"[147].

As indicated earlier in the thesis it is true that classification of contractual terms as conditions does indeed promote certainty, but certainty is not *per se* a basis for classification of contractual terms as conditions[148]. Thus it is the parties' intentions drawn from the particular context and

[145] *The Brimnes* at 482.

[146] Cf. section 2.3.5.2.

[147] *The Astra* at 96(§116).

[148] Cf. sections 2.2.1.2. and 2.2.1.3.

contractual setting which determines which of the rival values, i.e. whether certainty or flexibility, are to be favoured. There is no hard and fast rule which would stipulate that certainty is to be preferred for flexibility – if it was, there probably was no need for intermediate terms. However, it is true that it is in a commercial setting where certainty is most often given priority. As in the case of time stipulations[149], the choice between certainty and flexibility is to the large extent determined by the results of the value judgment about the commercial significance of the term in question in its factual and contractual setting. It is submitted therefore that it is a question of construction the answer to which depends how significant the punctual payment of hire is to be held in time charterparty context and it is indeed debatable whether the obligation to pay hire construed as a condition for the sake of certainty does not undermine the values with which the emergence of intermediate terms is associated.

2.3.5.6 The *obiter* judicial support

As indicated above, the fourth essential reason for the conclusion that clause 5 of the NYPE form is a condition given by Flaux J in *The Astra* was that the *obiter* statements in *Stocznia v. Latco* and *Stocznia v Gearbulk* supported this conclusion. These cases were commented upon in sections above[150] and are thus not repeated here.

2.3.6 Concluding remarks. Could *The Astra* have been decided differently?

Given the objective of this part of the thesis indicated in the Introduction and in the view of the discussion above, it is submitted that there is considerable room for questioning the legal grounds on which *The Astra* is based.

Although Flaux J indicated four essential reasons on which he based his conclusion in *The Astra* that the obligation to pay hire is a condition,

[149] Cf. section 2.3.5.2.

[150] Cf. section 2.3.5.1. and 2.3.5.2.

it is submitted that *The Astra* is mainly based on the following:

First, Flaux J relied on his interpretation of *Bunge v. Tradax* stating that according to the *Bunge v. Tradax* time stipulations in mercantile contracts are of the essence and thus conditions – as demonstrated in the thesis[151] *Bunge v. Tradax* should probably be read in a more limited manner;

Second, Flaux J indicated that *dicta* of the House of Lords in *The Tankexpress, The Laconia, The Mihalios Xilas, United Scientific Holdings* and *The Afovos* supported the idea that the obligation to pay hire is a provision where time is of the essence – as discussed in the thesis[152] these cases are of little persuasive value since they either are non-time charterparty cases or because the reasoning of the court in these cases did not concern the issue whether obligation to pay hire is a condition but the construction of withdrawal clauses;

Third, Flaux J relied considerably on non-time charter party cases, i.e. shipbuilding (*Stocznia v. Latco, Stocznia v Gearbulk*) and bareboat charterparty (*Mahakam*) cases, - and given the fundamental differences between such contracts and a time charterparty (as set out above) it is difficult to accept them as persuasive arguments[153];

Last but not least, Flaux J could not have reached his conclusion that the obligation to pay hire in clause 5 of the NYPE form is a condition without declining to follow *The Brimnes* – however, the reasoning not to follow *The Brimnes* is also open to debate[154].

Notwithstanding the above, it must be admitted that since there is no firm judicial authority on the matter the issue of characterization of the obligation to pay hire as a contractual term is controversial and probably will be until there is some further judicial development. Taking into account the above-mentioned *Chitty's list* of cases when a contractual term generally will be held to be a condition, it is submitted that the potential support for the proposition that the obligation to pay hire in

[151] Cf. section 2.3.5.2.

[152] Cf. sections 2.3.5.2. and 2.3.5.4.

[153] Cf. section 2.3.5.3.

[154] Cf. sections 2.3.5.3. and 2.3.5.4.

clause 5 of the NYPE form is an intermediate term lies in the analysis of parties' intentions, inferred from the nature of the contract and/or subject-matter and/or circumstances of the case[155].

Since standard time charterparties are not genuinely negotiated contracts by the parties and the content of these contracts has evolved through years, the source where the parties' intentions could be inferred from is most probably the commercial setting wherein the obligation to pay hire is found to be.

As analyzed in the thesis[156], according to Lord Kerr's approach in *The Golodetz* which was subsequently accepted by the House of Lords, the analysis of the commercial significance of the contractual term in question is two-fold: first, it is necessary to look whether the contractual term is a condition precedent to the performance of other term(s) by the other party; second, if the contractual term is not a condition precedent, the significance of a particular contractual term in a given commercial setting must be evaluated.

The first element, i.e. the interdependence of charterers' obligation to pay hire and ship-owners' obligation to provide services (whether the former is a condition precedent to the latter or not), is an important one, even though, admittedly, not decisive[157]. As indicated above[158], the *dicta* in *The Agios Giorgis* and *The Tankexpress,* albeit *obiter,* support the view that the obligation to pay hire is not a condition precedent to the immediate performance of the ship-owners. In the absence of a firm judicial authority on this point, however, it may be said that from commercial perspective the interdependence of charterers' obligation to pay hire and ship-owners' obligation to perform services cannot be equated to the interdependence of the buyers' obligation to give 15 consecutive days loading notice and the sellers' obligation to nominate port as it was held in *Bunge v. Tradax*. General business logics suggests that one non-/late

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155 As listed by *Chitty* in the above-mentioned list, case (iv), cf. Section 2.2.1.3.

156 Cf. section 2.2.1.3.

157 It is not decisive, because policy considerations may support construction of a term in question as not a condition, cf. section 2.2.1.3.

158 Cf. section 2.3.5.2.

payment of hire without more in the context of commercial setting of time charterparty, where hire is paid periodically at certain time intervals, may not undermine ship-owners' position so that charterers' default could be considered as going to the root of the contract, if to use the Lord Kerr's words in *The Golodetz* case[159]. It is therefore submitted that there is considerable force in the argument that charterers' obligation to pay hire is not a condition precedent to the ship-owners obligation to perform services and thus, in the absence of policy considerations to the contrary, not a condition.

If to follow Lord Kerr's approach in *The Golodetz* and if to ignore the possible arguments favouring the obligation to pay hire is a condition precedent to ship-owners' obligation to perform, it is namely the value judgment about the commercial significance of the obligation which has to be made.

Although a value judgment is a synonym of a subjective approach to a question, in certain situations, e.g. as in *The Golodetz* or *The Astra*, such exercise may be said to be unavoidable. As it was analyzed in the thesis[160], the commercial risk associated with trading of the vessel lies with the charterers, whereas the ship-owners by fixing the vessel with a time charterparty enjoy the benefits of regular and defined cash flow. From the ship-owners perspective, it is indeed charterers' capability to make punctual hire payments that is at stake. Since there are no subsequent contracts that may fall upon charterers' failure to pay hire punctually as it is in cases of sale-chains or "string" contracts[161], it is difficult to state with certainty that any breach of charterers' obligation to pay hire goes to the root of the charterparty. In addition, from commercial perspective the construction of the obligation to pay hire as an intermediate term finds support in court's reasoning in *The Gregos,* where a redelivery clause in time charterparty was held to be not a condition, although admittedly the breach of such clause exposes the ship-owners probably to greater risk (as subsequent charterparty may be at stake) than the breach of the

[159] Cf. supra note 53.

[160] Cf. section 2.2.

[161] Cf. section 2.3.5.2.

obligation to pay hire does. At this point Lord Roskill's words in *The Hansa Nord* may be instructive when he said "…where there is a free choice between two possible constructions…the Court should tend to prefer that construction which will ensure performance"[162].

To sum up, it is submitted that the question whether the obligation to pay hire is a condition or not is indeed controversial and arguments supporting both constructions may be found. As demonstrated by the above-discussion in the thesis the judicial *dicta* are mostly *obiter* and in most cases, where *obiter* pronouncements concerning the construction question are made, it is collateral issues to the construction question that are dealt with and not the straightforward question whether the obligation to pay hire is a condition. However, it is submitted that if in *The Astra* more attention had been paid to the question of commercial significance of the obligation to pay hire as well as to the analysis of the commercial setting and the interdependence of both charterers' obligation to pay hire and ship-owners' obligation to perform services, the conclusion in *The Astra* could have been different or, at least, the reasoning of the same conclusion would have been of greater persuasive value.

3 Legal effects and commercial implications of *The Astra* and characterization of the obligation to pay hire as a condition

3.1 Introductory remarks

It is worth noting that it is not crystal clear whether Flaux J's judgment on the condition point is *obiter* (and thus persuasive) or is it a judgment decided on a number of grounds (and thus binding). Flaux J's comment that the question whether or not the obligation to pay hire in clause 5 of

[162] Cf. supra note 64.

the NYPE form was a condition *could be* said to be academic[163] contributes to the uncertainty.

Nevertheless, *The Astra* is indeed "the most definitive judicial pronouncement on this issue [of the construction of the obligation to pay hire] to date"[164]. This part of the thesis thus aims to analyze legal and commercial implications of *The Astra*.

3.2 Legal effects of *The Astra*. Post-*Astra* case law

The practitioners agree that *The Astra* is unlikely to provide the final word on the issue and that until the higher court pronounces its position or at least until there is a binding decision directly on point the obligation to pay hire cannot be considered with certainty as a condition and Flaux J's findings in *The Astra* will possibly be of persuasive value only[165]. Interestingly, an absolutely fresh 7th edition of *Time Charters* (2014) shares the same opinion[166].

Even if not binding, *The Astra* nevertheless brings along certain legal implications.

First, the charterers are exposed to greater risk when making deductions from hire. If prior to *The Astra* short payment of hire would not be immediately considered to be repudiatory, post-*Astra* short payment is considerably more risky because the smallest of underpayments potentially entitle a ship-owner to terminate and claim what could be substantial damages for loss of bargain.

Second, it is submitted that *The Astra* makes ship-owners' and charterers' legal position probably more uncertain than prior to *The Astra*. This is so because it is not clear if *The Astra* will be followed as Flaux J's pronouncement on condition point is more likely to be *obiter* and not to carry the weight of a precedent. Thus, the question then arises – would the ship-owners be successful if they terminate the charterparty upon

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163 *The Astra* at 77(§33).

164 Steamship Mutual report *Non-Payment of Hire – Right to Withdraw* http://www.steamshipmutual.com/publications/Articles/Astra0613.htm.

165 Ibid., cf. supra note 3.

166 *Time Charters*, 7th ed., §16.131.

one missed charterers' payment of hire or even one short payment of hire (which would not amount to a repudiatory breach[167]) in the hope of receiving substantial loss of bargain damages? If it turns out that *The Astra* is not followed and the obligation to pay hire in question is not a condition the ship-owners, having terminated the charterparty as if for breach of a condition, may find themselves in a position of having lost a good charterparty and being only entitled to claim unpaid hire up to the date of termination[168]. From charterers' perspective *The Astra* does contribute to the uncertainty of charterers' legal position, which in any event means that the charterers need to be more careful in order to avoid any inadvertence in payments of hire and especially cautious in their finance management in order to have cash flow as smooth as possible.

It is submitted that taking into account the two above-mentioned points both the ship-owners and the charterers are likely to reconsider the wording of the standard time charterparty forms. However, the real legal effects of *The Astra* are probably to be seen after a longer course of time as the post-*Astra* case law have not addressed the condition point yet.

In a recent London arbitration case 7/14 (LMLN 20 March 2014) the charterers who failed to pay three hire payments were found to be in repudiatory breach on the grounds that the charterers had evinced that they would not or could not perform the contract (which was concluded on the NYPE form), even though the charterers had attempted to draft their messages to the ship-owners so as to evince an intention to perform the charterparty in future.[169] The arbitration tribunal did not find difficulty to conclude that the charterers were in repudiatory breach because

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[167] Repudiatory in a sense of (i) a serious breach of an intermediate term, which deprives the innocent party of substantially the whole benefit of the contract, and/or (ii) evincing an inability (incapacity) to perform or intention not to perform or to perform inconsistently with the contract are referred as "repudiatory breach".

[168] Provided that the charterparty contains withdrawal clause, which is normally the case, and the ship-owners have strictly complied with the procedure of termination (withdrawal) therein.

[169] INCE&CO report *Charterer who expressed intention to perform in future nonetheless held to be in repudiatory breach* http://incelaw.com/en/knowledge-bank/publications/charterer-who-expressed-intention-to-perform-in-future-nonetheless-held-to-be-in-repudiatory-breach

the charterers failed to pay three installments of hire and in addition to that they failed to respond properly to unequivocal ship-owners' questions concerning charterers' future intentions to pay hire[170]. The case did not address the question of construction of the obligation to pay hire and it seems the argument of possible waiver by the ship-owners was not raised.

In another recent case of *Januzaj v Valilas*, although a non-shipping case, decided by the Court of Appeal, the issue of what amounts to a repudiatory breach in the context of an innominate term to make regular payments was considered and, if to put the judgment in the shipping context, it would follow that the ship-owners should be wary of attempting to terminate for non-payments if the ship-owners know or ought to know that the charterers will eventually be able to pay everything that is due, because the court will treat those non-payments as being late rather than not paid at all, with the consequences more likely sounding in damages only, unless the delay is extreme[171]. It is submitted that, although *Januzaj v Valilas* is probably distinguishable from the cases where the charterers are in default in payment of hire, the case provides some assistance in reasoning that payment obligations in a commercial context are construed as intermediate terms and not necessarily "of the essence".

In the light of the discussion above, the legal effects of *The Astra* remains to be seen.

3.3 Commercial implications of *The Astra*

From commercial perspective, *The Astra* favouring the construction of the obligation to pay hire as a condition, which according to the current state of English law implies that the ship-owners are entitled to terminate the charterparty at common law and claim damages for loss of bargain upon any, even trivial charterers' breach, signifies a shift of balance to the ship-owners side.

The ship-owners faced with the charterers failing to make punctual

[170] Ibid.

[171] INCE&CO report *A Check-up for Shipowners Januzaj v Valilas [2014] EWCA Civ 436*, http://www.stonechambers.com/news-pages/31.07.14--article--a-check-up-for-shipowners---januzaj-v-valilas--2014--ewca-civ-436---james-smithdale.asp.

hire payments in a falling market are at a relatively stronger position when demanding that payments were made on time as well as when they are invited by the charterers to re-negotiate the original charterparty terms (notwithstanding the legal uncertainties[172]); whereas the charterers are exposed to greater commercial risks, since unsuccessful trading of the chartered vessel in a falling market is also associated with probable ship-owners' claim of damages for loss of bargain.

However, the claims of damages for loss of bargain for the ship-owners is of interest only in a falling market and for this reason further developments in case law are not be expected to come up soon.

3.4 Concluding remarks. Any prospects for development in the law of damages for loss of bargain?

Given the objective of this part of the thesis indicated in the Introduction and in the view of the discussion above, it is submitted that the legal effects of *The Astra* remains to be seen. It is indeed interesting how the market players, first and foremost the ship-owners and their legal advisers, in the post-*Astra* light will act and arrange their legal position in situations of charterers' default in payment of hire. And it is also interesting how the courts will develop the law of damages for loss of bargain.

It is a rule under English law that the breach of a contract discharging the innocent party from further performance entitles the innocent party to terminate the contract at common law and to claim damages for loss of bargain, i.e. the source of the innocent party's power to terminate at common law and to claim damages for loss of bargain is the same – repudiatory breach. Notably, apart from the repudiatory breach in a form of the evinced inability (incapacity) to perform or intention not to perform or to perform inconsistently with the contract, a contract may be repudiated due to breach of a condition or upon serious breach of an intermediate term which deprives the innocent party from substantially the whole benefit of a contract. Given the difficulties of construction of

[172] Cf. section 3.2.

certain contractual terms and the significance of classification of contractual terms into particular categories, first and foremost, because of the immediate availability of damages for loss of bargain if the contractual term is held to be a condition, legal literature presents ideas for development in the context of cases when the construction of a contractual term as a condition brings along unsatisfactory result as happened in *Lombard* case, namely, the award of damages for loss of bargain.

Peel in *Treitel on the Law of Contract* in his discussion about the legal effects of *Financings v. Baldock* and *Lombard* cases suggests that damages for loss of bargain should be available only when "there has been substantial failure to perform, or the term broken amounted to a condition other than a consequence of the parties' express classification"[173]. It follows that Peel is indeed suggesting a separate category of contractual terms – conditions as a consequence of parties' express classification – a breach of which would not entitle the innocent party to claim damages for loss of bargain, whereas the usual "conditions" would.

Similarly, Christopher Langley and Rebecca Loveridge suggests that there are grounds to divide the powers of the innocent party to terminate at common law and to claim damages for loss of bargain, the latter, as suggested by the authors, should depend on the magnitude of the breach, if the contractual term breached is a "condition" as agreed by the parties[174].

The above-mentioned ideas propose development in the law of damages for loss of bargain, namely, when they are claimed upon breach of a condition which is classified as such as a consequence of parties' agreement. In the light of *The Astra* it would mean that in order for the shipowners to get damages for loss of bargain, the gravity of charterers' default should be taken into consideration. Although the proposition supposes considerable change in the law of damages for loss of bargain under English law, the possibility and probability of the development may not be fully excluded.

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[173] *Treitel on the Law of Contract*, §18-069.

[174] Langley, Loveridge.

4 Conclusion

The analysis of *The Astra* in this thesis has attempted to demonstrate that there is considerable room for questioning the legal grounds on which Flaux J based his conclusion that the obligation to pay hire in clause 5 of the NYPE form is a condition. It has also been attempted to show that if the learned judge had paid more attention in *The Astra* to the question of commercial significance of the obligation to pay hire as well as to the analysis of the commercial setting and the interdependence of both charterers' obligation to pay hire and ship-owners' obligation to perform services, the conclusion in *the Astra* which the judge reached could have been that the obligation to pay hire in clause 5 of the NYPE form is an intermediate term or, at least, the reasoning of the same conclusion that the obligation is a condition would have been of greater persuasive value.

The attempted insight into legal effects and commercial implications of *The Astra* has shown that the question whether *The Astra* will produce measurable effects or will it remain as indeed one of the most debatable decisions in recent years is still open and probably will be as such until the shipping market faces significant downs in freight rates as it occurred in 2008, since *The Astra* presents significant changes of shipowners' legal and commercial position namely in a falling market.

Update on post-*Astra* case law: *Astra* not followed

It must be admitted that it did not take that long to have *The Astra* puzzle solved. After almost 2 years of debate in the shipping market the issue of classification of the obligation to pay hire punctually as a contractual term was reconsidered by another Commercial Court's judge Popplewell J in a recent judgement as of 18 March 2015 in *Spar Shipping* case, in which the learned judge stated that he has "the misfortune to differ from

the conclusion reached by Flaux J"[175] and thus declined to follow *The Astra*.

The background facts

Three supramax bulk carriers belonging to the Claimant *Spar Shipping* AS were let to Charterers Grand China Shipping (Hong Kong) Co. Ltd on three long-term time charterparties dated 5 March 2010 on amended NYPE 1993 forms. The charterparties provided for guarantees to be issued by the Defendant Grand China Logistics Holding (Group) Co. Ltd, which is the parent company of the Charterers. The Charterers paid hire punctually on all three vessels until April 2011, but from then the Charterers were continuously defaulting in payment of hire. In September 2011 the Ship-owners, faced with the recalcitrant Charterers, withdrew the vessels and terminated the charterparties. The Ship-owners commenced arbitration proceedings and claimed the balance of hire due under the charterparties and damages for loss of bargain in respect of the unexpired term of the charterparties.

The Commercial Court's decision

In *Spar Shipping* Popplewell J, having noted that the issue of classification of the obligation to pay hire punctually as a contractual term is "of general application and importance to shipping community"[176], presented an extensive analysis of the authorities and specifically addressed each of the four essential reasons, on which Flaux J based his conclusion in *The Astra*[177]. In the following overview of the judgment in *Spar Shipping* case Popplewell J's line of argument in respect of each essential reason listed by Flaux J will be presented.

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[175] *Spar Shipping* at §95.

[176] Ibid.

[177] Notably, the careful consideration of argumentation of *The Astra* in *Spar Shipping*, taking into account both conflicting authorities in *The Brimnes* and *The Astra*, was dictated by the doctrine of precedent, which requires a judge, faced with two conflicting decisions of courts of co-ordinate jurisdiction, to demonstrate confidence that the second judge was wrong in not following the first (*Spar Shipping* at §93-94).

Firstly, Popplewell J held, in disagreement with Flaux J, that the mere fact of express contractual right of termination conferred in a contract for any breach of a term does not answer the question whether that term is a condition and thus dismissed the first essential reason pointed by Flaux J in *The Astra*[178]. Support for such proposition is derived from *Financings Ltd. v. Baldock*[179], which was commented on in the thesis[180], and it is not apparent from the report whether it was cited before Flaux J in *The Astra*. In *Spar Shipping* Popplewell J concluded that the withdrawal clause in time charterparties provides for liberty to withdraw a vessel from service and thus should be treated as an option to cancel which does not confer greater rights to damages at common law, unless there is clear language to that effect[181]. The learned judge concluded that nothing in the language in clause 11 of the NYPE 1993 form suggests that the withdrawal clause, save for future performance, expands or restricts the rights of the parties and thus the withdrawal clause is neutral as to the common law rights of the parties (right to claim damages for loss of bargain)[182]. Following this argumentation, Popplewell J dismissed Flaux J's assertion that the express contractual right of withdrawal irrespective of the gravity of the breach "is a strong indication" that the obligation to pay hire punctually is a condition[183].

Secondly, Popplewell J stated that generally time of payment is not of the essence in commercial contracts unless a contrary intention clearly appears from the contract or surrounding circumstances, and thus dismissed the second Flaux J's essential reason suggesting the opposite

178 *Spar Shipping* at §104.

179 Popplewell J admitted that *Financings Ltd. v. Baldock* does not provide an immediate answer whether the obligation to pay hire in time charterparties is a condition due to important differences between time charterparties and hire purchase agreements, but nevertheless the judge was confident that the case illustrates well that the existence of a contractual right to terminate does not necessarily elevate the term upon breach of which such termination right is conferred to the status of a condition (cf. *Spar Shipping* at §104).

180 Cf. section 2.3.5.1.

181 *Spar Shipping* at §§190-191.

182 Ibid.

183 *Spar Shipping* at §202.

in *The Astra*[184]. Popplewell J held that a judgment in *Bunge v. Tradax* supported a more limited conclusion, which was also suggested in the thesis[185], that time is of the essence in cases where a term concerned is a dependent term, i.e. a condition precedent to the ability of the other party to perform its obligation pursuant to another term, and this is not the feature of the term requiring payment of hire in time charterparties[186]. Although it was submitted in the thesis that there is no clear authority on the question whether the charterers' obligation to pay hire is a condition precedent to the ship-owners' ability to provide services, except for several cases which indeed give *obiter* support that it is not[187], Popplewell J did not find it difficult to conclude that the ship-owners' ability to provide services to the charterers is not dependent on (is not a condition precedent to) the charterers' prompt payment of hire. Popplewell J, dismissing Flaux J's argument that the *obiter dicta* of the House of Lords in *The Tankexpress, The Mihalios Xilas, United Scientific Holdings, Bunge v. Tradax* and *The Afovos* support the proposition that the obligation to pay hire punctually is a provision where time is of the essence, gave a compelling explanation that "the *dicta* in the cases about the ship-owners' commercial interest in prompt and punctual advance payment provide good reason for approaching a contractual option to terminate with the stringency which its unqualified term require, but no reason additionally to treat the term as a condition conferring a right to terminate at common law with its different financial consequences"[188]. The analysis of time charter withdrawal authorities presented by Popplewell J in the judgment of *Spar Shipping* demonstrates that the ship-owners' commercial interest to be paid fully and punctually in advance is adequately protected by stringent construction of withdrawal clauses which follows from the *dicta* in *The Tankexpress* as well as other subsequent authorities and this

184 Ibid. at §§166, 171, 203.
185 Cf. section 2.3.5.2.
186 *Spar Shipping* at §166.
187 Cf. section 2.3.5.2.
188 *Spar Shipping* at §203.

interest does not require the term to be construed as a condition[189].

It is noted that Popplewell J gave an interesting analysis of Lord Diplock's speech in *The Afovos*, a case, as was suggested in the thesis, presenting difficulty to the conclusion that the obligation to pay hire is not a condition[190]. Popplewell J generally agreed with the reading of *The Afovos* by Flaux J in *The Astra* and stated that Lord Diplock's analysis in *The Afovos* is that the effect of the withdrawal provision is to make the payment term a condition although in the absence of the withdrawal provision it would be an innominate term[191]. It is submitted that in the thesis a different approach to the Lord Diplock's speech was suggested[192], therefore in this respect Popplewell J's reasoning and analysis is interesting.

The only exception to the *obiter dicta* statements of the House of Lords that the obligation to pay hire punctually is a provision where time is of the essence named by Flaux J in *The Astra* was *The Brimnes* case, which Flaux J distinguished (on an anti-technicality point) and declined to follow (due to its reliance on the Court of Appeal's case *The Georgios C* since it was subsequently overruled by the House of Lords in *The Laconia*). Interestingly, in *Spar Shipping* Popplewell J dismissed the main Flaux J's argument not to follow *The Brimnes* in a very similar line of reasoning as was suggested in the thesis[193]. Namely, Popplewell J held that *The Georgios C* was overruled, but it was, however, overruled on different point, not that for which Brandon J treated it as authoritative support in *The Brimnes*[194]. As to the anti-technicality point, on which Flaux J purported to distinguish *The Brimnes*, Popplewell J held that it does not afford a real ground of distinction and explained that "[a] notice to make time of the essence does not convert an innominate term into a condition"[195].

189 Ibid. at §114.

190 Cf. section 2.3.5.2.

191 *Spar Shipping* at §145.

192 Cf. section 2.3.5.2.

193 Cf. sections 2.3.5.3 and 2.3.5.4.

194 *Spar Shipping* at §204.

195 Ibid. at §§184, 204.

To sum up Popplewell J's findings in *Spar Shipping* in respect of the second essential reason on which Flaux J's conclusion in *The Astra* was based, it is submitted that Popplewell J conceded that the authorities, those which expressly address or mention the question whether payment of hire in time charters is a condition do not speak with one voice, but those cases which suggest that the obligation to pay hire on time is a condition (including *The Afovos*), according to Popplewell J, were not made after argument on the point and are counterbalanced by other judicial *dicta* and the decision of Brandon J in *The Brimnes* to the contrary[196].

Thirdly, Popplewell J considered that the importance of certainty in commercial transactions does not justify classification of the obligation to pay hire on time as a condition, and thus dismissed the third essential reason listed by Flaux J in *The Astra*. Popplewell J held that the uncertainty with which the ship-owners are faced in determining when exactly the charterers are in repudiatory breach entitling them together with the exercise of the right to withdraw (terminate) to recover damages for loss of bargain is no different from the uncertainty regularly faced by commercial parties whose contracts commonly contain innominate terms, and the learned judge saw no reason why ship-owners should be treated more favorably in this respect than others[197]. According to Popplewell J, certainty underlies the rationale of giving full and stringent effect to withdrawal clauses, as was also suggested in the thesis[198], but in Popplewell J's view it "must be counterbalanced with the need not to impose liability for trivial breach[es]"[199].

Fourthly, Popplewell J dismissed the fourth Flaux J's essential reason in *The Astra* related to shipbuilding cases by explaining that the position of a shipyard under shipbuilding contract is very different from that of a ship-owners in time charterparties, since in the latter case the withdrawal clause leaves the ship-owners free to employ their vessel profitably

196 Ibid. at §§188, 203.

197 Ibid. at §§200, 205.

198 Cf. sections 2.3.5.2 and 2.3.5.5.

199 *Spar Shipping* at §199.

elsewhere and puts an end to any loss continuing to be caused to the ship-owners resulting from the termination, whereas a shipbuilder exercising a right to terminate for default in payment by his buyer is left with an unfinished vessel in his yard whose presence will cause continuing damage[200]. Therefore the shipbuilding cases in the Popplewell J's view do not support the conclusion that the obligation to pay hire punctually in time charterparties is a condition[201].

To conclude, Popplewell J, having considered each of the essential reasons listed by Flaux J in *The Astra* and having analysed in detail the existing authorities on the issue, felt unable to follow *The Astra* and thus concluded that the obligation to pay hire is not a condition.

Comment

In *Spar Shipping* Popplewell J stated that the "[c]ommentary following the decision in *The Astra* suggests that Flaux J's decision has not been universally welcomed"[202], and these words of the learned judge rather precisely reflect the shipping community's response to *The Astra*. Having reviewed the first commentaries in respect of *Spar Shipping*, it is difficult not to see that legal practitioners consider Popplewell J's judgment as a sign that "finally all is well with the world again"[203] and, in a more reserved manner, as "restoring the previously accepted view that the obligation to pay hire when it falls due is not a condition"[204].

Taking into account Popplewell J's consistent and indeed compelling analysis of the authorities on the issue together with the convincing analysis of commercial setting in which the obligation to pay hire is to be envisaged as well as the general context of post-*Astra* case law[205] it is

200 Ibid. at §173.

201 Ibid. at §206.

202 Ibid. at §95.

203 Shirley, *The End of the Astra?* http://www.stonechambers.com/news-pages/19.03.15--article--the-end-of-the-astra----james-shirley.asp

204 INCE&CO report *Court finds payment of hire is not a condition: Astra not followed* http://incelaw.com/en/knowledge-bank/publications/court-finds-payment-of-charter-hire-is-not-a-condition-astra-not-followed

205 Cf. section 3.

very likely that *Spar Shipping* is to be considered as the leading case on the issue at least until the higher courts pronounce whether the obligation to pay hire punctually in time charterparties is a condition or not.

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Non-contractual third-party liability: A brief economic analysis

Kyle Jacob Ritter

Content

1 Introduction

The purpose of this paper is to analyze selected Norwegian non-contractual tort liability norms in order to determine whether they incentivize rational actors to engage in economically efficient behavior. This is not the end in itself, but is meant to serve the overall goal of the law and economics movement: i.e., to allocate society's limited resources such that maximum value is derived from its calculated regulatory spending. The process, at its most basic, involves identifying specific inefficiencies and attempting to deduce the most economically efficient solutions to them.

The method of this economic analysis is theoretical, and the claims made based on the modeling of behavior are not meant to be indicative of the state of reality. They are not empirically derived. Rather, this paper simply serves as an attempt to use theoretical economic principles to analyze the Norwegian framework of non-contractual third-party claims against shipowners in Norway. What sets the economic analysis of law apart from many other evaluative tools is that it does not look at individual situations, asking if justice was done in the specific instance. Rather, it takes a step back, to a societal standpoint, and asks whether the analyzed legal norm creates good incentives for actors to act in a way that is good for society. In this way, it is suggestive of a moral argument, because the method requires identifying and promulgating something that resembles a theory of Good (i.e., efficiency). The method by which this process occurs is introduced in Chapter 2.

Chapter 3 discusses the basics of Norwegian non-contractual liability norms. Particular attention is paid to liability regimes: negligence, vicarious liability, and strict liability. Using the economic method of analysis, in Chapter 4, this paper analyses these non-contractual liability norms with the relevant economic theory in order to highlight some potential areas where the legal norms may lead actors to behave inefficiently. Lastly, Chapter 5 discusses the relative strengths and weaknesses of the negligence and strict liability regimes in influencing actors' decisions, and

some normative suggestions are discussed.

Some have argued that the economic method of analysis of law is too limited to be persuasive, because it excludes non-economic factors from the discussion. However, in the opinion of this author, the economic analysis of law is persuasive as a means of evaluation and critique precisely because of its limitations. The movement has gone to great lengths to demarcate its goals clearly. Likewise, the metrics, method, and other evaluative tools used are defined and will be discussed in more detail below. The same cannot always be said of many other evaluative metrics, e.g., justice, equality, fairness, etc. Indeed, these are vague terms with definitions that vary depending on the user.

This paper also does not argue that other evaluative techniques ought to be replaced. Rather, this is merely a proposal to allow the economic analysis of law to help inform critical legal studies (particularly in the commercially-driven area of maritime law), and let it add to the several other methodologies of critical legal analysis.

2 Methodology

2.1 Introduction

The following is an introduction to the methodology of the economic analysis of law. It is a theoretical approach that has as its purpose the identification and modification of legal norms—or the absence of legal norms—that incentivize inefficient behavior.

The method consists of two basic processes. The first, known as the *descriptive process*, is an attempt to ascertain the state of the law as it currently exists. It does so by defining what the law is, and determining how actors respond to it based on the assumption that actors are rational. The second process, known as the *normative process*, asks whether the conclusions drawn during the descriptive process are socially desirable. This happens through an assessment of the law, in which the effects of

the legal norms are graded against chosen criteria. Together, the descriptive and normative processes offer an assessment of efficiency that can be used by legislators and legal critics to assess how effective specific legal norms are at incentivizing socially beneficial behavior. Below, each process is described in more detail, including the respective assumptions at play.

2.2 Descriptive analysis

The descriptive process attempts to apprehend how actors respond to the legal norms they experience on a microeconomic level. It does so by performing a two-step analysis. First, it requires a determination of the state of the law as it exists at the relevant point in time. This is basic legal work, i.e., surveying various sources of law (statutes, rules, regulations, judgments, etc.) and restating them into coherent rules in an effort to clarify what the law is. Secondly, models are used to approximate what effect the relevant legal norm has on different actors' behavioral choices. The modeling process consists of setting up scenarios in which actors are confronted with legal norms, and their responses are then projected based on assumptions at play in the model.

Because this paper uses various economic models throughout, some introduction to the assumptions at play in the models is necessary. It must be kept in mind that the models do not claim to perfectly reflect how the legal norms in question function in the world. Human activity is too complex to be perfectly represented in any economic model, let alone models as simplistic as the ones used in this paper. Indeed, it has been shown that human behavior can be, and often is, contrary to the assumption of the rational actor.[1] This reality necessitates a pragmatic cutoff point at which the model overlooks or discounts many idiosyncrasies that are observable in human nature, i.e., to overlook the individual aberrations and instead rely on observable trends. Accordingly,

[1] cf. Ariely, Dan; Loewenstein, George; Prelec, Drazen, *Coherent arbitrariness: Stable demand curves without stable preferences*, The Quarterly Journal of Economics (Feb. 2003); cf. also Becker, Gary S., *Irrational behavior and economic theory,* Journal of Political Economy (Feb. 1962)

within the models, assumptions are made about actors' behavior in order to deal with the limitations of rationality.

A variety of assumptions have been suggested for analyzing legal rules. These assumptions may be as detailed or as general as necessary in order to be persuasive. The following are assumptions used in this paper:

Rational actor. The assumption that is central to economic analysis of law is that of the rational actor. This method,[2] as expounded by the works of *inter alios* Becker,[3] assumes that the subjects in the models will acts in such a way so as to maximize their expected well-being.[4] In other words, an actor will respond to the incentives placed before her by choosing whichever alternative most increases—or least decreases—her well-being. With this assumption in play, it can authoritatively be stated that an actor confronted with a choice between acquiring 5 dollars and acquiring 7 dollars will always choose 7 dollars, all other things being equal.[5] Similarly, an actor may choose not to follow a legal rule if the increase in well-being derived is greater than the potential harm of the resulting penalty.

Probabilistic risk assessment. As an extension of the rational actor assumption discussed above, this paper also assumes that actors are forward-looking and assess future events probabilistically.[6] Both in the models and in real life, the future is unknowable. Accordingly, the actors in the models have expectations that are clouded with uncertainty. This creates obvious difficulties in predicting in what ways actors will behave,

[2] The word "method" is used purposely, as Becker explains: "Unlike Marxist analysis, the economic approach, I refer to does not assume that individuals are motivated solely by selfishness or material gain. It is a method of analysis, not an assumption about particular motivations," cf. Becker, Gary S., *Nobel lecture: The economic way of looking at behavior*, Journal of Political Economy (Jun. 1993), p.385

[3] cf. Becker, Gary S., *The economic approach to human behavior,* University of Chicago Press (Chicago 1976)

[4] Becker, Gary S., Nobel lecture: *The economic way of looking at behavior*, Journal of Political Economy (Jun. 1993)

[5] Note that the assumption in the model is not consistent with how reality actually works. A person may have many reasons to choose 5 dollars over 7 dollars at any given time.

[6] Becker (1993), p.386

even with the assumption of rationality.[7]

In order to account for this uncertainty, the models assume that actors will approach their decision making processes *probabilistically*, i.e., by assigning probability values to events in line with their expected likelihood of occurrence.[8] Actors then choose to take—or not to take—a calculated risk relative to their expected increase in well-being.[9] As an example, suppose that an actor were confronted with the choice to play a game in which she is given a 25 per cent chance of winning 50 dollars, but must spend 10 dollars to play. If it is assumed that the actor views risk probabilistically, it can also be assumed the actor will always choose to play the game, because her expected return from the game (.25 * 50 = 12.5) is 2.5 greater than the expected losses from playing (10).

Utility as a function of well-being. Actors' well-being in this paper is expressed in terms of utility. An individual's utility "can depend on anything about which the individual actors care: not only material wants, but also, for example, aesthetic tastes, altruistic feelings, or a desire for notions of fairness to be satisfied."[10] In short, it may rightly be said that anything that increases an actors' well-being also advances her utility, and anything causing her harm detracts from her utility.

It is of primary importance for the purpose of measuring actors' utility levels, then, how one defines the concept of well-being. This paper employs the *willingness-to-pay method* (also called market valuation) as the tool by which valuation levels are assigned.[11] In simplest terms, the willingness-to-pay method assigns a value of utility to a thing based on the price

7 Sen, Amartya, *The discipline of cost-benefit analysis*, Journal of Legal Studies (Jun. 2000), p. 942

8 Expected likelihood of occurrence, for some things, is almost impossible to predict. Third parties who are injured from a ship collision may have never experienced a similar injury, and may never do so again. Professional shipowners, however, should have collected at least a marginal amount of data from past experiences such that they will have a foothold on relevant probabilities.

9 Shavell, Steven, *Economic analysis of accident law*, John M. Olin Paper Series, No.396 (Dec. 2002), ch.2 p.1

10 Shavell (2002), ch.1 p.2 (this conceptual framework is most appropriately attributed to Jeremy Bentham and his "hedonic calculus" evaluations)

11 Richardson, H.S., *The stupidity of the cost-benefit standard*, Journal of Legal Studies (Jun. 2000), p.985

an actor would choose to pay for it.[12] If an actor would pay a maximum of 1 dollar for a thing *X*, then *X* can be said to bring 1 dollar's worth of well-being, or utility, to the actor. Theoretically, this means that the more an actor is willing to pay for thing *X*, the more they value *X*.[13]

Implementation of this method is simple when it comes to things with ascertainable monetary values (what's known as explicit valuation[14]). The total loss of a vessel, for instance, with a value of *A* and daily earning capacity *B* will detract from the vessel owner's utility in an amount equal to $A + (B * D)$, where *D* is the number of days' earning capacity lost due to the vessel being lost.

The use of the willingness-to-pay method is more problematic in the context of those things to which assigning monetary value is difficult or impossible. Examples abound: clean water, unique art, distributional fairness, morality, etc. (often referred to as "soft" variables). There are, therefore, obvious shortfalls to the willingness-to-pay metric, and many poignant critiques have been put forward.[15] These critiques in large part include highlighting various categories thought to be underrepresented by willingness-to-pay valuation. Another, more basic critique, is that the willingness-to-pay method does not adequately represent an actor's utility because her willingness to pay may be skewed by her wealth constraints.[16] A person who barely has enough purchasing power to feed herself may

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12 Calandrillo, Steve P., *Responsible regulation: A sensible cost-benefit, risk versus risk approach to federal health and safety regulation*, Boston University Law Revue (Dec. 2001), (citing Sen, Amartya, The discipline of cost-benefit analysis, Journal of Legal Studies (Jun. 2000), p.945)

13 Id, p.1021

14 Sen (2000), p.935

15 cf. Sunstein, C.R., *Cognition and cost-benefit analysis*, Journal of Legal Studies (Jun. 2000), pp.1089-91 (showing that willingness-to-pay includes potential motivational and cognitive distortions; willingness pay is not ability to pay); cf. also Sen, (2000), pg. 945 (noting that willingness-to-pay generally does not account for distributional fairness); cf. also Dworkin, Ronald M., Is wealth a value?, Journal of Legal Studies (Oct. 1980), pp.197-201

16 Sen, (2000), pg. 946 (illustrating that a poor person uses 30 per cent of her income for X may signal a greater willingness to pay than a rich person doing the same thing); Sunstein (2000), pp.1089-90 (arguing that lack of elastic income may skew the willingness-to-pay metric)

care tremendously about air quality, but the economic constraints of surviving may skew her willingness-to-pay. In contrast, a very wealthy person may not care much at all about air quality, but have no qualms about paying $1000 or even $100,000 in order to have it.

While certainly merited, the critiques of the willingness-to-pay method have not put forward a better solution.[17] Indeed, some of the critiques propose metrics based on the same underlying methodology, but simply retooled to be more sensitive to specific factors.[18] For this reason, willingness-to-pay has continued to be the most widely accepted method of utility valuation in law and economics analysis.[19]

Additionally, it must be kept in mind what the willingness-to-pay method is actually attempting to achieve: to place a monetary value on utility. Utility, as stated above, includes all the collected cares of an individual. It is therefore a "mistake to believe," explains one commenter, that utility "reflects only narrowly 'economic' factors, namely, the amounts of goods and services produced and enjoyed."[20] With this in mind, at least theoretically, the utility an actor derives from living in a clean environment, or from distributional fairness—or any other "soft" variable—is accounted for in the willingness-to-pay method. If an actor achieves *X* utility from an event occurring in a model, it can be assumed that the number *X* accurately reflects the total utility—including from soft variables—the actor derives in the model, no matter how difficult it may be to assign analogous numbers in reality. In this way, even if it is impossible to assign valuations to certain things in the real world, they are accounted for in the models.

Finally, it must further be kept in mind that this paper is generally analyzing the economic decisions of firms and other commercial actors.

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17 Calandrillo (2001), p.1023 (citing Posner, Eric A., *Cost-benefit analysis: Definition, justification, and comment on conference papers*, Journal of Legal Studies (Jun. 2000), p.1161

18 See e.g. Kornhauser, Lewis A., *On justifying cost-benefit analysis*, Journal of Legal Studies (Jun. 2000), pp.1050-51 (simultaneously defending cost-benefit analysis while critiquing its method of assigning value)

19 Calandrillo (2000), p.945

20 Shavell, Steven, *Foundations of economic analysis of law*, Belknapp Press (Cambridge 2004), p.2

There are certain considerations that categorically distinguish commercial actors from individual actors in regard to daily decision-making and incentives, particularly with regard to public perception.[21] Many firms are publically listed entities and thereby accountable to shareholders, meaning their primary goal is profit. Therefore, in descriptive processes dealing with commercial actors, generally, more weight is given to "purely economic" factors than would be given, for instance, in a consideration of the economic incentives on private actors through income tax regulation.

2.3 Normative analysis

The second process involved in the economic analysis of law is the *normative* process, which asks whether or not a given legal norm is *socially desirable*. The normative process presents its own difficulties because it is not immediately evident how one ought to define what is or is not socially desirable. Indeed, whether an action is socially desirable is a question of ethics that requires one to establish criteria for judging actors' motivations and decisions. The criteria utilized for defining social desirability, therefore, must be introduced as a point of departure.

Whether an action is socially desirable in this paper is understood as a function of the actors' utilities. The point at which the sum total utility of all actors in a given situation is maximized will be used as a proxy for the most socially desirable (or efficient) result, and will be referred to as the social optimum.[22] Whether something is socially optimal, therefore, is highly dependent on two factors: (1) how utility values are assigned in the descriptive process; and (2) how efficiency is defined in the normative process.

With respect to the first factor, as discussed above, utility values are assigned based on the willingness-to-pay metric. In this way, how one defines and assigns value to utility is intimately linked with whether

[21] Id, p.212 (consider, for instance, the effects of risk aversion on firms with limited liability versus risk aversion of individuals, for whom a personal liability may prove disastrous)

[22] Shavell (2004), p.178 (using the term "social optimum" to mean the situation in which total social costs are minimized)

something is socially desirable.

With respect to the second factor, debate has occurred with regard to how economists ought to aggregate costs and benefits in order to determine which actions are considered efficient.[23] In many ways the debate is similar to the debate discussed above regarding the assignment of value to "soft" variables.[24] Though much of this debate is outside the scope of this analysis, suffice it to say that this paper employs the definition of efficiency put forward by Kaldor[25] and Hicks,[26] which is best understood in relation to Pareto efficiency. When a transaction is Pareto efficient, it means that by the transaction occurring, at least one actor is put in a better position (i.e., derives some utility) and no actors find themselves in a worse position. This is a severely restrictive understanding of efficiency, particularly when one considers the existence of negative externalities and the costs of bargaining (discussed below). The definition of Kaldor-Hicks efficiency, on the other hand, is broader. A transaction is Kaldor-Hicks efficient if an actor benefitting from the occurrence of the transaction is able to compensate the actor that is made worse off while still deriving utility in the aggregate. In other words, the method aggregates utility values by simply adding the total utility of all actors and subtracting the total social costs to all actors with the assumption that transaction costs are negligible.[27] To the extent the transaction derives a net total positive result, a transaction or event is considered Kaldor-Hicks efficient.

The normative process, therefore, is a constant reevaluation process in which lawmakers ask whether promulgated legal rules align incentives such that rational actors' self-interest aligns with socially desirable (i.e., efficient) behavior. In this paper, that standard will be the marginal utility

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23 Calandrillo (2001), p.980

24 cf. e.g. Kornhauser (2000), pp.1040-44 (arguing that one must account for more than individuals' willingness to pay)

25 cf. Kaldor, Nicholas, *Welfare propositions of economics and interpersonal comparisons of utility,* The Economic Journal (Sept. 1939)

26 cf. Hicks, J.R., *Foundations of welfare economics*, The Economic Journal (Dec. 1939)

27 Kennedy, Duncan, *Law-and-economics form the perspective of critical legal studies,* The New Palgrave Dictionary of Economics and the Law, ed. Newman, Palgrave Macmillan (New York 1998), pp.468-9

of Kaldor-Hicks efficiency, in which total utility gains of every actor in the scenario are aggregated and then offset by total losses.

2.4 The purpose of liability: Why use legal rules?

The imposition of liability has traditionally been thought of as the way in which victims are compensated for losses they incur due to the activities of other actors.[28] The primary consideration is that the victim, to the extent possible, be restored to her original position, i.e., as if the injury had not occurred. Naturally, this justification is quite appealing. It is assumed, almost innately, that if someone has been harmed despite doing nothing improper or malevolent, that person ought to be made whole by the injurer. The inverse is also true: "[m]ost people feel this very strongly: if you [do] something wrong, then you have to compensate."[29]

The law and economics movement views this traditional justification for liability rules as incomplete for various reasons, most importantly because of the numerous avenues for full or partial compensation that exist outside of private tort claims. Examples include the availability of public[30] and private[31] insurance coverage (which, in many cases, is obligatory[32]), and the possibility to apply to various funds for compensation.[33] Even in the absence of liability rules, "the victims of maritime accidents would usually receive full compensation or indemnity regardless

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28 Shavell (2004), p.97

29 Røsæg, Erik, *Lecture of 11 and 12 October 2012*, Scandinavian Institute of maritime law: JUS5402 Maritime law: Liability & Insurance

30 cf. Act of 28 February 1997 no.19, National Insurance Act (Lov om folketrygt), ch. 11

31 Specifically, protection and indemnity ("P&I") and hull and machinery insurances cover a reder's liability for personal injury, death and damage to and loss of property

32 cf. e.g., Act of 24 June 1994 no.39, Maritime Code § 208 (hereinafter referred to as "MC") (Lov om sjøfarten) (insurance/financial security obligation for potential bunker oil pollution); MC §§ 194, 197-200 (compulsory insurance for oil tanker vessels); MC § 432 (compulsory insurance with regard to passenger liability in the event the regulations are promulgated requiring it)

33 cf. e.g., International Convention on the Establishment of an International Fund for Compensation for Oil Pollution (FUND), 18 December 1971 (superseded by 2002 protocol), given direct legal effect in Norway via MC § 192

of ship owners' liability."[34] Indeed, the special maritime liability regimes are among the most funded compensatory regimes in the world, with considerable funds available to claimants that suffer loss,[35] including shipowners, their customers, their passengers, and even, in many cases, third parties. Because of the presence of these other avenues of compensation, it is possible that liability, as judged by its ability to compensate, may not be considered socially desirable.[36]

This, however, does not mean that liability law is unnecessary in the modern context. Though liability may not serve the compensatory purpose as efficiently as other avenues of compensation, liability rules remain a vital tool for incentivizing actors into behaving in socially desirable ways. Because rational actors are assumed to act so as to maximize their utility, it can thereby also be assumed that their actions will be affected by the legal incentives placed before them in the form of liability rules.[37] In this way, considerations of efficiency are linked with various forms of liability. For this reason, it is important for lawmakers to analyze the way liability models incentivize actors to behave, and whether or not those resulting actions are efficient and beneficial to society.

2.5 The problem to be addressed

In any economic analysis, it must be determined whether there is an inefficiency that needs to be solved, and which solutions allow it to be dealt with most efficiently. Below is an introduction to the problem of negative externalities, a specific type of market failure. The presence of negative externalities is the major problem with which law and economics grapples when determining how to design liability rules in order to incentivize efficient behavior.

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[34] Billah, Muhammad Masum, *Effects of insurance on maritime law*, Springer Publishing (London 2014), p.38

[35] Id, p.38 (citing the three-tier CLC Convention fund of up to $1 billion and the SDR 250 million available in the coming HNS Convention, not to mention various national-level funds)

[36] Id, (explaining that the cost of maintaining a liability system may not offset the benefits of compensation alone)

[37] Shavell (2004), p.1

2.5.1 Market failures

Market failures are those circumstances in which the free market is unable to efficiently incentivize socially optimal behavior when left to its own devices.[38] In other words, some form of regulatory action is necessary in order to avoid incentivizing actors into taking socially harmful behavior. These situations occur as a result of some fundamental misalignment between the actors' personal interests and societal interests.

A simple example of a market failure is the tragedy of the commons scenario.[39] In this hypothetical situation, public lands are used by farmers for their livestock to graze. Because the land is freely available to the public—and no fee is levied for its use—the farmers have incentive to use as much of the free resources available as frequently as possible rather than use more costly alternatives. These incentives lead to overuse until the land is barren, creating the socially detrimental situation in which the public land has been stripped of all value.

The free market, in the absence of restrictions, has no suitable answer to the tragedy of the commons problem.[40] However, privatizing the land and protecting the exclusive private property rights of those holding legal title can solve this problem of overuse.[41] Privatization would allow for a finite number of farmers to exclude the others from using the land, or charge for others to use the land, thereby creating scarcity in the right to graze. Privatization also gives the owners incentive to use the land sustainably so that maximum value can be derived over time. In this way, protection of private property rights aligns private incentives with socially optimal behavior.[42]

There are, however, many market failures that cannot be solved by such a simple solution. The famous freerider problem[43] is one such example. Calandrillo explains:

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38 Calandrillo (2001), p.971 (citing "Sloman", *Economics 4th ed.* (Pearson, 2000), p.297)

39 Hardin, Garrett, *The tragedy of the commons*, Science (Dec. 1968), p.1243

40 cf. Id

41 Calandrillo, (2001), p.971

42 Id, p.973

43 Id, p.972

> The paradigmatic example is a nation's military. All citizens benefit, whether or not they believe in the merits of creating and maintaining a military force. There is no enforceable system in which a citizen could 'opt out' of military protection and receive a commensurate and proportional tax refund. […]
>
> It is not difficult to see that most markets would collapse if free riding were allowable. If one knows that all of one's neighbors are contributing to build a military force […] one's incremental contribution—or lack thereof—will do very little to change whether or not the program gets funded and how good the program is. From each individual's perspective, nobody wants to pay, preferring instead to free ride off everyone else's tax dollars. Since everyone has exactly the same incentive to refuse to pay, nothing gets accomplished—even though all would have been better off making their modest contributions….[44]

Privatization, though it works for the tragedy of the commons, is not a solution for the freerider problem. This is because, as explained, there simply is no viable framework for excluding citizens from some public benefits.[45] The point is that the regulatory solution for these market failures must be tailored to the unique inefficiency caused by each problem. Because market failures come in many variations, there is no universal remedy for them. This can lead to expensive, overlapping, and even conflicting regulatory solutions.

2.5.2 Negative externalities

One specific subset of market failures—and the main source of headaches among those economists attempting to design legal rules that incentivize efficient behavior—is what is known as a *negative externality*. The term negative externality refers to any situation in which the behavior of one actor causes a detrimental external effect on the utility of another,[46] usually because the behavior of the first actor (known as the *injurer*)

[44] Id
[45] Id, p.973
[46] Shavell (2004), p.97

exposes the second actor (known as the *victim*) to some sort of risk. Negative externalities can rightly be understood as a problem that arises precisely from society's decision to enforce property rights in its attempt to combat market failures such as the tragedy of the commons. This is because, for a victim to have any claim in the first place, both the injurer and the victim must legally own, or have a legal interest in, property rights. After all, a person cannot claim to have been injured if that person has no legally protected interest in what was harmed.

These externalities are generally understood to arise probabilistically, meaning that the expected harm caused by the action can be understood as a function of the number of times, or the degree to which, an injurer takes a risk-creating action. It can therefore be assumed that when parties engage in risk-creating behavior, the probability of an accident occurring (i.e., the negative externality causing an injury) will be influenced by the degree of care the actors take.

Traditionally, the policy answer given to the question posed by negative externalities is an attempt to constrain behavior through restrictive measures or by taxing the risk-creating activity until it is no longer economically feasible.[47] However, it is indisputable that this solution creates societal costs. Enforcement is expensive. For this reason, many economists have argued regulatory solutions ought to be avoided when it is possible to use the unencumbered free market to combat inefficiencies.

2.5.3 Coase and reciprocity

In the 1960s, an important paper by Coase[48] appeared arguing for the use of market solutions as an efficient way to incentivize socially optimal behavior.[49] The paper shed light on a conspicuously missing part of measuring social cost, by emphasizing what Coase referred to as the "reciprocal nature" of the problem of negative externalities. He explains:

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47 Kennedy (1998), p.466-7 (discussing the relationship between Pigovian and Coase solutions to negative externalities)

48 cf. Coase, R.H., *The problem of social cost*, The Journal of Law & Economics (Oct. 1960)

49 Shavell (2004), pp.108-9

> The question is commonly thought of as one in which A inflicts harm on B and what has to be decided is: how should we restrain A? But this is wrong. We are dealing with a problem of a reciprocal nature. To avoid the harm to B would inflict harm on A. The real question that has to be decided is: should A be allowed to inflict harm on B or should B be allowed to inflict harm on A? The problem is to avoid the more serious harm. [...] What answer should be given, of course, is not clear unless we know the value of what is sacrificed to obtain it.[50]

In other words, Coase made the case that social policy needed to account for not only the costs created by those actors taking risk-creating activities, but must also weigh those societal costs that occur when injurers' risk-creating activities are restrained. This is because the risk-creating behaviors are themselves utility-producing behaviors, because theoretically no rationally self-interested actor would create a negative externality that has no accompanying benefit. Therefore, restraining the behavior is itself a cost on total social utility that ought to be accounted for in the economic analysis. Essentially, Coase was arguing that the Kaldor-Hicks measurement of efficiency, of *total* benefits minus *total* costs, ought to be used to measure the effect of injurious behavior on society, rather than looking only through the lens of the injured victim. This way of thinking significantly diminished the number of recognized market failures, because it expanded the measure of what was considered an efficient transaction, leading to a renewed interest in market-based solutions to externalities.

2.5.4 Market solutions

The reason Coase's paper was, and still is, so influential is because it led to the conclusion that the market (or what Coase referred to as the "pricing system") could act as the solution to the problem of social cost. Put differently, even in the absence of liability rules, parties may still be rationally compelled to take socially optimal actions through transacting with one another to lead to an outcome that is efficient by the Kaldor-Hicks definition. In what is now known as the Coase theorem, it is

[50] Coase (1960), p.2

assumed that where an increase in total social utility may occur, rational actors will always come to such an agreement. This occurs any time the total social utility derived from the performance of the transaction outweighs the total disutility it costs to do so, and is known as a mutually beneficial agreement.[51]

Mutually beneficial agreements can be made to combat the disutility caused by negative externalities in many situations. The concept is illustrated in the examples below:

Ex.1

	Injurer's utility from activity (I1)	Victim's utility from activity (V1)	Injurer's utility if transaction occurs (I2)	Victim's utility if bargain occurs (V2)	Net social utility/ cost (I1 + V1) = (I2 + V2)
1	30	-50	-30	50	(30 – 50) < (-30 + 50) -20 < 20 optimal transaction
2	50	-50	-50	50	(50 – 50) = (-50 + 50) 0 = 0 sub-optimal transaction
3	65	-50	-65	-15	(65 – 50) > (-65 – 15) 15 > -15 sub-optimal transaction
4	50	-50	50 + (25 – 25) = 50	-50 + (-25 + 35) = -40	(50 – 50) < (50 - 40) 0 < 10 optimal transaction

Assume that, in Ex.1, I_1 and V_1 are the utility levels derived from an injurer's risk-creating activity. Assume further that I_2 and V_2 are the utility levels available to each through transaction.
If $(I_1 + V_1) < (I_2 + V_2)$, a mutually beneficial agreement is possible, and a more socially beneficial (i.e., Kaldor-Hicks efficient) arrangement can be made. If $(I_1 + V_1) > (I_2 + V_2)$, on the other hand, a mutually beneficial agreement is not

[51] Shavell (2004), p.84

possible, and no shifting of circumstances through transaction is socially optimal.
The general rule can be summarized as follows: if the total utility derived from the transaction is greater than the cost of performing the transaction, the transaction is mutually beneficial.

In Row 1 of Ex.1, the injurer's activity derives utility of 30, but at a cost of -50 to the victim for a total social utility of -20. However, if the victim were to pay an amount to offset the injurer's loss of utility in order to induce the injurer to cease the risk-creating activity, not only would the injurer continue to derive utility (by way of victim's payments), but the victim would as well (-50 < (50 – 30)). This results in an increase in total social utility of 40 (from a total of -20 to a total of 20), and therefore the agreement will be made between the two parties.

Row 4 of Ex.1 also describes a socially beneficial transaction. In this situation, the victim pays the injurer less than the total amount of utility that the injurer derives from the activity; not the full amount. This is in order to compensate the injurer for restricting, slowing down, or performing less often the risk-creating activity, thus decreasing both the utility derived from the activity, as well as the disutility experienced by the victim. The general rule still stands as above: it is socially desirable for the injurer to do this if and only if the cost of the transaction is less than the total utility derived from it performance. With respect to Row 4, the victim pays the injurer 25 to decrease the risk-creating activity. This restricted behavior decreases the level of utility derived by the injurer to 35 and reduces the disutility experienced by the victim to -20. The shift results in the injurer continuing to derive a utility of 50, but the victim now experiences less disutility than before (-40 versus -50), leading to an overall increase in total social utility of 10, and a transaction that would theoretically occur between rational actors.

Another example of a successful use of the market solution is in the context of the relationship between customers and firms, to the extent the customer has a perfect knowledge of the risks involved with being a customer of that firm. If there are no liability rules that allocate responsibility to pay for the damages, customers will always bear the losses caused

by firms (because no system exists for re-allocating liability costs). Therefore, customers will factor potential accident costs into the total cost of buying goods or services from a given firm.[52] For example, suppose a seller has entered into a contract of affreightment with a shipper to transport goods with a value of 100. If the seller knows the vessel has a 10% chance of completely ruining the goods en route, the seller will add a "risk tax" of 10 (100 * .10) to the total transaction price of the contract of affreightment in her personal risk analysis. The less care the shipper uses, the greater the "risk tax." Therefore, in order to attract customers and compete in the relevant market, firms will attempt to minimize total social costs in order to competitively provide their customers with the best price.[53]

2.5.5 The limits of market solutions

There are, however, other situations in which the pricing system fails to lead rational actors to behave in socially optimal ways. Continuing the example of the shipper and seller above, if the seller does not know the level of care the shipper will use—which generally is the case—the seller will not know how to properly gauge her own economic analysis. Imperfect knowledge, the price of bargaining, abuse of market power, etc. are all ways in which the pricing system may fail to produce a mutually beneficial agreement, even where one theoretically exists.[54] Even more problematic, however, are the numerous situations in which no market exists at all for the pricing system to be utilized. This can happen for a number of reasons, but the most obvious example is when actors that may theoretically engage in socially optimal bargaining are simply unknown to each other. When the participants have no contractual relationship to each other, there is of course no opportunity to effect a Kaldor-Hicks efficient transaction.

Row 2 of Ex.1 above describes the point at which a mutually beneficial agreement will no longer be possible. The marginal utility derived by the victim (50) from paying the injurer to stop the risk-creating activity only

52 Shavell (2002), ch.3 p.5

53 Id

54 cf. Shavell (2004), p.87-92

offsets the disutility to the victim (-50), leading to no change in total social utility. Therefore, in the absence of other offsetting factors, there is little rational interest in the victim paying the injurer to stop, because both parties would end up having the same utility levels as they would without the transaction occurring.

Row 3 shows a situation in which a mutually beneficial agreement cannot occur. In it, the injurer derives a level of utility from taking the risk-creating action (65) that more than offsets the disutility to the victim (-50). Therefore, the status quo is the social optimum. If any exchange were to occur, total social utility would be decreased even further. Therefore, in this situation, rational actors will not enter into a transaction.

The market system may be an elegant theoretical model that makes liability rules superfluous in certain situations. However, legal rules have an advantage because they eliminate the need to go through the expensive process of bargaining and incurring the transaction costs that are associated with the Coase pricing system.[55] Liability rules are also preferable because they have the effect of incentivizing actors to behave in socially beneficial ways in circumstances that the pricing system may not, such as when there is no relevant market for a transaction to occur. This is because the legal rules shift the costs of the relevant externality back to the injurer themselves.

Most importantly, liability rules can do these things directly and predictably. In this way, even though liability rules were initially justified for their compensatory purposes, they have been successful as a solution to negative externalities even where regulatory and market solutions have fallen short. They are, in the modern legal context, more successful in curbing risk-creating behavior than they are at achieving the compensatory purposes for which they were created. It therefore makes sense to evaluate liability norms through the lens of whether they successfully deter parties from acting in socially undesirable ways.

[55] Id, p.108

3 Descriptive analysis

3.1 Basic Norwegian liability norms

The purpose of this chapter is to briefly introduce the Norwegian liability norms that govern *reder*[56] liability for damages claims by third party victims, in order to critically evaluate their effectiveness using the theoretical framework introduced in Chapter 2.

3.1.1 Negligence

In Norwegian law, negligence is the main cause of action for a third party that experiences damages because of the actions of another party. It is always available to claimants to the extent it is not excluded contractually or by statute. Under Norwegian law, in order for liability to be imposed on an injurer for any damage her actions may have caused, a third-party claimant must establish the three parts of a negligence claim: *culpability*, *causation*, and *damages*. These elements are briefly summarized below.

3.1.1.1 Culpability, causation, damages

Culpability. Negligence is a term of art that means behaving in a "culpable manner, whether through act or omission, so as to cause damage."[57] That a *reder*'s behavior was the cause-in-fact of the damage is not sufficient to establish liability with regard to a claim based in negligence. Rather, the injurer must have acted in some blameworthy or culpable way. Fault is

[56] There is no English equivalent of the Norwegian term *reder*. Essentially, it means the entity—whether an individual, corporation, partnership, or otherwise—that is responsible for the daily operation of a ship and that uses a ship for her/its own account. Though reder is often translated into English as "owner," there are circumstances in which the party that owns the shares of a vessel in question is not actually the reder. This is most common in a bareboat charter situation. For this reason, and to avoid confusion, this paper will employ the use of the Norwegian term throughout rather than assigning a definition to an English word that may mean something different colloquially.

[57] Falkanger, Thor; Bull, Hans Jacob; Brautuset, Lasse, *Scandinavian maritime law: The Norwegian perspective*, 3rd ed. Universitetsforglet (Oslo, 2011), p.234

the essential criterion. The evaluation of fault can be summarized as follows:

> The judge must decide whether a party's act or failure to act, which was a cause [of the resulting harm], can be considered reasonable in the light of what could be expected from a normally intelligent and insightful person in such a situation. In reaching his decision, the judge will be assisted by written rules of conduct in the particular field, as found in legislation or public regulations, or in acknowledged public customary rules. He will evaluate the risks involved in the relevant act or omission, in other words how great a risk there was that the [damage] might occur, and how serious the damage in such a case would be expected to be. Whether or not there was time and possibility to prevent the accident will also be an important factor.[58]

Note that this is not a subjective standard. Rather, the parties are judged against the objective standard of what a "normally intelligent and insightful person" would do in the same situation. Should the injurer be determined to have fallen below this due care standard in the course of causing damage, the injurer may be held responsible for compensating the victim for the damages caused to the extent the other two components (causation, damages) are established as well.

Causation. The Norwegian Maritime Code[59] ("MC") does not contain lex specialis regarding how causation ought to be determined with regard to maritime accidents. Therefore, the general principles of Norwegian tort law apply.[60] The causation component requires the injury to have occurred in connection with the injurer's failure to adhere to the requisite standard of care. If a reder fails to do so, and damages occur, liability will be imposed on the reder only to the extent the damages are found to have resulted from the specific negligent behavior. In other words, before liability can be imposed, it must be shown that the negligent act was a necessary cause-in-fact of the damage that occurred. If, for instance,

58 Id

59 Act of 24 June 1994 no.39, Maritime Code (Lov om sjøfarten)

60 Falkanger, et al. (2011) p.238

a reder's failure to secure a load of cargo resulted in damage to the cargo, the negligence would likely be found to have been a necessary cause of the damage. On the other hand, if a reder fails to secure cargo and the carrying vessel later discharges bulker oil through some negligent act, the negligence in securing the cargo will not likely be found to have contributed at all to the discharge occurring, because failure to secure cargo was not a necessary cause of the bulker oil discharge.

Secondly, there is also a requirement that the damage be relatively proximate to the event or action that caused it. This requirement protects tortfeasors from paying for damage that is simply too attenuated to the actual cause. Norwegian law requires a showing of "adequate causation," meaning that the damages being claimed must be of a reasonably foreseeable type when viewed in relation to the relevant negligent specific act. The assessment of whether the causation is adequate is a discretionary decision. If the damage cannot be said to be reasonably foreseeable to the negligent act that caused it, the damage will be found too attenuated to the cause for liability to be imposed on the reder.[61]

Damages. Like the causation element, the Maritime Code stipulates no method for calculating or determining damage for third-party claims arising from maritime accidents. Therefore, the default Norwegian tort rules apply with respect to damage requirements.[62] The type of damage suffered is generally irrelevant; what is important, however, is that the damage or injury can be appraised in terms of economic value.

As stated above, and in line with basic Norwegian tort law principles, a claim for damages based in negligence is generally available as an option to injured third parties unless statutorily or contractually[63] excluded, and therefore no statutory cause of action is necessary. That said, the

[61] Id, p.168

[62] The damage calculation instructions in MC § 279 apply only to the calculation of damage to goods within the context of a contract of affreightment, and do not extent to damage of a third-party's property.

[63] This discussion deals only with the liability rules regulating third-party claims against reders, and therefore it will not include an analysis of so-called "control" liability, which is common when injurers and victims are contractual partners. It will also exclude analysis of contractual shifting of risk, such as "knock-for-knock" agreements, which are popular in the offshore industry.

Maritime Code also statutorily ties liability to certain actors' negligence for a variety of types of damage, most dealing with damage that arises in the context of a contractual relationship.[64] However, the Maritime Code also prescribes liability pursuant to negligence for some third-party claims.[65] An example where this can be seen most clearly is in MC § 161, which regulates third-party claims for damages arising in the context of ship-to-ship collisions, pursuant to the following:

When one ship is at fault. MC § 161 paragraph 1 states that when damage is caused to ships, goods or persons as a result of collision for which the "fault is all on one side," the owner of such ship shall "cover the damage," including the losses to the other party resulting from the collision.[66] The rules in MC § 161 are based heavily on the Collision Convention of 1910,[67] which relies on the negligence standard, as seen from the language of the statute. The mere event of two vessels colliding

[64] cf. MC § 140 (liability for master's negligence), MC § 174 (exclusion of reder's limitation rights for gross or willful negligence), MC § 275 (carrier liability for cargo damage unless shown carrier was not negligent), MC § 276 (exclusion of liability exceptions if vessel is unseaworthy due to negligence), MC § 277 (carrier liability for damage resulting from carrying live animals based in negligence), MC § 283 (exclusion of contract of affreightment damage limitation for gross or willful negligence), MC § 328 (voyage charterer liability for unsafe port assignment based in negligence), MC § 336 (voyage carrier liability for failure to take "reasonable" circumstances in to account regarding loading and storage), MC § 343 (voyage charter responsible for increased payments connected with damage due to fault or negligence), MC § 344 (exclusion of duty to pay freight for damaged goods based in negligence), MC § 357 (voyage charterer liability for damage caused by goods due to fault or negligence), MC § 377 (time charterer's liability for damages based in negligence), MC § 384 (exclusion of time charterer's liability for time carrier's negligence in keeping vessel seaworthy), MC § 385 (time carrier's liability for damage to vessel due to negligence), MC § 418 (carrier's liability for death, personal injury and delay to passengers based in negligence), MC § 419 (liability of carrier for damage to passengers' luggage based in negligence) MC § 424 (exclusion of carrier's damage limitation rights for gross or willful negligence)

[65] cf. MC § 151 (liability on reder for any "damage" caused by negligence of those acting in service of the ship), MC § 161 (liability on reder for damage/person injury/death caused by negligence in connection to collision of vessels)

[66] It excludes, however, damage to the other ship's crew and, potentially, passengers, which are governed under separate rules, see e.g., MC § 401 et seq.

[67] Convention for the Unification of Certain Rules of Law with respect to Collisions between Vessels (Brussels, 23 September 1910)

does not trigger liability under MC § 161; rather, for liability to be imposed in the event of ship-to-ship collision, the reder or someone for whom the reder is responsible pursuant to MC § 151 (see below), must have caused the collision by acting negligently.[68] To the extent that vessels collide, but no showing of negligence accompanies it, the event will be considered an "accidental collision," and, regardless of the extent of damages, each party will subsequently bear its own loss.[69]

This method therefore requires a court to perform a negligence analysis for both ships involved in order to determine if fault can fairly be assigned to only one of the parties. This method is identical to the general negligence analysis discussed earlier, except that the court is instructed to consider especially "whether or not there was time for deliberation."[70] However, as one commentator as already pointed out, this is of little guidance, because whether the actor had time to deliberate would be central to a finding of fault in the first place anyway.[71]

When more than one ship is at fault. MC § 161 paragraph 2 states that, "[i]f there is fault on both sides," then both reders must compensate for the damage "in proportion to the faults on each side." This requires the court not only to perform a negligence analysis on both actors—as before—but also to perform the discretionary[72] act of assigning fault proportionally to each actor. If the circumstances present no grounds for the court to make an apportionment of fault in any definite manner, the responsibility will be assigned to both reders equally. The discretionary allocation of liability is apportioned on a pro rata basis (i.e., each actor is liable only insofar as their culpability contributed to the accident), except in the event of personal injury, for which the actors are held jointly and severally liable.[73]

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68 Falkanger, et al. (2011), p.227

69 cf. MC § 162

70 MC § 161 paragraph 5

71 Falkanger, et al. (2011), p.234

72 Id, p.228

73 cf. MC § 161

3.1.2 Vicarious liability (respondeat superior)

Under Norwegian law, a *reder* is potentially liable for the damages caused not only by her personal actions, but also for the negligent acts of a variety of other persons. This is because MC § 151 allocates responsibility to compensate for "damage caused by the fault or negligence of the master, crew, pilot, tug or others performing work in service of the ship" to the *reder*.[74] This mechanism has its basis in Norwegian tort law,[75] and has the effect of expanding the potential for *reder* liability. This means that if an actor connected to the vessel commits a negligent act in the scope of employment such that it incurs personal liability on the actor for resulting damages, the *reder* is liable for those actors' negligence as if the *reder* had committed the negligent act herself.[76] In other words, the *reder* is statutorily liable for, not only her own negligent actions, but also the negligent actions of anyone working in the service of the ship. This doctrine is known as *respondeat superior* (lit. "let the master answer"), or "vicarious liability," and is found in both common law and civil law jurisdictions.

The scope of vicarious liability as prescribed in MC § 151 includes all parties performing acts in service of the ship. This is not necessarily identical to those acts taken in service of the *reder*. For instance, the behavior of actors working exclusively for a charterer, and not for the *reder*, can incur liability for the *reder*.[77] Moreover, actors do not need to have any employer/employee contractual relationship to the *reder*; independent contractors and other parties acting in service of the ship can also incur liability for *reder*s through their negligence acts.[78] It even includes those parties that the *reder* is legally obligated to use, such as

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74 MC § 151 paragraph 1

75 Act of 13 June no.26, Torts Act (Lov om skadeserstatning) § 2-1

76 Falkanger, et al. (2011), p.170

77 Id, p.177 (showing that liability from personal injury caused by the negligence of a longshoreman, who has been hired by a stevedore company, which had been hired by a charterer, may be imputed to the reder of the vessel, because the action was taken in service of the ship)

78 Id

pilots[79] (though some exclusions apply[80]), and those responsible for mooring and securing vessels in harbor.[81]

While the scope of the vicarious liability rule in MC § 151 is broad, there are limits. The reder's responsibility to compensate may not be triggered, for instance, if the damage caused is due to actions taken outside the scope of the actor's employment. It also does not extend to those acts that would not incur personal liability on the negligent actor herself.[82] Precisely demarcating the limits of this doctrine, however, is outside the scope of this economic analysis.[83] What is important for the sake of the economic analysis is the general rule: a reder is liable for harm caused by the negligent actions of those performing work in the service of the ship.

3.1.3 Strict liability

Strict liability, unlike negligence, is not generally available as a basis for tort liability within the maritime sector in Norway. However, strict (or "no-fault") liability has been imposed via statute in the maritime context. Some examples specific to the maritime sector include: (1) liability arising out of "emergency situations"; (2) liability for oil pollution; and (3) pollution from garbage dumping. Each is briefly discussed below.

Emergency situations. Domestic Norwegian tort law enforces strict liability on those actors that cause damage in the course of so-called "emergency situations."[84] Certain actions that would normally give rise to an action in negligence—or even criminal liability—may be reasonable to take due to the extreme context in which the actions arise. An example

79 cf. ND 1923.289 NSC IRMA-MIGNON

80 cf. e.g., ND 1972.93 NSC STELLA ALTAIR (State and reder allocated equal liability for damage resulting in the State for sending an unqualified person to pilot a vessel)

81 ND 1984.122 NSC (harbor masters were found negligent in positioning private vessel in harbor, but the reder was found liable for resulting damages because mooring was found to be "integral element of the maritime activity of a reder's activities," and therefore the harbor masters were determined to be within the scope of MC § 151)

82 Falkanger, et al. (2011), p.180

83 For a discussion on the limits of a reder's vicarious liability, cf. Falkanger, et al. (2011), p.176-183

84 cf. Act of 13 June no.26, Torts Act (Lov om skadeserstatning) § 4-1

is a master grounding his vessel in order to avoid a collision with another vessel. In such a situation, purposely running a vessel aground may be found to be a reasonable, and even necessary, thing to do to limit the total damage of the situation. When damage due to such an emergency situation arises, the person taking the emergency action may avoid a negligence suit or criminal liability being imposed upon them, but will still be held responsible to pay the direct and consequential damages that arise from the emergency action.

The case of the CONSUL BRATT,[85] in which a ship damaged subsea cables when it was forced to drop anchor to avoid collision, is a good example. In this case, civil liability was imposed on the reder for damage to cables and for consequential damages to a nearby business that lost electricity access as a result.[86] There was, however, no criminal liability imposed for the damage because the dropping of the anchor had been necessary due to a technical malfunction onboard. The act of dropping the anchor, therefore, was not a negligent act, but liability was imposed despite the absence of fault, i.e., strict liability.

Oil pollution. MC chapter 10 imposes liability on a reder[87] for bunker (i.e., fuel) oil[88] and tanker (i.e., cargo) oil[89] "regardless of fault." The use of strict liability in these circumstances stems from Norway's obligations from two international conventions: the Bunker Convention of 2001[90] and the CLC Convention of 1992,[91] respectively.

Garbage dumping. Norway has also imposed strict liability for pollution in connection with garbage dumping under the Pollution Act[92]

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85 ND 1955.181 NSC CONSUL BRATT

86 Falkanger, et al. (2011), p.171

87 cf. MC 183 paragraph 6 regarding bunker fuel, MC § 191 paragraph 5 regarding tanker fuel

88 MC § 183 paragraph 1

89 MC § 191 paragraph 1

90 International Convention on Civil Liability for Bunker Oil Pollution Damage, International Maritime Organization, 23 March 2001

91 International Convention on Civil Liability Oil Pollution Damage, International Maritime Organization, 29 November 1992 (amended by 2002 protocol)

92 Act of 13 March 1981 no.6, Act on Protection of the Environment (Lov om vern mot forurensninger og om avfall)

chapter 8. While the Pollution Act doesn't explicitly apply to garbage dumping from ships, it extends the coverage of the Act to those sectors that have unspecified liability for garbage dumping, so long as the action takes place within the geographical scope outlined in the Act.

Additionally, Norwegian courts have not been hesitant to apply strict liability where they consider it appropriate, including situations in the maritime context. It seems that the imposition of strict liability by Norwegian courts generally rests on a risk-allocation analysis,[93] with the justification that those parties engaging in "particularly dangerous activities must expect damage occasionally to result,"[94] and should therefore pay for this inevitability when it occurs. However, the courts have been vague in establishing a clear rule for when strict liability ought to be imposed on a reder within the maritime context. What can generally be said is outlined below:

> In Norway, two Supreme Court decisions have imposed strict liability where ships have collided with and damaged land-based installations after a breakdown has made reversing impossible, see ND 1921.401 NEPTUN [and] ND 1952.320 SOKRATES.[95] Damage to another ship, however, does not fall within the scope of the strict liability rules, see MC § 168 […]. Another important step toward strict liability in the field of maritime law was taken in ND 1969.389 LADOGALES, where strict liability was imposed for personal injury caused by a loading boom. Nevertheless, ND 1973.438 NSC UTHAUG provides some uncertainty over the extent to which strict liability applies in maritime law. In this case, compensation was denied where a submarine ha[d] surfaced and damaged a trawl.[96]

[93] Røsæg (2012)

[94] Falkanger, et al. (2011), p.171

[95] It is unclear whether the imposition of strict liability in the cases of SOKRATES and NEPTUN was due to the fact that, in each case, the vessel struck a land-based structure, or whether it was due to the common occurrence of a breakdown in equipment (which Røsæg calls a "technical failure"), or both. Whether both common factors here are considered by the court to be contributing causes, sufficient causes, or both—or, indeed, neither—has not yet been made clear. This obviously adds to the murky nature of the law.

[96] Falkanger, et al. (2011), p.171

This is particularly interesting because it shows that the Norwegian courts are accepting of risk-allocation based arguments for the imposition of strict liability, even in situations where the decision could adequately be dealt with through ordinary negligence rules. Again, exactly when a court may impose strict liability apart from statute is unclear in the maritime context, but the important part is that there is precedent to do so when the court determines it suitable.

4 Modeled behavior

Because negative externalities arise probabilistically as a function of parties' levels of care (i.e. the attention a party puts toward avoiding accidents while performing a risk-creating activity), account must be taken of what behaviors various legal regimes incentivize actors to take. The following analyzes how liability rules may influence injurers' and victims' levels of care in both the unilateral and bilateral accident contexts.[97]

4.1 Unilateral accidents

A *unilateral* accident is an accident in which only one actor's level of care has any bearing on the probability of an accident occurring.[98] This party will be referred to as the *injurer*. The following table (Ex.2) is an example of how an actor's chosen level of care affects unilateral accident probability:

[97] The following discussion is based heavily on the analysis of accident law in Shavell (2004), pp.175-206

[98] Id, p.178

Ex.2

Level of care	Cost of care (X)	Accident probability (P)	Expected losses (L = 1000)	Total social cost (C)
None	0	20%	200	200
Low	35	12%	120	155
Moderate	80	9%	90	170
High	120	4%	40	180

Assume that the probability of an accident occurring is dependent on the level of care to which the injurer chooses to conform her activity, as reflected in the table above. Assume further that an accident causes a constant 1000 in harm (L). To determine the total social cost of each level of care, the probability (P) of the accident occurring is multiplied by the harm caused by the accident (L) and added to the cost of care.
Equation for determining total social cost: $X + (P * L) = C$

The socially optimal level of care is the level that, when chosen, minimizes the total social costs of all relevant actors in the model. In Ex.2, the socially optimal level of care is Low care, because it yields the lowest total social costs (155). Note that, while Low care yields the lowest total social costs of the four choices in Ex.2, it does not lead to the lowest expected accident costs (120). Indeed, a High level of care would yield two-thirds fewer accident costs (40) than the Low care level would. However, once the costs of care are taken into account, a different picture becomes clear. This is because of the "reciprocal nature" of the problem of externalities, as pointed out by Coase, and discussed above. The cost of care, or the costs imposed on the injurer to avoid injury, must also be accounted for in determining total social costs. Without the costs of care being factored into the analysis, only half the relevant information to measure whether the situation is Kaldor-Hicks efficient has been gathered.

Absence of liability rules. In the absence of any liability rules in the unilateral context, an injurer has no incentive to take any care to avoid injury.[99] Because taking care involves costs, and because injurers know

[99] Id, p.179

they will not bear responsibility for the harm their actions cause, in the absence of liability rules injurers maximize their own utility by choosing to act without care. This is detrimental to society because it maximizes total social costs (200), which is ultimately in direct conflict to the goal of maximizing total social utility. This is, however, only the case when victims are third parties or other actors that have no opportunity to contractually shift their risk.[100] As discussed above, injurers will have an incentive to conform to socially optimal levels care (i.e., minimize total social costs) in the context of their contractual relationships so as to price compete with other firms offering the same services, but only to extent their customers have knowledge of firm's standard of care.

Strict liability. If strict liability is employed to regulate unilateral accidents, injurers bear all costs associated with the injuries their activities create. Through this mechanism, all potential harms are shifted back to the injurer, and the injurer will therefore act so as to minimize these costs. In this way, the strict liability regime incentivizes injurers to act according to the socially optimal level of care. The strict liability regime has the effect of aligning injurers' interests with choosing behavior that minimizes total social costs. One could therefore expect that rational injurers will always act according to the socially optimal level (in Ex.2, the Low level) of care if a strict liability regime is chosen.

Negligence liability. Under a negligence regime, an injurer is held liable for harm caused if and only if her chosen level of care fails to meet the due care standard established by statute or court practice.[101] Insofar as injurers meet the requisite level of care, they face no liability for the costs associated with their activities. Clearly, then, imposition of negligence liability will lead injurers to act in a socially optimal way only if courts and lawmakers set due care at an optimal level. As an example, suppose instead of choosing the socially optimal level of care in Ex.2 (i.e., Low level of care), lawmakers were to promulgate a rule requiring a reder to take at least Moderate care while engaging in her shipping activities in

[100] Faure, Michael; Hui, Wang, Economic analysis of compensation for oil pollution damage, Journal of Maritime Law & Commerce (Apr. 2006), p.182

[101] Shavell (2004), p.179

order to avoid liability. In this case, the reder would take Moderate care because doing so allows him to escape accident liabilities of 90 by incurring costs of care of only 80, leaving the reder with the incentive of a marginal utility of 10 for taking a suboptimal level of care. Given this situation, reders would no longer take the optimal Low level of care, because doing so would mean they would likely be found to have fallen below the requisite standard of care, and would have liability imposed accordingly for the harm. In this way, to the extent lawmakers set the due care standard at the appropriate social optimum, injurers will respond accordingly.[102]

4.2 Bilateral accidents

A *bilateral* accident is an accident in which two parties' chosen levels of care affect the probability of an accident occurring.[103] A ship collision is a good example: both parties, regardless of the proportion of fault assigned to each, have the potential to influence the probability of an accident occurring through the levels of care they apply in taking risk-creating activities. The introduction of a second actor has ramifications; the following table (Ex.3) provides another specific example of how the second actor's chosen level of care affects accident probability in the bilateral context:

Ex.3

Injurer's level of care	Victim's level of care	Injurer's cost of care (X)	Victim's cost of care (Y)	Accident probability (P)	Expected losses (L = 1000)	Total social cost (C)
None	None	0	0	20%	200	200
None	Care	0	40	15%	150	190
Care	None	50	0	12%	120	170
Care	Care	50	40	6%	60	150

Assume, for simplicity, that the probability of an accident occurring is dependent on both the actors choosing to either take care or to not take care. Assume further that an accident causes 1000 in harm (L). Finally, as an

[102] Faure, et al. (2006), p.183

[103] Shavell (2004), p.108

extension of the rational actor assumption, assume that the way in which one actor behaves will accordingly influence other actors.[104] To determine total social cost, the probability of the accident occurring (P) is multiplied by the harm caused by the accident (L), and then added to the costs of care taken by both parties (X and Y).
Equation: ***(X + Y) + (P * L) = C***

The socially optimal result in Ex.3 occurs when both parties take care. This is, of course, not always the case. If only one actor taking care reduces accident probability more efficiently than both taking care (a situation that is certainly possible), creating incentives for both parties to incur costs of care is wasteful to society. Instead, the thinking goes, the party that is able to take care at less cost ought to bear the burden of doing so. This actor is known as the *least cost avoider*.[105] This process takes place through contractual risk shifting, in which the costs of taking care are allocated to the contractual party that can most efficiently avoid the harm, which is then reflected in the cost of the contract. In this context, however, the least cost avoider analysis is not relevant because this paper deals with liability to third parties who are not in contractual relationship with injurers (i.e., "third parties"). In this context, no bargaining process by which one party can be identified as the least cost avoider can occur, as it might if the parties were contractual partners.[106]

Absence of liability rules. In the absence of liability rules in the bilateral context—as in the unilateral context—injurers have no incentive to take care because they bear none of the costs associated with their risk-causing behavior.[107] An injurer, consequently, has no incentive to limit total social costs, because any attempt to do so would incur costs where she previously had none. Victims, on the other hand, will be incentivized to take care because, in the absence of rules that reallocate costs back to injurers, they will bear the full costs of harm. This situation can be seen in Row 2 of Ex.3, in which injurers are under-incentivized to take care, leading to a

[104] Id, p.183 (explaining the possible interdependence of actors' behaviors)
[105] Id, pp.198-90
[106] Id, p.190
[107] Id, p.183

sub-optimal result with higher than necessary total social costs (190).

Strict liability. Under a strict liability regime, injurers are liable for any harm caused as a result of their activity. Injurers are therefore compelled to minimize the harm they create by taking care, because it represents a simultaneous minimization of their potential liabilities. Victims, however, have no incentive to take care under strict liability, because any costs arising from the risk-creating activities will be borne by the injurer under a strict liability regime.[108] This situation is represented by Row 3 of Ex.3. It also leads to a sub-optimal result with total social costs of 170.

Negligence liability. As in the unilateral context discussed above, the negligence standard is effective at incentivizing injurers to take a socially optimal level of care, but only insofar as lawmakers set due care at the socially optimal level. Because injurers will avoid liability by taking due care, injurers will always meet the due care standard to the extent that the costs associated with meeting due care are less than the expected accident costs of taking no care at all. Similarly, because victims will bear liability whenever injurers are not liable (i.e. when injurers act with due care), victims will be incentivized to minimize the probability of accidents, and will therefore take care, accordingly minimizing total social cost. This may lead to the socially optimal result if the correct level of due care is chosen.

5 Normative analysis: Comparison of liability rules

The following analysis draws on the theoretical framework for analyzing liability rules introduced above in Chapter 4, and applies these principles to the Norwegian third party liability rules discussed in Chapter 3.

As seen from the modeling of actors' behavior above, if it is assumed that lawmakers are able to effectively set the due care standard at the appropriate level, negligence is the best option of incentivizing both

[108] Faure, et al. (2006), p.183

injurers and victims to act according to socially optimal levels of care. This is because it successfully incentives both injurers and victims to take socially optimal levels of care in every situation discussed, whereas strict liability fails to incentivize socially optimal victim behavior in the bilateral context. There are, however, some problematic aspects inherent to the negligence regime for which an economic analysis must account.[109] These are discussed below.

5.1 Negligence

The process by which liability for negligence is imposed exposes actors to various uncertainties. Shavell identifies two particular categories of uncertainty that can lead to inefficiencies within any negligence determination: uncertainty in setting the level of due care and uncertainty in assessing actors' actual levels of care.[110] The following discusses both in more detail.

5.1.1 Uncertainty in setting the level of due care

Determining the socially optimal level of due care requires significant resources. Lawmakers cannot set due care at a socially optimal level without first acquiring and analyzing the private data of firms, individuals, and third parties regarding their various expected accident probabilities, accident costs, and the expected costs associated with taking various levels of care. Additionally, many firms may not want to share their data, if it exists at all.[111] Similarly, the data may be faulty or incomplete, which may lead to skewed results and enforcement of inefficient liability regimes.

Additionally, the negligence standard, by its very nature, is specific to each situation. The standard of care is not the same in every situation.

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[109] Shavell (2004), p.224-229

[110] Id, p.188

[111] How, for instance, can lawmakers collect data on third-party victims' levels of care when, by their very nature, third party victims are usually unknown until they are injured? Indeed, for many third party victims, the incident that causes them harm is a unique situation for which they previously had not accounted for in their micro-economic decisions.

The standard of care for the master of a tanker vessel is greater than the standard of care to which a private individual paddling her canoe must conform, because what is reasonable in each situation depends greatly on the ramifications that could potentially result. This means that the requisite level of care must either be dictated in statute by lawmakers, or deduced anew (with guidance from precedent) in each situation presented. This is a time and resource intensive process.

Moreover, any attempt to set a standard for negligence behavior will be an incomplete analysis, because lawmakers simply cannot consider every factor that could contribute to harm in a negligence analysis when determining a standard. There will always be some dimensions of care that are left out of the analysis. An example of a factor that is generally not considered is level of activity, or the frequency with which an actor takes a risk-creating activity. If, for the sake of simplicity, one were to assume that a doubling of risk-creating behavior in a given period (e.g., operating two daily liner voyages instead of one) leads to a doubling of the potential harm created, it is clear that the level of activity ought to be seriously considered as a contributing factor to harm.

In both the unilateral and bilateral contexts, the absence of consideration of actors' levels of activity can affect the way actors behave because imposition of liability will only affect those behaviors it considers part of the negligence analysis. Refer to Ex.4 below for a unilateral example:

Ex.4

Activity level	Total utility (*U*)	Cost of care (*C*)	Accident losses (*L*)	Marginal social utility (*B*)
0	0	0	0	0
1	100	17	25	58
2	175	35	50	90
3	240	52	75	113
4	280	70	100	110

Assume that accident losses increase by 25 each time the injurer increases her level of activity. Assume further that the actor must take care at a cost of 17.5

(rounded down) per level of activity in each given period of time. Therefore, in order to determine the amount of total social benefit (B), the actor's costs of care (C) and expected accident losses (L) must be subtracted from the utility (U) gained from each action.
Equation: *U – (C + L) = B*
Because the activity is repeated, the costs increase by 42.5 (25 + 17.5; rounded down) each time the injurer increases her level of activity in the given period of time. An additional level of activity is only socially beneficial if it increases total social utility to a greater extent than it increases total social costs. Put another way, repeating the activity in Ex.3 is only socially beneficial if the additional utility derived is more than the additional social costs (the "marginal utility").

Using the equation $U – (C + L) = W$, it is evident that, in Ex.3, total social welfare is maximized at Activity Level 3. In terms of marginal utility, an injurer choosing to increase her activity from Activity Level 2 to Activity Level 3 is an increase of 65 (240 – 175). This marginal utility is greater than the consistent increase in social costs associated with each additional increase in activity level (17.5 + 25). In contrast, if the injurer were to increase her activity level from Activity Level 3 to Activity Level 4, the additional utility derived is 40 (280 – 240), which is less than the increase in expected costs of 42 (127 – 85) from repeating the action an additional time. Accordingly, the increase in total expected costs is greater than the marginal utility of the increase to society, and it is not a socially beneficial increase in activity. Note, however, that there is still an increase in utility to the injurer herself in moving from Activity Level 3 to Activity Level 4, creating a misalignment in private and public interests.

Absence of legal rules. In the absence of liability rules, injurers will be incentivized to take activities at excessive frequencies, because the costs to society are not reallocated back to them. They are therefore under-incentivized to act in a socially responsible way.

Negligence liability. A negligence regime does not lead to the socially optimal level of activity. While it can compel injurers to act with the socially optimal level of care (as discussed above), injurers, compelled to act with due care to eliminate their liability, will bear no costs of the accidents they create, and therefore will act at socially excessive frequ-

encies. Injurers under the negligence rule will fail to factor the costs of accidents into their activity level analysis, and will choose to act whenever utility is produced in excess of their increased cost of care. In Ex.3, the injurer would be incentivized to choose activity level 5 (and perhaps even beyond), because the marginal utility of 35 (305 – 280) is greater than the increased costs of care (17.5).

Similar over- and under-incentivization occurs in the bilateral context, however, only in certain situations. Refer below to Ex.4:

Ex.4

Activity level (injurer)	Activity level (victim)	Accident losses (*L*)	Cost of care
0	1	0	0
1	1	See Ex.5	See Ex.5
0	0	0	0
1	0	0	0

In the bilateral situation, because both the injurer and the victim can influence the probability of harm, for the sake of simplicity, assume that if either chooses not to act, then the probability of harm occurring will be 0. Assume also that because no harm will occur without both actors' influence, neither injurer nor victim will incur costs of care in their activity unless the other acts as well.

In Ex.4, some costs of care are necessary but only in the situation in which both parties take action, because then at least one actor must take care to avoid accident costs. The analysis of bilateral levels of activity below is then only relevant in a situation in which both parties choose to act.

In determining what the socially optimal level of activity is for injurers and victims, however, the derived utility and the costs of care and harm must be calculated for both the injurer and the victim, as it is below:

Ex.5

Activity level	Injurer's utility ($X_{0\text{-}4}$)	Victim's utility ($Y_{0\text{-}4}$)	Cost of care (combined) (C)	Accidents losses (L)	Marginal utility minus costs (M) $[U - (L + C)]$
0	0	0	0	0	0
1	100	75	25	30	120
2	190	135	50	60	40
3	255	180	75	90	-55
4	280	200	100	120	-175

In Ex.5, assume that the injurer's and the victim's derived utility diminishes at every increase of their activity level.[112] Assume further that total costs of care (C) and accident losses (L) remain constant at 25 and 30, respectively. To determine the socially optimal level of activity, the sum of the costs of care and accident losses ($C + L$) is subtracted from the additional utility derived by the increase in activity, to determine marginal utility $[(X_{n+1} - X_n) + (Y_{n+1} - Y_n)]$. It is socially optimal to increase the levels of activity insofar as the marginal utility (U) from increasing the level of activity is greater than the combined social costs (C).
Equation: $\boldsymbol{(X_{n+1} - X_n) + (Y_{n+1} - Y_n)}$

In Ex.5, Activity Level 2 is the socially optimal choice because it is the last Activity Level in which society derives more marginal utility than the combined cost of care and accidents ($L + C$).[113] Additionally, it must be noted that, because no costs of care are necessary when only the injurer or the victim acts, whenever an additional level of activity causes one party to derive less marginal utility than the combined costs of care, it is not socially optimal for both parties to act. In Ex.5, the victim (who derives less utility from acting than the injurer), in moving from Activity Level 2 to Activity Level 3 derives only 45 (180 – 135) in additional utility, which is less than the expected additional costs of care of 55 (25 + 30). Therefore, it would be better for society for the victim to simply stop

[112] Generally, for each additional level of activity, less discrete utility is derived ("law of diminishing returns"), cf. e.g., Hartmann, Peter; Reuter, Martin, Spearman's law of diminishing returns tested with two methods, Intelligence (Jan.-Feb. 2006)

[113] Shavell (2004), p.200

acting altogether, eliminating the risk-creating activity, than for her to choose Activity Level 3.

*Absence of the legal rules. In the absence off legal rules, like in the unila*teral context, injurers have incentive to act at excessive frequencies because they are not held responsible for the social harms they produce. Accordingly, they will increase their activity level whenever they can derive utility from doing so. In Ex.5, without the influence of liability rules, this would result in the injurer choosing Activity Levels 4 and even 5; not the social optimum of Activity Level 2. This is because they can still derive positive utility while not having to pay for the increased probability of accidents. Victims, conversely, will choose to minimize social costs because in the absence of legal rules they bear the entirety of their costs.

Negligence. Injurers under the negligence standard can escape liability completely by acting according to due care. Because of this, injurers may be incentivized to choose a higher than optimal activity level, because to the extent they take due care, they will have no accidents costs to constrict their decision making. If injurers act according to a due care standard, they can rely on not having to factor in any accident costs, and therefore have extra funds to devote either to excessive activity or to acting excessively safely. Victims, however, will choose to act in a way that minimizes total social cost, because they will bear their own losses when injurers act according to due care.

Given that it is impossible for lawmakers to account for every dimension of care, it is plain that even where due care is set at the appropriate level to incentivize optimal levels of care, the various unaccounted for dimensions may still lead to inefficiencies. Indeed, the level of activity factor is merely one example. Other factors not considered by Norwegian courts in their negligence analysis include whether the injurer had limitation of liability rights, whether the injurerwas aware that her victim was or was not insured, whether the injurer was indeed not a "normally intelligent and insightful person," as they are assumed to be,[114] etc.

[114] Falkanger, et al. (2011), p.234

5.1.2 Uncertainty in calculating actors' actual care

The fact-specific nature of the determinations required in a negligence proceeding can also create situations in which errors in perception easily occur.[115] Even if due care were set at a socially optimal level by lawmakers or courts, "due care" can be a nebulous term. It is foreseeable that parties could misinterpret what the requisite level of care to avoid liability is. This can lead actors into being held liable for harms they would have expected to avoid. Similarly, when the requisite level of care is unclear, even those parties who incur expenses to adhere to due care in good faith may be adjudged to have failed in their attempt. This can happen for any number of reasons: factual error, unreliability of witnesses, judicial error, misinterpretation, unavailability of evidence, etc. This also leads to social waste, because if an actor that incurs costs of care were found to have acted negligently, it would have been socially optimal for that actor to have not taken care at all to avoid the costs of doing so.

This uncertainty inherent in the negligence regime can theoretically alter the behavior of individuals in a meaningful way. In an attempt to minimize her chances of being found to have acted below due care, an actor might choose to take a higher level of care than is socially optimal. As an example, suppose in Ex.2 that the injurer has a 30% chance of being found to have acted at a lower level of care than she actually practiced due to uncertainty. The injurer, in determining her level of care, must then allocate an additional 30% to the potential total of her accident costs, for a total cost of 165 (35 + 100 + 30), which is more than the cost of taking a Moderate level care. She would therefore have incentive to take a higher level of care than the socially optimal Low care level.[116] In this way, uncertainty may incentivize parties to take sub-optimal approaches to avoiding liability, causing social harm.[117]

[115] Shavell (2004), p.229
[116] Id, p.225
[117] *Id*, p.227z

5.2 Strict liability

As seen above in the level of care analysis, strict liability successfully incentivizes injurers to choose the socially optimal level of care in all circumstances. By shifting all costs of the risk-increasing behavior back to the injurer, strict liability aligns private and societal interests. It also requires no finding of fault or blameworthiness for liability to be imposed, and there is therefore no need for lawmakers to set a due care standard or for courts to apply one. This avoids administrative costs that go along with those processes. Moreover, with strict liability, there is very little risk of court error in determining the cause of injury, because a court need only determine whether or not the injurer's activity was a necessary cause-in-fact of the harm that the victim experienced. Along the same lines, injurers can be certain that they will reliably be held accountable for the costs they cause to other actors regardless of the level of care they choose, and act accordingly.

Additionally, all dimensions of care are rolled into the costs of injurers' strict liability automatically, because it does not matter how the damage occurred, only that it occurred in the first place. A injurer may have acted with socially optimal care in every way with the exception of level of activity, and a court would still impose liability under a strict liability regime. As discussed above, this would likely not occur in a negligence suit, because level of care is generally not factored into the negligence analysis.

5.2.1 Dilution of victims' incentives

The weakness of strict liability occurs in the bilateral context, because it dilutes victims' incentives to take socially optimal care. When victims understand that injurers will bear all costs associated with their injurious behavior, they are not adequately compelled to minimize total social costs. One solution to incentivize victims to act in a socially optimal way is to introduce the defense of *contributory negligence* to accompany a strict liability regime. With this rule, if a victim fails to take at least due care in the course of being injured, the injurer will escape liability for

the harm caused.[118] Another similar solution is the defense *comparative negligence*. This solution also requires courts to determine whether the victim was negligent, and if so, to allocate the victim a percentage of liability in accordance with her contribution of the damages, reducing recovery pro rata.[119] Both the contributory and comparative negligence rules introduce incentives for victims to exercise whichever level of care lawmakers or courts set as due care. This is essentially the determination that a Norwegian court is called to make in the situation of a ship-to-ship collision governed by MC § 161 paragraph 2.

The criticism of these solutions is that they require the court to do the expensive processes of setting due care and evaluating actors' levels of care that strict liability attempts avoid in the first place. Indeed, for this reason the contributory negligence rule is superior to the comparative negligence rule from an economic perspective, because it requires a less burdensome fault analysis.[120] Under the contributory negligence rule, the court need only determine whether the victim was negligent, and then only if the defense is used in court by the injurer. It requires no analysis of the negligence of the injurer, nor does it require any allocation of liability to the various actors.

The option of enforcing a contributory negligence defense sets up a cost-benefit, risk versus risk analysis for lawmakers to perform. Lawmakers must determine whether the cost of implementing a contributory negligence rule is worth the benefits of correcting the problems associated with under-incentivized victims. If it is determined that enforcing the defense of contributory negligence incurs more societal costs than it avoids by incentivizing victims to behave optimally, it is not worth doing so. This is a decision that requires empirical data to inform it, and cannot be opined on in this paper.

The defense of contributory negligence is not a panacea, however. Even with it, there is no liability scheme that perfectly incentivizes every

118 Shavell (2002), ch.2 pg.10
119 Id, ch.2 pg.10
120 Shavell (2004), p.202

actor into socially optimal levels of activity.[121] This is because, in the bilateral context, victims under a strict liability regime are under-deterred, leading to excessive activity levels and a sub-optimal total social utility. Like the injurer in the unilateral level of activity situation, the victim would increase activity levels whenever personal utility could still be derived, regardless of the effect on total social welfare. This, again, creates a cost-benefit, risk versus risk analysis for lawmakers, in which the disadvantages associated with the enforcing the negligence rule (i.e., injurers engage in risk-creating activities at a socially excessive frequency) must be compared with the disadvantages associated with enforcing strict liability (i.e., victims will engage in socially excessive risk-creating activities).[122]

In terms of Norwegian law, in those situations in which strict liability has been applied (i.e., emergency situations, various types of pollution, and ship-to-land collisions), it must be determined whether it is more socially desirable to restrict those parties causing harm, or those parties experiencing harm (i.e., victims). From a purely economic approach, conclusions are difficult without data . From a risk-allocation standpoint, however, it seems more appropriate to allocate risk to injurers than victims in pollution and ship-to-land collision situations, because those injured by pollution and ship-to-land collisions have less opportunity to affect the probability of those events occurring than does the injurer reder. It is difficult to imagine a situation in which a vessel striking a land-based structure or discharging a pollutant would be under the victims' power to control to the extent that they ought to bear the risk of such occurrence.

5.2.2 Dilution of injurers' incentives: Judgment proof problem and vicarious liability

When liability is imposed regardless of fault on injurers, the possibility of a dilution of incentives can occur if injurers are unable to pay for the costs they produce. This is because, as Shavell explains, "[injurers] will

[121] Faure, et al. (2006), p.183

[122] Shavell (2004), p.202

treat losses that they cause that exceed their assets as imposing liabilities only equal to their assets."[123] This is, of course, because no actor can pay more than they have. This can leave injurers under-incentivized to take socially optimal care. Refer to Ex.6 below for an illustration:

Ex.6

Level of care	Cost of care (X)	Accident probability (P)	Expected losses (L = 1000)	Total social cost (C)
None	0	20%	200	200
Low	35	12%	120	155
Moderate	80	9%	90	170
High	120	4%	40	180

Assume that in Ex.6 (exactly the same as Ex.2), the injurer's assets are limited to 100, so any costs exceeding 100 will be unenforceable against the injurer.

In Ex.6, as in Ex.2, a solvent injurer subjected to strict liability would be incentivized to take the socially optimal (Low) level of care, because it minimizes her total costs. An injurer with liabilities that exceed assets, however, will only factor liabilities into her cost-benefit analysis to the extent they do not exceed her assets. Accordingly, an injurer with assets of 100 would have the same incentives to take the sub-optimal no care option as she would to take Low care, because both will lead to losses of more than the injurer's total assets, leading to higher probabilities of accidents, higher social costs, and less chance of enforcing a judgment.

One solution[124] to this problem is the imposition of vicarious liability, like the kind imposed by the Norwegian Maritime Code, but for all damage caused in service of the ship; not just those harms that arise from "negligent" action.[125] This type of vicarious liability can work to decrease a judgment proof injurer's level of activity and/or increases their level of

[123] Shavell (2004), p.230

[124] Other solutions include minimum asset obligations and minimum insurance obligations, cf. Shavell, Steven, Economic analysis of accident law, John M. Olin Paper Series, No.396 (Dec. 2002), ch.4 p.7

[125] MC § 151 paragraph 1

care, both decreasing the probability of an accident occurring. If a reder, for instance, is able to observe and control the behavior of those acting in service of her ship (such employees and direct contractors), then imposition of vicarious liability will lead to a socially optimal result. This is because the reder will place an obligation on her employees to act so as to minimize the total costs that the reder will be forced to pay.

However, if the reder cannot control the behavior of those working in the service of her ship (as is the case with pilots, harbor authorities and others), there is little the reder can do to avoid liability.[126] In this case, it makes littler economic sense to impute the liability of these actors to the reder, because it may incentivize overly-careful behavior from the reder in attempting to avoid mishaps, and under-incentivize those actors working in service of the ship, knowing that any liability they incur will be imposed on a party to which they have no fiduciary relationship.

6 Conclusion

The economic analysis of law is incomplete on its own. In tandem with other evaluative techniques, however, it can be a useful tool of identifying and rectifying inefficiencies for the good of society. When applied to third party liability rules in the maritime context, it works particularly well in evaluating the basic deterrent structure that liability norms create.

From the economic perspective, neither negligence nor strict liability create a perfectly efficient incentive structure for both injurers and victims. Negligence under-incentivizes actors because they can escape all liability by acting according to the due care standard. It does the same by failing to take all factors of care, such as level of activity, into account. Further, the uncertainty associated with, and the resources required in, setting the due care standard and in determining actors' actual level of care lead to inefficient behavior.

[126] Shavell, Steven, *Economic analysis of accident law*, John M. Olin Paper Series, No.396 (Dec. 2002), ch.4 p.7

Strict liability, while much less burdensome to carry out, fails to incentivize victims properly in the bilateral context. This leads to excessive victim activity and suboptimal social utility levels. Enforcing strict liability can also open the door to other problems, such as the judgment proof problem, because there is no way for injurers to escape any liability their actions may cause. While some of the weaknesses of strict liability can be overcome through the enforcement of supporting doctrines such as contributory negligence and vicarious liability, some level of concession will have to be made in choosing between restricting victim or injurer activity.

In order to determine the normative way forward with regard to choosing one liability regime over the other, empirical information will have to be gathered such that the costs associated with the negligence rule can be compared with the costs associated with restricting either victim or injurer behavior under strict liability (whichever is less).

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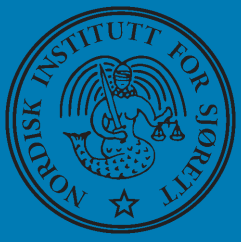

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