


# **End of Year Review 2012**

For the year ended 20th February, 2012



## **Chairman's Statement**

**“The UK continues to be  
the jurisdiction of choice  
for the majority of disputes.”**

**Total Number of Ships Entered**

3,311

**Total Funds**

£51.4 million

**End of Year Reserves**

£21.5 million

For the year ended 20 February, 2012



**“When I joined the Board of the Association in 1994, shipping markets had just experienced one of their worst periods. At that time average earnings across all sectors were in the order of \$12,000 per day. If we look at today, rates are currently at similar levels and could well go lower. With rates such as these, coupled with high bunker prices, is there any wonder that many shipowners and operators are under considerable financial pressure.”**



## Chairman's Statement (continued)



Since the heady heights of 2008 the Association has been involved in a considerable number of cases assisting Members to lessen the impact of defaulting counterparties. In many cases considerable effort and cost has been expended in order to secure these claims. Worldwide freezing orders granted by the English High Court have proved to be an effective way of reducing the risk of dissipation of assets. Rule B applications in the US also continue to prove helpful in some cases. With the assistance of the Association, Members have been able to secure their claims which, in some instances, have run into many millions of dollars. No doubt these measures will continue to be deployed where there is a risk of counterparty default particularly if pressure on freight rates continues.

The Association has also been involved in a number of cases where a Member is part of a chain of charterparties. These are notoriously difficult to resolve particularly when one or more parties adopts an inflexible position. The LMAA terms continue not to allow consolidation unless by agreement and therefore the cost consequences of a multi chain arbitration can be considerable. One aspect that Members need to bear in mind is that liability for costs may not be limited solely to their own arbitration, as there are circumstances where a contingent cost liability may arise from a sub-arbitration as well.

The Association has not however just been involved in cases relating to counterparty risk. A large number of cases have been litigated, particularly in the United Kingdom, both in court and by way of arbitration. The case of the RAINY SKY probably says more about the Association than any words can do. Not only does this case reinforce the value of the cover, it also provides evidence of the vitally important, but probably understated, role that the Association plays in shaping English maritime law.

As many will be aware the case of the RAINY SKY involved refund guarantees totalling \$46.2 million. The key aspect of the case was whether such

guarantees should respond to the insolvency of a shipyard. The decision has had far reaching implications for maritime law in the UK and elsewhere.


At first instance the English Commercial Court found in the Member's favour, essentially holding that the refund guarantees should be interpreted in a commercial way. This however was overturned by a majority in the Court of Appeal who applied a strict interpretation of the guarantees. The Supreme Court restored the balance with Lord Clarke holding that,

"If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other."

This decision, which places "business common sense" at the forefront of issues of interpretation, is to be welcomed and applauded. The industry needs an approach such as this so that commercial considerations are not overlooked or dismissed. This is precisely why the English Commercial Court and indeed the LMAA were established many years ago.

The UK continues to be the jurisdiction of choice for the majority of disputes. The legal and technical expertise that is available is unquestionable. It is however clear that costs are becoming a significant issue on many claims. What were once apparently routine matters now have the propensity to escalate disproportionately. This may in part be due to charterparty chains and multiplicity of litigation however legal cost inflation is also a factor.

The Managers have, to some extent, managed to contain these costs through their Value for Money programme however much more needs to be done. The Directors still see too many cases where the initial estimates that are provided by third party service providers have been found wanting. The Directors place a great deal of reliance on the estimates that are provided and have requested that the Managers take further steps in order to ensure the accuracy of estimates that are provided.



## **“The financial strength of the Association should not be under estimated.”**

Image: Axmouth Harbour, Devon

2011/12 has been very successful in terms of the level of claims that have been upheld in Members' favour. This is borne out by reference to the cost recoveries that have been made. It is anticipated that cost recoveries in the order of \$3.5 million will have been made as against cost liabilities in the region of \$1.5 million. Not all cases can be won, however this proportion of recoveries to liabilities evidences that the processes that the Directors and the Managers have in place are, in my view, appropriate and fit for purpose.

The Association's financial position remains strong with free reserves in the order of £21.5 million. This has meant that the Association has been able to deal with a significant increase in claims over the past few years without having to levy significant premium increases or change the underlying terms of the cover. A 5% general increase for this policy year, lower than many of its competitors, highlights the benefit of this financial position.

The financial strength of the Association should not be under estimated. Members will be aware that this Association is independent and is not a class of P&I cover unlike many of its competitors. What does this mean for Members? It means that this Association, its Board and Managers are focused purely on defence related matters, and the Association's reserves have been established solely for this. As an independent organisation the Association sets its own investment policy and one which the Board reviews regularly. The Board has historically always taken a conservative approach to its investments recognising that these are the funds of Members. Notwithstanding this, I am pleased to report an investment return of 4.6% for the year which was an excellent result particularly in light of the volatile investment markets and low interest rates.

Your Board also continues to be very mindful of new solvency requirements, in the form of Solvency II, which are to come in to force in the next few years. A significant amount of time is being devoted by the Board to ensure that the Association meets these requirements.

In terms of Members, I am pleased to report that through the year owned entered ships grew from 2,434 to 2,501 with chartered entries now totalling 810. The Association's Membership is drawn from all maritime shipping nations. I am pleased to report that we have seen very pleasing growth from a number of regions this year in particular Asia Pacific and Japan along with Greece and the Middle East.

These areas are ably supported by the Managers who have significant operations in various locations including Hong Kong, Singapore and Greece and who are able to respond to Member issues in their own time zones. I and my fellow Directors also ensure that the Board is representative of the Membership and I am pleased to say that we have representation from many different countries and fleet profiles.

I would finally like to thank my fellow Directors for their support and sound advice. Their commitment and dedication to the Association is second to none. I would also like to express my appreciation to the management team for protecting the interests of the Membership so diligently and also assisting the Board in the conduct of the Association's affairs.

For Members the year ahead will undoubtedly be far from straightforward however I am absolutely convinced that the Association will remain on a solid footing to assist Members throughout this period and in to the future.

### **M.G. Pateras**

Chairman

The United Kingdom Freight Demurrage and Defence Association Limited

May, 2012

# Claims Review

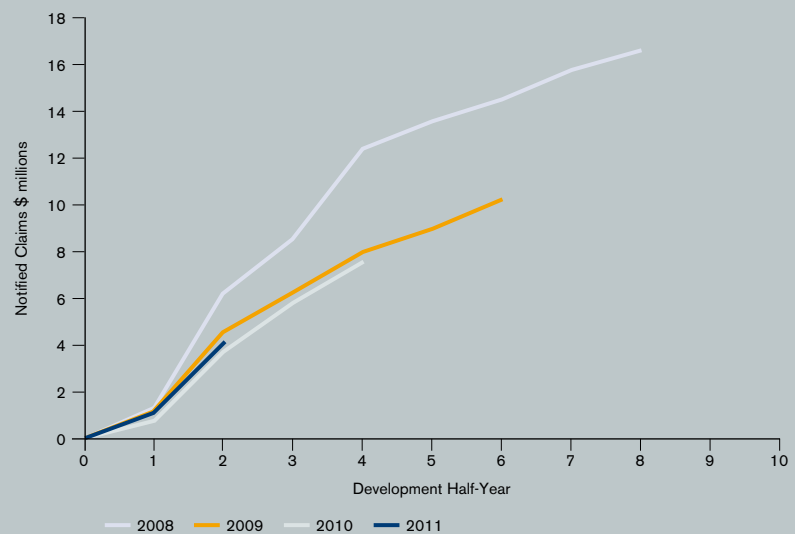






The year to 20th February, 2012 was an extremely busy but positive one for the Association in a number of respects. Following on from the heightened claims environment experienced in 2008-2010 there was some uncertainty as to how claims might develop in 2011 however, whilst claim numbers remained at a relatively high level, the cost of those claims has reduced somewhat from those seen in 2008 and 2009.

### Net Notified Claims Development (All claims)



# Claims Review (continued)

**The recent years' claims development is no surprise given the market circumstances that arose in 2008. Some of the impact of this is still being felt today with disputes occurring on contracts agreed before 2008 when the market was very different. In some of these cases the contracts have been renegotiated however in other cases disputes have arisen. In numerous cases these claims run in to many millions of dollars and consequently the costs of resolving the disputes increased proportionately. The average cost of claims has shown a marked rise over the last few years. Part of this is down to legal cost inflation however some of it was also caused by the front loading of costs at an early stage in the development of the case. However, if costs are being incurred much earlier it should also mean that there will be a much shorter tail.**

## LMAA arbitrations and English Court proceedings

Another factor that has influenced the increase in costs is that many more disputes are being arbitrated or litigated. Over the past year the Association has been involved in a considerable number of cases that went to arbitration or some form of litigation. Why is this? One explanation is that the legal issues involved require a final determination. This of course has always been the case however it is clear that in a number of cases commonly understood legal principles are being reviewed and are being challenged, which is one of the hallmarks of English common law.

Another feature is that hearings are being set down more swiftly than in previous years. In the recent past there was a time when one of the constant criticisms of the LMAA was the speed of the process however that time now seems to have passed. Justice requires efficient but effective resolution and the efforts of the LMAA in turning this around need to be recognised.

## RAINY SKY

One of the most significant cases that the Association has been involved in this year relates to the RAINY SKY which ultimately required resolution in the UK Supreme Court (the predecessor to the House of Lords), the UK's highest court.

The case concerned a \$46.2 million dispute between the buyer Member and the guarantor bank under a shipbuilding contract as to whether refund guarantees should respond to the insolvency of the shipyard. From the Member's perspective the first instance judgment

of the English Commercial Court was in keeping with commonly held views as it found that the refund guarantees should be interpreted commercially and that the very purpose of such a guarantee was to protect against shipyard insolvency. This judgment however was overturned by the Court of Appeal. In a very surprising judgment a majority of the Court of Appeal considered that a literal interpretation of the guarantees should be applied and, that as the guarantees did not specifically make reference to shipyard insolvency, the parties could not have intended that it should respond to such a circumstance.

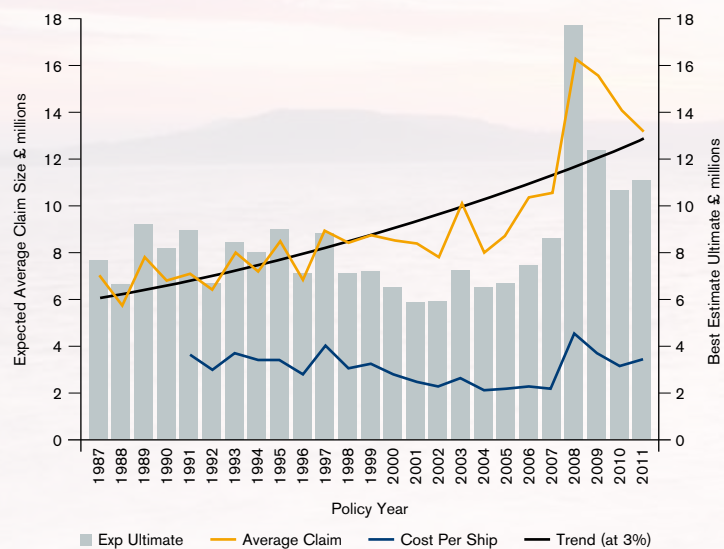
The Supreme Court, in a unanimous decision, overturned the Court of Appeal. Lord Justice Clark gave judgment and commented that,

"...the language used by the parties will often have more than one potential meaning... the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions the court is entitled to prefer the construction which is consistent with business common sense and to reject the other."

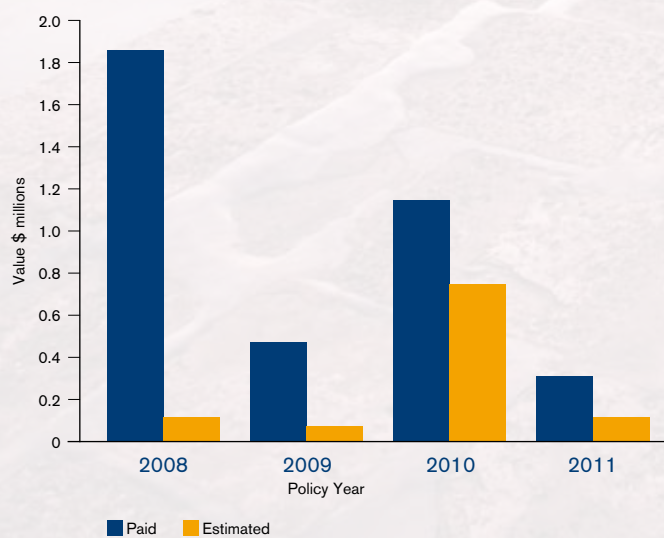
Business common sense was quite rightly placed squarely at the forefront in the interpretation of commercial contracts. The Association was privileged to have been able to support the Member throughout this landmark case which is a further testament to the role that the Association has historically played in shaping English maritime law. The RAINY SKY will undoubtedly be referred to for many years to come. It should also be remembered that the Member was able to recover its \$46.2 million along with interest and costs. Without question this case epitomises what the Association stands for.



## Expected Average Claim Size



## Cost of defaulting counterparty cases (paid and estimated)





# Claims Review (continued)

## Time charter disputes

The Association has of course been involved in many cases over the year and time charter disputes and related enquiries continue to dominate as they have done in previous years.

A considerable number of these time charter issues stemmed from the tragic events in Japan early in the year. Another feature has been the impact of counterparty risk issues. This is of course nothing new however the pressure of freight rates is undoubtedly placing considerable pressure on certain operators with longer term commitments at rates in excess of the current market. In the policy years 2008-2011 a total of 150 cases were identified as relating to "defaulting operators". In financial terms the overall cost of such cases opened in policy years 2008-2011 is currently estimated to be in the region of \$4.8 million.

Looking forward, the prevailing market conditions suggest that there are likely to be more operators who will suffer financial difficulties of one sort or another. From the Association's perspective, the experience that it has gained in this area in recent years means that it is very well placed to support Members in dealing with defaulting counterparties, whether through negotiation or by taking legal steps to protect their position.


## The management of legal costs

As the leading provider of legal costs insurance to the maritime industry the Association is understandably focused on the management and control of costs. The Managers' Value for Money ("VfM") initiative was introduced to ensure "best practice" was applied to claims handling services, both by the Managers and by third party suppliers. A natural consequence of this has been identifying the cost effectiveness of those services and this, combined with the application of VfM guidelines aimed at achieving the "most appropriate outcome" in all cases, has assisted the Association in controlling costs at a crucial time.

What has however given some cause for concern over the last year is the inadequacy of various cost estimates. In some cases cost overruns are difficult to avoid especially when a case takes a different direction to that initially envisaged. Whilst it is widely accepted that estimating is not an exact science, and a case may develop in such a way as to materially affect an estimate previously given, in those circumstances there is an obligation on the third party provider to notify the Managers and the Member of any change and the estimate should be updated as soon as any change occurs. The importance of accurate estimating was highlighted in a case before the Supreme Court in 2007 (*Mastercigars Direct Ltd v Withers*) which was summarised in a Soundings publication in 2011, where it was held that a firm of solicitors was bound by a cost estimate provided to its client.

The Managers will shortly be writing to third party suppliers emphasising the need for accurate estimating and the reliance that is placed by the Board and the Managers on the estimates that are given. The Managers will also be exploring fixed fee agreements with a number of firms.



A photograph of the Rainbow Bridge in Tokyo at night. The bridge is illuminated with green lights, and its reflection is visible in the water below. The city skyline is visible in the background with various buildings lit up.

**“...the Association has made significant cost recoveries totalling \$3.5 million...”**

Image: Rainbow Bridge, Tokyo

### **Cost recoveries**

In the 2011 policy year the Association made significant cost recoveries totalling \$3.5 million where Members have been successful in progressing their claims. The Directors considered 35 major cases during the year, in addition to which the Managers considered a substantial number of requests for support under the authority delegated to them by the Board. Of all the cases formally considered by the Board or the Managers, some 98% received a significant measure of support, illustrating the importance attached by both the Board and the Managers to the Association being supportive of its Members whenever appropriate.

In terms of cost liabilities, historically there has been an assumption that the losing party in US litigation or arbitration is unlikely to attract a cost liability. In 2011 the Association was involved in a significant dispute subject to New York arbitration. Unexpectedly, the tribunal found against the Member but perhaps more surprisingly it awarded the other party a significant cost recovery. This appears an increasing trend in New York arbitrations.

### **Advice and assistance**

In addition to the cover it provides for legal and other costs, a key feature of the Association is the advice, assistance and support provided by the Managers both in London and in the regional offices in the United States, Greece and Asia Pacific. The highly qualified and experienced staff in these offices are, on a daily basis, assisting Members with general enquiries, the drafting of clauses and in resolving disputes amicably. These additional services are often understated however they are of crucial importance to Members at a time when the international trading environment is becoming increasingly complex.

Piracy does of course continue to affect the industry, and is likely to for the foreseeable future, and the Managers receive regular enquiries relating to charterparty clauses and related issues. The international sanctions regimes are a complex area that continue to give Members cause for concern. The Managers closely monitor any changes in the sanctions regimes to ensure that they are well placed to respond to any enquiries from Members.



## Seminars & Publications



In 2011 the Managers participated in a number of seminars and events in a variety of locations. Most notably seminars were held in Greece, Singapore and the Middle East where a key topic for discussion was bunker quality and quantity claims. The increase in bunker prices has given rise to a variety of bunker related claims and the Managers took the opportunity to share their experience and expertise in this area. In support of these seminars a publication entitled “Bunkers: a guide to quality and quantity claims” was produced. This covered a variety of issues from good shipboard practice during the delivery of bunkers to the preservation of evidence and legal issues that can arise.

The Managers have continued to deliver bespoke seminars to individual Members in their own offices and in 2011 these focused on the early re-delivery of a ship under a time charterparty, the withdrawal of a ship for non payment of hire and defaulting counterparties and the enforcement of claims against them.

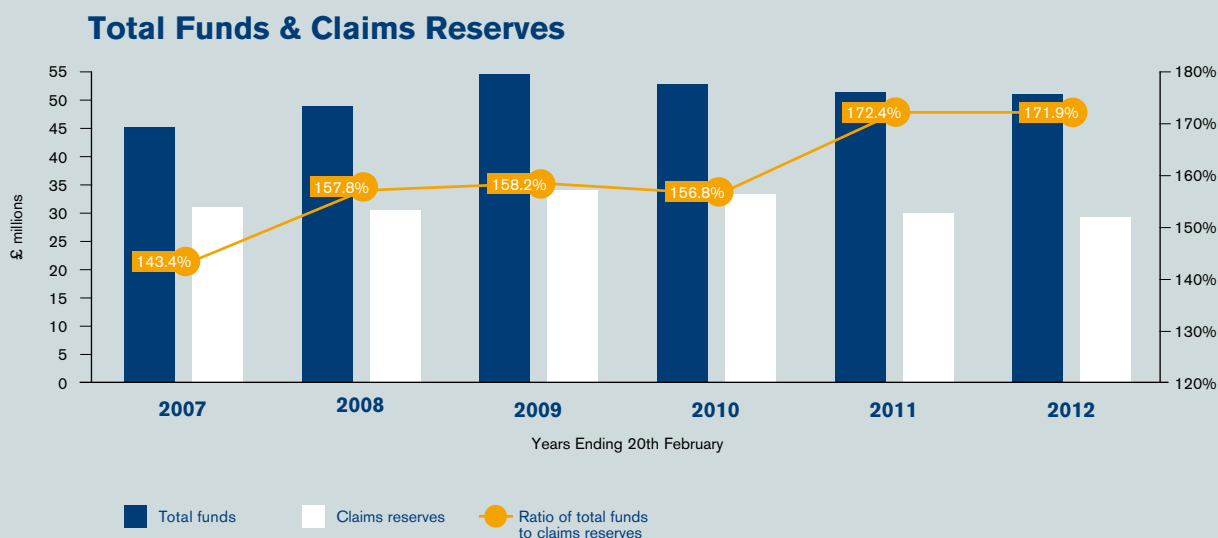
In addition to the “Bunkers” publication a number of other “Soundings” bulletins have been produced on subjects as diverse as issues arising from the

Japanese tsunami, the calculation of damages, Korean bankruptcy proceedings and hull fouling.

It is without question that 2012 will be a challenging period for Members however the Association and its cover are here to assist Members whenever possible.



# Financial Highlights 2012



The UK Defence Club reinsures its past and present risks on a quota share basis with the UK Defence Insurance Association (Isle of Man) Ltd ("UKDIA"). Members of the UK Defence Club are also Members of UKDIA.

The table set out below presents the results and reserves of the Club and its quota share reinsurer for the financial year ending 20th February, 2012 on a combined basis.

The financial highlights for the year are as follows:

- Premium income fell by 7% to £16.5m in 2011/12, largely due to the weakening of the US dollar against Sterling in the early part of the year compared with 2010/11. In US dollar terms premiums declined by 2% as a result of a drop in chartered entries.
- Net claims incurred, including the change in provisions, were £15.3m, up from £11.4m in 2010/11. 2011 policy year claims with costs incurred rose by 23% compared with the previous year as a result of the continued difficult trading conditions for Members, though average claim values fell by 9%. There was also a £0.4m deterioration in prior policy years' claims reserves.
- Investment return totalled £2.2 million, equating to 4.6%, and was assisted by the strong performance of equity markets in the last quarter of the year. In addition, there were net exchange gains of £0.5 million resulting from the hedging of premium income and the strengthening of the US dollar against Sterling in the second half of the year.
- The net result for the year was a small deficit of £0.2 million, leaving free reserves at £21.5m.
- The Club continues to have a strong balance sheet with assets of £51.4m and a ratio of assets to liabilities of 172%.

Year ended 20th February	2012 £'000	2011 £'000
<b>Income and Expenditure Account</b>		
Calls and premiums	16,479	17,672
Reinsurance premiums	(367)	(386)
	<b>16,112</b>	17,286
Net claims incurred	(15,325)	(11,365)
Acquisition costs	(2,131)	(2,132)
Net operating expenses	(1,503)	(1,552)
	<b>(18,959)</b>	(15,049)
Operating surplus/(deficit)	<b>(2,847)</b>	2,237
Investment return	2,158	1,155
Exchange gains/(losses)	528	(694)
Surplus/(deficit) before taxation	<b>(161)</b>	2,698
Taxation	-	-
Surplus/(deficit) after taxation	<b>(161)</b>	2,698
<b>Reserves and Capital</b>		
Total funds	51,434	51,623
Claims reserves	(29,920)	(29,948)
Free reserves and capital	<b>21,514</b>	21,675
Total funds/claims reserves	<b>171.9%</b>	172.4%





**“Investment return totalled £2.2 million, equating to 4.6%, and was assisted by the strong performance of equity markets in the last quarter of the year.”**

Image: Arcachon Bay, France

Strength with independence.

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