UK DEFENCE CLUB

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soundings

Where is the logic of Requiring an Owner to Undertake Repairs Vastly in Excess of a Ship's Sound Market Value – THE KYLA

The English High Court has recently ruled that a where a charterparty sets out the ship's hull & machinery value an owner may be required to repair up to that full amount irrespective of whether the ship could be said to be a CTL.

In May, 2004 the KYLA, whilst loading alongside a berth at Santos, Brazil, was struck by another ship. Substantial damage was caused with the cost of repairs being in the order of $9 million compared to her market value at the time of the incident of $5.75 million. At the time of the incident the ship was on charter to Bunge. The intention was that she would be scrapped, once the charter had come to an end.

In light of the extent of repairs the owner Member, entered in the Association, determined that its contract with Bunge could no longer be performed on the grounds of frustration.

The English law doctrine of frustration has, like many principles of English law, developed over a period of time. Initially, the basis for the doctrine had been an implied term in the contract. In parallel with this were a series of shipping cases that established that it was an implied term of a time charterparty that, where the cost of repairs exceeded the value of the ship, the charterparty would be terminated by operation of law.

The modern law on frustration later came to be summarised in a well-known passage from a decision of the House of Lords in Davis Contractors Ltd v Fareham UDC where it was held that:

"…frustration occurs whenever the law recognises that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract… It was not this that I promised to do."

The Member's position was that as a result of the collision, and the extent of the required repairs, its contract with Bunge was radically different from that which it contracted and this gave rise for grounds for termination.

The case proceeded to London arbitration before a senior QC acting as arbitrator. Along with having to review the extent of repairs required both in cost and time, the arbitrator also had to consider what effect a reference to the hull & machinery value in the charterparty had on the doctrine of frustration.

As with many charterparties the Member's charterparty with Bunge contained reference to the hull & machinery cover and the value of that cover. The clause itself provided inter alia as follows:

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Where is the logic of Requiring an Owner to Undertake Repairs Vastly in Excess of a Ship's Sound Market Value - THE KYLA (continued)

"Clause 41 Insurance/P&I Cover

41.1 Owners warrant that throughout the currency of this Charterparty the vessel shall be fully covered by leading insurance companies/ International P&I Clubs acceptable to the Charterers against Hull and Machinery, War and Protection and Indemnity Risk.

41.3 Insurance full style and value

Hull and machinery: USD16,000,000 London, Norway and USA Markets…"

As Members will be aware clauses such as these are generally included to inform a charterer in order for them to be able to calculate the cost of war risk and other additional premiums.

In the arbitration Bunge argued that this clause operated as a "repair fund" which required the owner to repair up to the level of $16 million irrespective of the sound market value of the ship.

The arbitrator disagreed and held that clause 41 was not sufficiently clear to require the owner to repair up to this amount. Therefore he held that it did not alter the "usual conclusion" that an owner is not obliged to repair a ship where the cost of doing so was greatly in excess of the value of the ship.

Having been granted leave to appeal, on the grounds that the point was one of general public importance, the High Court disagreed with the arbitrator Having looked at the contract as a whole Mr Justice Flaux decided that clause 41 did require the owner to repair the ship up to its insured value. As a result, he held that performance of the charterparty was not "radically different", or the continuation of the charterparty was not "commercially impossible", because the parties had included a term in their contract that covered the event in question. Put another way, the risk had been allocated to the owner to repair the ship up to the insured value if it was damaged.

Although the Member sought leave to appeal to the Court of Appeal, Mr Justice Flaux refused leave on the grounds that the issue was not one of general public importance. The owner Member is now appealing directly to the Court of Appeal in order to challenge this decision.

Clauses such as clause 41 in the KYLA are relatively common in the industry and a number of particular problems arise from the decision. These include the following:

1 Whenever an insured value is set out in a charterparty, that charterparty cannot be brought to an end by frustration in circumstances where the repairs exceed the ship's repaired value. This will apply whether the event causing the damage was the fault of the owner, the charterer, or a third party.

2 The principle may also apply when the insured value is not written into the charterparty but where there is a continuing warranty to insure.

3 Where a ship has been seriously damaged requiring it to be taken out of service for repair, an owner must also bear in mind that it remains under an obligation to have the ship repaired within a reasonable period. It will not be a defence to a claim by a charterer that the repair took too long to argue that;

a. Hull underwriters were slow (or failed completely) to agree to or pay for the repair; nor

b. That they exercised their right of veto over potential repair yards and/or to insist that a particular yard be utilised for the repair; nor

c. That mortgagee banks, to whom hull and machinery policies are typically assigned, did not want the proceeds of the insurance policy to be spent on what could be commercially useless repairs.

It should also be borne in mind that the parties' obligations always depend upon the construction of the contract as a whole and its application to the events that have occurred. Therefore, it is possible that the result in the KYLA could be displaced by other provisions in the charterparty.

In order to try and avoid some of the potential consequences of the judgment Members are advised to consider carefully the rationale for including reference to the ship's hull & machinery value in their charterparties. Where it is to be included consideration could be given to including a clause in the following terms:

"The existence of any term in this charterparty requiring owners to maintain any hull and machinery insurance and/or the stipulation in this charterparty of any particular level of insurance and/or insured value shall be irrelevant to and independent of any obligation owners may have to charterers to repair damage to the ship.

The effects of this provision include that the limit of owners' obligation to repair is not to be assessed by reference to the ship's insured value.

In case of conflict between this clause/ sub-clause and any other clause/sub-clause in this charterparty, this clause/ sub-clause is to take precedence."

The above is provided for guidance only and specific advice should be taken from your usual Club contact.

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