Shipping

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THE LENDER ON THE HOOK?

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Jenny Salmon, of Holman Fenwick Willan, and James Turner, of Quadrant Chambers, examine the ship finance implications of the recent court decision in *The Kyla*.

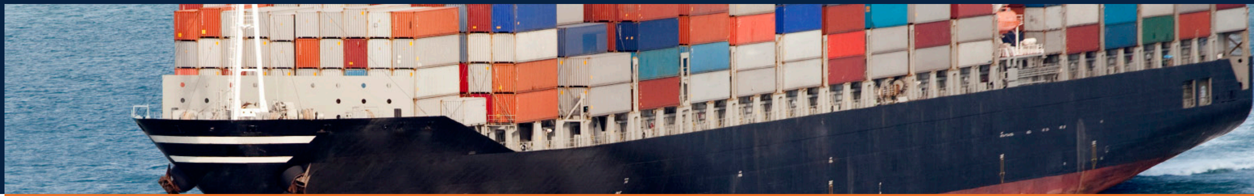
Shipowners put their most valuable assets at the mercy of the waves and weather every day so as to earn freight or hire, yet there are few more perilous ways to employ an asset. The mortgagee bank, whose principal security may be the ship itself, will therefore commonly insist on assignment of the owner's hull and machinery insurance policy to protect its position in the event of loss of or damage to the mortgaged vessel.

During the trading life of a vessel, any number of incidents may trigger contractual rights or obligations under the charterparty, the hull policy or the loan agreement. On the whole, these three types of contract - insurance, charterparty and finance - tend to keep themselves to themselves. Even where they come into contact - for example, by an assignment of hire or insurance - their interaction is fairly predictable, well understood and (contractually speaking) well regulated. The well-known principle of privity of contract and the rule that a party's insurance is generally a matter between that party and his insurer (and should not be taken into account for the purposes of ascertaining the parties' respective rights and obligations under a charterparty) have helped to establish and maintain the predictability of the position. Predictability, of course, is something for which the common law is known and valued.

Following the Commercial Court's recent decision in *The Kyla (Bunge S.A. v Kyla Shipping Company Limited [2012] EWHC 3522 (Comm)*), however, the boundaries between these contracts look a little less secure than might have been supposed.

Hull and machinery insurance and mortgagee banks

The terms on which the loan agreement or mortgage requires the H&M insurance to



be assigned to the bank will, of course, vary. The policy itself may be assigned to the bank; it is not uncommon to see assignments of "all [the shipowner's] rights" in the insurance, which may include claims handling rights; the proceeds of an insurance claim can be assigned; or present and future claims under the policy can be assigned.

'Loss payee' clauses attached to the insurance policy often differentiate between how high and low value claims are to be dealt with as between the insurer, the owner and the bank. Generally, such clauses provide that all claims (including those for actual total loss, constructive total loss, compromised total loss, unrepaired damage and partial loss) will be paid to the mortgagee bank. However, they also commonly provide for partial loss claims below a certain threshold to be paid directly by the insurer to the owner, notwithstanding the assignment, to allow the owner to effect repairs.

Neither the run-of-the mill damage claim nor the catastrophic actual or total loss claim present much difficulty (in purely contractual terms, that is): in all probability the insurer will pay out to the owner (if not to the repairer) in the first case; and to the bank in the second. Major damage will inevitably be more problematic commercially, but - as long as repair makes commercial sense - soluble.

But what of the cases where the cost of repairing the damage, while uneconomic, is insufficient to trigger a CTL (due to the near-universal underwriting practice of requiring the cost of repairs to exceed the insured value, rather than merely the market value, for a CTL to arise)? Exactly that scenario arose in *The Kyla*.

Insurance and the owner's charterparty obligations - *The Kyla*

The Kyla was under time charter when she was badly damaged in a collision for which her owners were not responsible. At the time of the collision, the vessel was fast approaching the end of her trading life, but there was enough time to repair her and put her back into service for the last three months or so of the charter. The repairs would have cost US$9 million, more than 50% more than the vessel's repaired value, and well over double the benefit of repairs (i.e., the repaired value less the scrap value). It would, plainly, have made no commercial sense to carry out repairs so out of proportion to the value to be gained from performing them. Owners invoked a line of case going back to the middle of the nineteenth century to argue that, in those circumstances, the charterparty had been frustrated as a result of the collision. The arbitrator agreed with them.

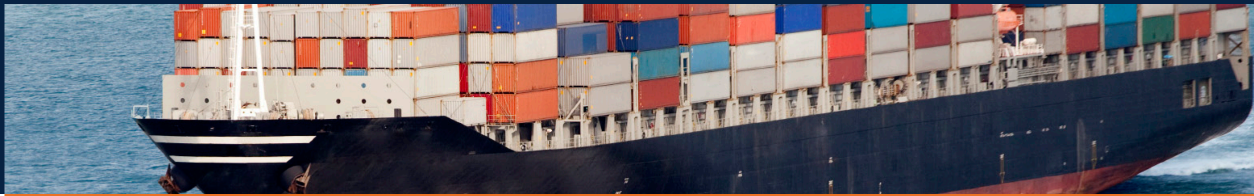
Charterers appealed the arbitrator's decision to the Commercial Court. The main issue on appeal was the effect of a clause in the charterparty by which Owners warranted that, throughout the currency of the charterparty, the vessel would be fully covered for hull and machinery (amongst other) risks. Within the same clause, the hull and machinery value was stated to be US$16 million. Charterers argued that this clause, read in combination with the repairing obligation in clause 1 of the NYPE 1946 charterparty, amounted to an allocation to the Owners of the risk of damage to the vessel costing less than the insured value to repair.

The judge agreed with this assessment. He held that the charterparty was accordingly not frustrated and that Owners were in repudiatory breach of contract for failing to carry out the repairs and return the vessel to Charterers' service to perform the balance of the charter period.

The Commercial Court's decision gives rise to a number of practical difficulties for the owner of a time-chartered vessel, who will be required to commence repairs as quickly as he reasonably can. While the owner may well be entitled to an indemnity under his hull and machinery insurance, the requirement to get on with the repair is unlikely to synch with the investigations hull and machinery insurers will undoubtedly wish to make as part of their claims-handling procedures. Indeed, the most common standard London hull clauses allow insurers to decide (and to veto) the place of repair. The Court held that problems of this sort were part of the commercial risk borne by Owners.

The Kyla - financing implications

In one sense, there is nothing unusual about this: it is capable of arising in any case of damage falling short of a CTL. The difference in a case of what might be called 'commercial total loss' lies in the funding of the repair. In most cases, the hull underwriter does not have to pay until the repairs have been made and paid for; in those circumstances, if the owner does not have pockets deep enough to pay for them, then



he must look to his bank. Whilst a bank might be prepared to fund repairs costing about the same as the value they will restore to its security, it is less obvious that it would wish to do so where the repairs will cost a multiple of the value restored. But if the bank will not advance the repair funds - and if the hull and machinery underwriter (for whatever reason) delays or refuses to approve the necessary repairs - then the owner will find itself in breach of charter.

Quite apart from the practical difficulty, where the damage has yet to be repaired, of identifying the true extent of the damage or the cost of repairing it, the decision in *The Kyla* places not merely owners but their financing banks in a Catch 22 situation: refuse to (fund the) repair, and accept that the value of the security will be diminished to scrap, with the owner exposed to a potentially significant claim from his charterer (and arrest of other ships in the same 'fleet' in arrest-friendly jurisdictions such as South Africa); or fund an uneconomic repair, risking non-payment by underwriters and at least diluting the value of security (where there is cross-security on other vessels in a fleet) or even accepting a "negative equity" situation (where the vessel in question is the only one financed)?

In purely cash terms, the most attractive course for a bank may be to refuse to fund the repairs, require the owner to scrap the ship and pursue an unrepaired damage claim against underwriters - leaving the owner to fend for himself against charterers. For banks with close relations with their shipowners, this "bean-counter's" approach may not commend itself.

Conclusions

In a practical and commercial sense, therefore, the decision in *The Kyla* puts the mortagee bank in the eye of the storm which can arise between hull underwriters, owners and charterers in the case of serious damage. Given their acute interest in the extent and cost of repairs, in serious casualties, banks may well want to consider exercising the claims-handling powers often conferred on them under policy assignments.

An application for leave to appeal the judgment in *The Kyla* is currently under way.

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