

SHIPPING

THE 16 MILLION DOLLAR QUESTION AND ITS FRUSTRATING ANSWER

Introduction

The no-so-pithy question of law referred to the Commercial Court on appeal from Simon Rainey QC's arbitration award was:

"What is the effect on the doctrine of frustration of a clause in a time charterparty which requires that owners maintain H&M insurance at a stipulated level? In particular, is the insured value res inter alios acta [a matter concluded between other persons] when considering the owners' obligation to repair damage or does it create an assumption of risk and responsibility on the owners to repair hull damage up to this figure?"

Allowing the Charterers' appeal, Mr Justice Flaux held that the relevant clause created an assumption of risk and responsibility on the part of the Owners to repair the hull damage up to the insured figure of US\$16 million.

While the decision raised some eyebrows (not least the Owners'), especially among practitioners and commentators operating in civil jurisdictions, it is submitted that the Commercial Court's decision is the right one.

It remains to be seen whether the decision has a broader application to charterparties which contain the standard NYPE 1946 insurance clause or simply require owners to take out "full" or "adequate" insurance without stipulating the precise value of cover required.

Background

The Facts

On 6 February 2009, the vessel was chartered on an amended NYPE 1946 form for a period of 12 to 15 months in Charterers' option.

Clause 1 of the Charterparty provided that the Owners should keep the vessel in a thoroughly efficient state in hull, and holds, machinery and equipment. The Charterparty also included an express term at Clause 41 which provided:

"41.1 Owners warrant that throughout the currency of this Charter Party the vessel shall be fully covered by leading insurance companies/international Clubs acceptable to the

Charterers against Hull and Machinery, War and Protection and Indemnity Risk.

[41.2]

41.3 Insurance full style and value Hull and Machinery: USD16,000,000 London, Norway and USA Markets."

On 4 May 2009, the vessel was struck by another vessel while berthed at Santos, Brazil. There was no fault whatsoever attributable to the vessel.

Owners gave notice of abandonment to their H&M underwriters insisting that the vessel was a constructive total loss on the basis of surveyors' reports which indicated that the cost of repairing the vessel would be in excess of her sound repaired value. After tendering notice of abandonment to H&M underwriters, the Owners informed the Charterers that the cost of repairs would exceed the market value of the vessel. The Owners, therefore, contended that the Charterparty had been frustrated.

Charterers disputed that the Charterparty had been frustrated and claimed against Owners for the losses they had suffered as a result of Owners declaring the Charterparty to be frustrated.

The matter was referred to arbitration.

The Law: Frustration-General Principles

The distinctive feature of the doctrine of frustration is that it immediately discharges the contract and all contractual liabilities, including any obligation to pay damages.

The doctrine was developed in *Taylor v. Caldwell* (1863) 3 B&S 826:

"...in contracts in which the performance depends on the continued existence of a given personal thing, a condition is implied that the impossibility of performance arising from perishing of the personal thing shall excuse the performance."

It was then extended to circumstances where the commercial adventure envisaged by the parties had been prevented, even without physical destruction.

The doctrine was reviewed and refined by the House of Lords in *Davis Contractors Ltd v. Fareham UDC* [1956] AC 696. Lord Radcliffe said that the test for frustration was whether the circumstance in which performance is called for has rendered it radically different from that which was undertaken in the contract. Lord Reid considered that the key question was whether the contract made was wide enough to apply to the new circumstances.

In *The Super Servant Two* [1990] 1 Lloyd's Rep 1, Bingham J said that the doctrine should not be invoked lightly and must be kept within narrow limits and held that the frustrating event must take place without the fault or blame of either party, and the frustration of the venture must not be due to the act or election of the party seeking to rely on it.

In *The Sea Angel* [2007] 2 Lloyd's Rep 517, Rix LJ proposed a multi-factorial approach to the application of the doctrine of frustration. Among the factors which have to be considered are the terms of the contract itself, its matrix or context, the parties' knowledge, expectations, assumptions and contemplations, in particular as to risk, as at the time of the contract, at any rate so far as these can be ascribed mutually and objectively and then the nature of the supervening event, and the parties' reasonable and objectively ascertainable calculations as to the possibilities of future performance in the new circumstances. Rix LJ reiterated that the purpose of the doctrine is to do justice and the interests of justice should be used as a "reality check" when applying the doctrine.

The Arbitration

maritime lien and a statutory lien. That a maritime lien is not The principal dispute in the arbitration was whether the Charterparty was frustrated. The arbitrator held that the damage to the vessel caused by the collision would have taken approximately 180 days to repair, and that this was insufficient to frustrate the Charterparty. In relation to the cost of repairs, the arbitrator held repairs would have cost US\$9 million. The parties agreed that the vessel's sound market value at the date of collision was US\$ 5.75 million.

On the basis that the likely cost of repair far exceeded the sound market value of the vessel, the Owners said that the vessel was a "commercial total loss". The Owners asserted that there was a general principle, peculiar to charterparties, that a charterparty would usually be frustrated where the vessel was damaged such that the cost of repair exceeded the value of the vessel.

The Charterers countered that, even if there is such a general principle, clause 41 was part of a scheme whereby the Owners were obliged to repair the vessel up to the insured value of US\$16 million.

The arbitrator first considered the position generally without reference to the specific terms of the Charterparty. He then reviewed the relevant cases and determined that there was such a general principle and, applying the principles laid down in *Davis*, considered that performance would be radically different if the Owners were obliged to repair.

The arbitrator then applied the "reality check" of the justice of the situation advocated by Rix LJ in *The Sea Angel*: If the Charterparty was frustrated, the Charterers suffered loss of use of the vessel for 6 months. If the Charterparty was not

frustrated, the Owners would have to repair the vessel "at a greatly disproportionate cost far exceeding the value of the vessel".

The arbitrator considered justice favoured the Owners. Clause 41 existed to give the Charterers the benefit of having a vessel which was fully and properly insured but fell short of an undertaking by the Owners binding themselves to use the insurance for a particular purpose and did not infer a specific undertaking by the Owners to repair the vessel using the insurance up to the insured value.

The arbitrator stated that a very clear and express clause would be required in the Charterparty to obligate the owner to repair in such circumstances and he did not consider clause 41 to be such a clause.

The Charterparty was held frustrated and the Owners were entitled to terminate.

The Commercial Court Decision

The Charterers argued that clause 41, 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 the Charterers.

He first considered the principles of the modern law of frustration (as discussed above). He then held there was no rule of law that a charter party would be frustrated in the event of a constructive total loss.

The Judge then considered whether, in light of the terms of the charter as a whole, the risk of the frustrating event had been contemplated and allocated between the parties. He concluded that the insurance clause had the result of creating a fund sufficient to repair the vessel, and so the risk that such repairs would be required had been contemplated and it had been agreed that it would lie upon the Owners. It followed that, as the charter had allocated the risk of the event it could not be a frustrating event.

In arriving at his decision, the judge applied an amalgamation of the tests for frustration formulated in *Davis* and *The Sea Angel*:

1. Was performance radically different from that originally envisaged?
2. Was the contract wide enough to apply to the changed circumstances?
3. A multi-factorial approach should be adopted, considering all the facts and circumstances, and whether holding the contract to be frustrated would be in the interests of justice.

The Judge also emphasised that the "reality check" discussed in *The Sea Angel* did not involve a consideration of events long subsequent to the alleged frustrating event.

If service under the Charterparty could not be performed as the Owners chose not to undertake those repairs, the cause of that inability to perform was not the original allegedly frustrating event but that commercial decision.

It is also interesting that Flaux J commented, albeit obiter, that the doctrine cannot apply to self-induced frustration and that it was the Owners' own decision not to deploy the proceeds of the insurance they had agreed to procure, which led to the inability to perform the charter service.

The Judge held that the Charterparty was accordingly not frustrated and that the Owners were in repudiatory breach of contract for failing to carry out the repairs and return the vessel to the Charterers' service to perform the balance of the charter period.

Comment

The doctrine of frustration was evolved to mitigate the rigour of the common law's insistence on literal performance of absolute promises. In this regard, the case has both modernised and clarified the doctrine of frustration by amalgamating the approaches advocated in *Davis* and *The Sea Angel*. At the same time, it has confirmed that the courts will always look carefully at the agreed allocation for risk as expressly reflected in the contractual terms and parties will unlikely be permitted to walk away from performance simply because this has become much more commercially onerous for one of them.

Nevertheless, as mentioned at the outset, the case does insert an element of unpredictability in the treatment of cases where the vessel's insured value is not stated in the charterparty.

In practical terms, the insurance terms in a charterparty should be considered carefully and, as always, care should be taken to consider the charterparty as a whole before concluding on whose shoulders risk and responsibility fall.

(The full case citation of *The Kyla is Bunge SA v Kyla Shipping Co Ltd (The "Kyla")* [2012] EWHC 3522 (Comm)).

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