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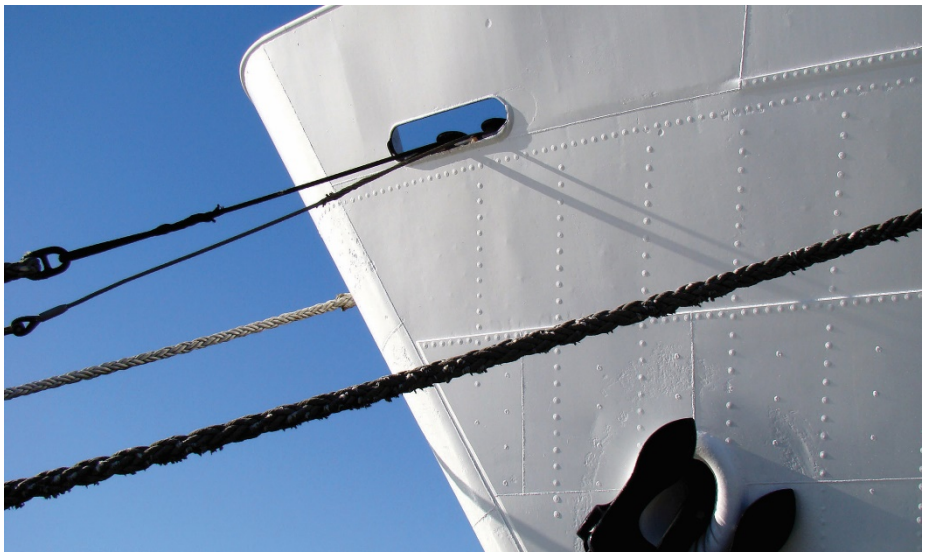
BRIEFING

SUPREME COURT CONSIDERS DETERMINATION OF "CONSTRUCTIVE TOTAL LOSS"

JULY 2019

- UK SUPREME COURT HOLDS THAT PRE-NOTICE OF ABANDONMENT COSTS TO BE TAKEN INTO ACCOUNT IN DETERMINING WHETHER A VESSEL IS A CONSTRUCTIVE TOTAL LOSS
- HOWEVER, SCOPIC REMUNERATION IS NOT TO BE TAKEN INTO CONSIDERATION



The UK Supreme Court's recent decision in *The Renos*[1] provides important guidance for both shipowners and insurers as to the costs that can be taken into account in determining whether a vessel is a constructive total loss under its hull and machinery policy.

"IMPORTANT GUIDANCE ... AS TO THE COSTS THAT CAN BE TAKEN INTO ACCOUNT IN DETERMINING WHETHER A VESSEL IS A CONSTRUCTIVE TOTAL LOSS."

The brief facts

The Renos lost main engine power due to a fire in the engine room whilst sailing laden with cargo in the Red Sea.

Owners appointed salvors on the 'no cure no pay' Lloyds Open Form ("LOF"), which included the Special Compensation Protection and Indemnity clause ("SCOPIC") under which the salvors would receive extra payment at set tariffs due to the environmental risk posed by the vessel, whether or not it was successfully salved.

The vessel was insured under a hull and machinery ("H&M") policy on the Institute Time Clauses – Hulls (1/10/83) for an insured value of US$12m. Owners said that the estimated cost of repairing the vessel exceeded its insured value, making it a constructive total loss ("CTL"). This would entitle owners to abandon the vessel to insurers and to be paid its insured value under sections 60 and 61 of the Marine Insurance Act 1906, which state:

[1] *Sveriges Angfartygs Assurans Forening (The Swedish Club) & Ors v Connect Shipping Inc & Anr* [2019] UKSC 29

> 60(1): "…there is a constructive total loss where the subject-matter insured is reasonably abandoned on account of its actual total loss appearing to be unavoidable, or because it could not be preserved from actual total loss without an expenditure which would exceed its value when the expenditure had been incurred."
>
> 60(2): "In particular, there is a constructive total loss –
>
> …(ii) In the case of damage to a ship, where she is so damaged by a peril insured against that the cost of repairing the damage would exceed the value of the ship when repaired. In estimating the cost of repairs, no deduction is to be made in respect of general average contributions to those repairs payable by other interests, but account is to be taken of the expense of future salvage operations and of any future general average contributions to which the ship would be liable if repaired…".
>
> 61: "Where there is a constructive total loss the assured may either treat the loss as a partial loss, or abandon the subject-matter insured to the insurer and treat the loss as if it were an actual total loss."

"THE COURTS HELD THAT THE NOTICE OF ABANDONMENT HAD NOT BEEN GIVEN TOO LATE."

After five months of discussions, during which conflicting figures were presented by the parties as to the estimated cost of repairs and whether the vessel was a CTL as a result, owners served notice of abandonment ("NOA") on the underwriters as required by section 62 of the Act, abandoning the vessel and claiming its insured value on the basis that it was a CTL.

However, the lead underwriters said they were only liable to pay for a partial loss of the vessel (namely its US$1.4m diminution in value) and not for a CTL (US$12m).

Owners therefore commenced court proceedings.

High Court and Court of Appeal decisions

The High Court and the Court of Appeal held in favour of owners, rejecting the insurers' arguments that:

1. The owners had elected not to abandon the vessel to the insurers. The courts rejected this argument – there had been no such election.
2. The owners could not claim a CTL on the basis that the NOA had been given too late, in breach of MIA section 62(3), which states:

> "Notice of abandonment must be given with reasonable diligence after the receipt of reliable information of the loss but where the information is of a doubtful character the assured is entitled to a reasonable time to make inquiry".

The courts held that the NOA had not been given too late. The owners had not received "reliable information of the loss" before giving the NOA, and so section 62(3) of the Act (which requires NOA to be given with "reasonable diligence after the receipt" of such information) was not triggered. Moreover, even if the owners had received such information, it could not be said that they had failed to give the NOA "with reasonable diligence" or within a "reasonable time": whilst five months was relatively unusual viewed in the abstract, the estimated repair figures

provided by the underwriters during the five months of discussions had suggested that the vessel was not a CTL, in addition to which there was no danger or immediate urgency requiring an immediate decision to be taken, nor was this a case where the owners had decided to abandon the vessel but had failed to communicate this to the underwriters.

3. The estimated cost of repairs did not exceed the insured value on the basis that the salvage costs, standby tug charges and other costs that had been incurred before the NOA was given could not, unlike post-NOA costs, be treated as costs of repair. The courts rejected this argument – the pre-NOA costs and SCOPIC remuneration were costs of repair.
4. The US$1.4m SCOPIC remuneration awarded to the salvors could not be treated as costs of repair as they were costs incurred to avert environmental damage which the vessel's Protection and Indemnity ("P&I") Club might otherwise be liable to pay, rather than costs of an H&M nature. The courts rejected this argument – the SCOPIC charges were costs of repair.

The lead underwriters appealed to the Supreme Court on the issues of the pre-NOA costs[2] and SCOPIC remuneration[3].

Supreme Court decision

Pre-NOA costs

The Supreme Court held in favour of the owners:

1. The case-law was of no assistance. The only two authorities that supported the insurers' position (*Hall v Hayman*[4] and *The Medina Princess*[5]) lacked reasoning and had not involved argument on this point. They were also controversial.
2. The language of section 60(2)(ii) did not, as the insurers were arguing, assist either:
   a. "Would" reflected the hypothetical character of the exercise, as opposed to (as the insurers were arguing) the date when the costs are incurred; and
   b. The reference to "future" salvage operations and general average contributions did not, contrary to the insurers' submission, point to any particular point in time and (the Supreme Court considered on an *obiter* basis) was probably limited to the treatment of general average contributions anyway.
3. Applying general marine insurance principles:
   a. The loss under an H&M policy occurs at the time of the casualty, not when it is ascertained at a later stage. The underwriters must hold owners harmless against that loss, and they are technically in breach of that obligation when the physical damage occurs.
   b. It follows from this that the reference in section 60(2)(ii) to the "cost of repairing the damage [exceeding] the value of the ship when repaired", is to the entire damage as from the date of the casualty, irrespective of when the cost of recovery/repair is incurred.
   c. The requirement to give NOA does not affect this analysis. Indeed, in certain circumstances defined by section 62(2)(ii), NOA is not needed.

"THE REFERENCE ... TO THE "COST OF REPAIRING THE DAMAGE [EXCEEDING] THE VALUE OF THE SHIP WHEN REPAIRED", IS TO THE ENTIRE DAMAGE AS FROM THE DATE OF THE CASUALTY, IRRESPECTIVE OF WHEN THE COST OF RECOVERY/REPAIR IS INCURRED."

[2] If pre-NOA costs were excluded from the calculation, estimated cost of repairs would be between US$9.1m and US$11.2m, i.e. less than the US$12m insured value.
[3] If SCOPIC remuneration was excluded from the calculation, estimated cost of repairs would be between US$11.8m and US$14m, rendering the vessel a CTL if the exact figure in that range exceeded the US$12m insured value.
[4] (1912) 17 Comm Cas 81
[5] [1965] 1 Lloyd's Rep 361

On this basis, the pre-NOA costs were to be taken into account.

SCOPIC remuneration

The underwriters asserted that the answer to the question whether an expense forms part of the "cost of repairing the damage" to the vessel for the purposes of section 60(2)(ii) depends on the characterisation/nature of that expense. On this basis, they said the SCOPIC charges were not such costs. By contrast, owners asserted that they were such costs because they were an integral part of the salvors' remuneration and had to be paid in order for the vessel to be salved.

"THE OBJECTIVE PURPOSE OF SCOPIC REMUNERATION IS TO AVOID POTENTIAL P&I LIABILITY FOR ENVIRONMENTAL POLLUTION. THIS HAS NOTHING TO DO WITH THE SUBJECT MATTER OF THE H&M POLICY, NAMELY THE HULL."

The Supreme Court rejected owners' argument, holding that the "costs" to which section 60(2)(ii) refers includes costs such as salvage charges, towage charges and temporary repairs, that are incurred prior to the vessel's reinstatement and whose objective purpose are to enable the vessel to be repaired. However the objective purpose of SCOPIC remuneration is to avoid potential P&I liability for environmental pollution. This has nothing to do with the subject matter of the H&M policy, namely the hull. The point can be tested this way: (i) if the owners had contracted with the salvors to salve the vessel and with other contractors to avoid environmental damage then (as the owners accepted) the environmental charges would not be preliminary to the repairs; whereas (ii) salvage charges, towage charges and temporary repairs would be preliminary to the repairs no matter who carried out these tasks. It followed from this that the fact that the salvors received the SCOPIC remuneration was irrelevant: one looks at the objective purpose of the remuneration rather than who receives it.

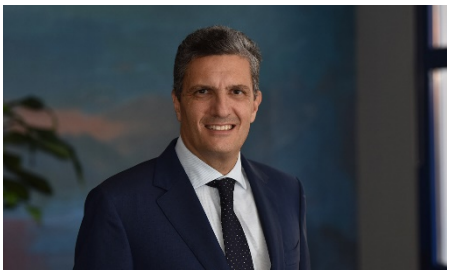
The Supreme Court remitted the matter back to the judge at first instance, to decide the exact amounts involved and whether the vessel was a CTL in light of the decision on the SCOPIC remuneration.

Conclusion

The Supreme Court's decision is principled and in line with industry expectations – certainly in relation to pre-NOA costs, but also with regards to SCOPIC charges, which are of a P&I nature rather than an H&M character – as were the decisions of the High Court and the Court of Appeal in relation to the NOA in light of the facts of this case. All three decisions will promote certainty moving forward and achieve a fair result.

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this briefing, please speak with one of the authors below or your regular contact at Watson Farley & Williams.



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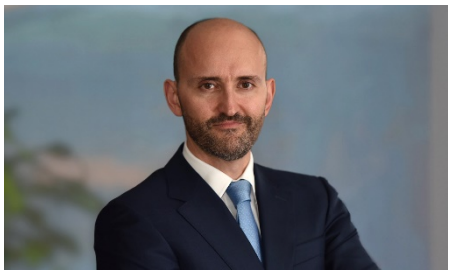

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