The Unreasonable cost of repairs

I chose for my topic for today, the "Unreasonable cost of repairs". In any claim, once you have established causation and coverage under the policy, this is the next big question that needs to be addressed.

You may have thought that with the hundreds of years of precedent that the marine insurance industry has had, that we would be pretty confident that we had this part of the equation right. It is fair to say that there have been relatively few cases in recent years which deal with this question for a Particular Average or partial loss claim. I suspect that this has more to do with the fact that the differences at stake are not financially significant enough to justify legal action and the matter is compromised rather than the issue never comes up or is, at least, thought about.

If one looks back through the cases, the decisions on the reasonable cost of repairs are usually allied with claims for Constructive Total Losses and very often as one of a number of issues which are in dispute between the insurers and shipowners.

The reason that it does occasionally come up in Particular Average cases (whether they result in legal action or not) is usually as a result of a fundamental difference of opinion about the correct course of action between the shipowners and the surveyor appointed by the insurers. A lack of effective or timely communication by one side or the other (or both) leads to a situation where the shipowner thinks he is being financially coerced in to doing something to his vessel which he does not think is advisable or the insurers' surveyor thinking that the shipowners are taking the insurers for a ride.

Very often, it is the Average Adjuster who has to try and be the voice of calm in the middle and establish what is reasonable. This is not always easy and there are certainly some topics and allowances which cause more problems than others. You often feel like a French rugby referee at the end of a British and Irish Lions verses All Blacks test match – whilst you are trying to just get it right, you know that not everyone will agree with your decision. The art of adjusting is often about being able to explain the reasonableness of your rationale and have it make sense to all parties. This can be challenging given that subtle differences in the circumstances surrounding a casualty or repair can lead to differing results. Things are rarely black and white and we all live and work in the "grey".

Helpfully a few relatively recent decisions by the Courts have established or re-established a few ground rules. Whether these have made the position clearer or increased the fog is a matter of opinion. Certainly some are perhaps slightly at odds with at least my perception of where the dividing line between reasonable and unreasonable lay.

It is worth, therefore, looking at some of these issues.

As is normal, the starting point has to be the Marine Insurance Act.

Section 69(1) provides:

Where the ship has been repaired, the assured is entitled to the reasonable cost of repairs, less the customary deductions, but not exceeding the sum insured in respect of any one casualty.

Simple enough one would have thought.

The first question should therefore be "What does "reasonable" mean"?

Geoffrey Edge, in his 1952 address to the Association of Average Adjusters quoted Stroud's Judicial Dictionary as saying:-

"It would be unreasonable to expect an exact definition of the word reasonable. Reason varies in its conclusions according to the idiosyncrasy of the individual and the times and circumstances in which he thinks."

What this is trying to say, I think, is that what is "reasonable" depends upon your point of view. What may appear "reasonable" from a shipowner's perspective, may not appear so from an insurers. The Shipowner will generally be looking to get the vessel repaired as fast as possible and back earning money. The insurers may be looking to get the vessel repaired as cheaply as possible and looking to justify not taking account of the owner's commercial issues by reference to the fact that loss by delay is not covered by the Institute Time Clauses (Hulls)[1]. The Marine Insurance Act gives us no guidance as to through whose glasses we should look at the problem from.

The Courts have, however, given us some guidance.

What is "reasonable" is what a "reasonable man" would do in the circumstances.

McQuire v Western in 1903 gave us the "man on the Clapham Omnibus" as the definition of the average "reasonable man". In his 1976 address, Bernard Dann (the eminent Average Adjuster from Liverpool) took issue with this definition and suggested the people on the Fazakerley Tram or the Birkenhead Ferry were no less reasonable. Being from where I am in New Zealand, I would add the commuters from Auckland or Wellington but may balk at adding our cousins from New Zealand's "West Island" in places such as Sydney or Melbourne.

The case law (such as the 2013 case of the "*The Irene M*") also regularly points to the test of what a "prudent uninsured shipowner" would do. As has been pointed out by others previously, many in this room may feel, with some justification that the words "prudent" and "uninsured" do not really belong in the same sentence together.

It was Bernard Dann, once again, who reminded us that the "prudent uninsured" is not some abstract fiction. All owners do considerable work on their vessels in maintenance and other areas which are not the subject of insurance claims - we do not only have to look at those few Owners who insure on Total Loss Only conditions. Where there are high

[1] Section 55 2(b) of Marine Insurance Act.

deductibles for instance, there may be many damage repairs which a shipowner undertakes where he is, in fact, uninsured regardless of whether he does those repairs prudently or not.

If an owner can show that he incurs a certain expense or does something a certain way when he is paying for it himself, then it will go a long way to providing evidence of what he (if not the man on the Clapham omnibus) considers to be reasonable.

Conversely, if he would not incur a certain expense if he were paying for it himself, then one would have to question whether insurers should be liable for the expense in the event of a valid claim.

It is much in this vein that the practice of allowing temporary repairs and the excess cost of overtime without to many questions for liner vessels came about. Owners of liner vessels which operate to an advertised schedule are more concerned about maintaining their schedule and keeping their regular customers happy than the additional one off cost of doing repairs a little more expensively. This has become accepted and any insurer who accepts a liner operator as an insured is deemed to understand that this is generally the "norm" for such operators.

Equally there is now general acceptance of airfreight as the normal mode of transport for most small to medium sized spare parts. Such things are the modern "norm" and most shipowners would incur the costs whether the work was for their own account or insurers'.

Back in the 1879 case of **Aitchison v Lohre**, Lord Blackburn gave us that:

"the actual outlay on the repairs, if bona fide made, would be strong evidence what the reasonable cost was."

Whilst this may not be a binding argument in all cases, it does somewhat put the insurers on the back foot where the repairs have been done a certain way and paid for.

The old case of **Field v Burr** is generally brought out as the authority that the insurers are only liable for the cheapest possible repair. Whilst more modern cases have been more generous to the Owners and, as I have mentioned, certain allowances are now the norm, the case of the **Brilliante Virtuoso pt. 1** in 2015 potentially takes this to a slightly new level.

You may recall that the vessel suffered from a fire as a result of an explosion set off in the purifier room by some persons who boarded the vessel off Aden in 2011. As a result of the fire, the vessel's engine room and accommodation were severely damaged and the vessel was left without power.

The claim was eventually struck out in 2016 due to the shipowners' inability or unwillingness to provide certain documents during discovery for during Part 2 of the trial on policy liability. Mr. Justice Flaux's decision in Part 1 of the trial, however, with regard to whether the vessel was a constructive total loss based on the reasonable cost of repairs exceeding the insured value, still stands.

There are several aspects of Justice Flaux's decision which are of interest – but I would like to concentrate on the simple one of the reasonable cost of repairs.

Following the casualty, the vessel was taken to Khor Fakkan where the cargo was discharged and the vessel then remained anchored in international waters for some time before being sold for scrap.

During this time repair specifications were drawn up and sent to repair yards in the Middle East and China.

In his judgement, Flaux concluded that the cost of repairs in Dubai in the Middle East would have been around $64.4m and the equivalent cost in a Chinese yard (including the cost of the tow to get there) would have been around $53m. A substantial difference of $11.4m or 17.5%.

Given the size of the difference, one might be forgiven for assuming that the China option was the reasonable one and the one which the average shipowner on the Clapham omnibus would elect to take if he were uninsured.

Of interest, however, are the factors which Justice Flaux took in to consideration in determining that Dubai was the reasonable option.

- A two month tow from the Middle East to China is a substantial amount of time for the vessel to be out of action in itself.
- The quoted repair period in China was longer and the accepted evidence was that substantial time overruns in China were far more likely than in Dubai. It was acknowledged that any owner would want his vessel back up and running sooner rather than later.
- The tow itself represented a risky venture. With the potential for a further casualty from collision or grounding and potential liabilities for wreck removal and pollution.
- Whilst the quoted costs of the Chinese repair yard was cheaper, there was a perceived risk of significant cost overruns.
- On the completion of the repair in China, the vessel would have had to make a substantial voyage back to the Middle East to be available for further employment resulting in more time and expense – although the wages and fuel consumed during the voyage would likely have been a part of the claim.
- There was concern with regard to the quality of repairs in China as compared to Dubai.

It is a long list of which the only one of direct interest to hull and machinery insurers is the possibility of cost overruns in China whether as a result of an increased repair specification or time delays leading to increased dock costs and general services.

A more enlightened insurer may also have concern with regard to the risk of the tow and the quality of repairs for fear of a future claim assuming that they were to remain on risk.

Issues, however, with regard to the commercial consequences of the length of the repair period and the potential for time overruns and the fact that the vessel may be out of

position for future engagements following the repair would not be factors which an insurer would, I would suggest, traditionally concern himself with too much – more especially if he is looking at a potential $11.4m saving in repair costs.

Even if there were a few cost overruns, there would have been a good chance that it would still likely end up significantly cheaper in China.

The judgement, however, makes us consider these other factors in deciding what a prudent uninsured owner might do. It would appear that if he would incur the additional cost for whatever justifiable reason, where the repairs for his own account, then they will form a part of the reasonable cost of repairs for which hull and machinery underwriters are liable.

Take a vessel which is on time charter for $5,000 a day, the charter having been entered into when rates were relatively high. A casualty occurs whereby the owners can save 20 days under repair by effecting a $50,000 temporary repairs and waiting to do permanent repairs until the vessels next scheduled docking. A prudent uninsured owner would likely say that *"if I can earn $100,000 for an additional 20 days work and incur $50,000 to do so, that is what I should do".* Does this make the temporary repairs reasonable?

Take a similar owner who only fixed his vessel for US$ 1,000 a day. He would likely say *"to spend $50,000 in order to earn $20,000 does not seem like a good deal"*. Would the incurring of the cost of temporary repairs therefore be unreasonable in this case?

To what extent do we have to take into account the particular circumstances of the particular insured? In the "Brilliante Virtuoso" the items to be considered would have influenced any owner regardless of their circumstances. The risk of the tow, the vessel being out of position, potential cost overruns, the quality of the repairs and uncertainty about repair times. There was nothing unique about the "Brilliante Virtuoso" and the issues to be considered would be the same for any owner.

What do we do, however, where the circumstances of the owner are unique? They may have an unusually lucrative charter which will influence their decisions on repairs. A tramp vessel may be in line for a particular voyage charter but they need to be at a certain place at a certain time and therefore need repairs done quickly and more expensively? Conversely, the vessel may be at the end of a charter and looking at a period of unemployment at the completion of the repair.

The Courts constantly remind us that every case needs to be considered on its particular facts. In this respect it is possibly unfair to pick out one sentence from Justice Flaux's decision but he stated:

"*it seems to me that the prudent uninsured owner <u>in the circumstances of this case</u> would have been entitled to conclude that it was preferable to carry out repairs in the Middle East…"*.

This would seem to suggest that we have to look at the particular circumstances of the particular owner and all of the factors that may have influenced his decision on where and how to repair the vessel. This may then beg the question as to whether the owners of

vessels on unusually lucrative charters, for instance, should declare this as a material fact in the placement of the risk on the basis that it is likely to influence the determination of the reasonable cost of repairs in the event of a casualty. Certainly, if they were to do so, it would deflate any arguments which insurers may have as to whether it should be a matter for consideration in determining the reasonable cost of repairs.

_____

The second case to look at is **Versloot v HDI**.

As with the "Brilliante Virtuoso" case, the legal proceedings have gained more fame for issues other than their consideration of the reasonable cost of repairs. The case is noted for Supreme Court's decision in 2016 with regard to the consequences of using a fraudulent device during claims negotiations. However, the original 2013 High Court decision by the Honourable Mr. Justice Popplewell has some interesting points.

In January 2010 the vessel's engine room flooded as a result of a crack in an emergency fire pump which allowed seawater to enter the vessel. There was an intricate debate as to whether the loss was or was not a peril of the seas and various other issues which, though interesting, are not relevant to this discussion.

The issue with regard to the reasonable cost of repairs was with respect to the cost of replacing the old engine with a new one.

The cover was based on the Institute Time Clauses (Hulls) 1/10/83 which, as I am sure you will be aware, contains the "New for Old" clause which states simply *"Claims payable without deduction new for old".*

The Owners claimed that this meant that once it was determined that the old engine was irreparable, they were entitled to a new one. Since no new similar engine was available, they had picked a new alternative equivalent and that, therefore, was the reasonable cost of repairs under the terms of the policy.

The insurers pointed out that a reconditioned engine similar to the original was available and that therefore set the benchmark for what was the reasonable cost of repairs.

In one of those rare moments which, no doubt, result in a mischievous twinkle to the eye of all judges, Justice Popplewell declared that they were both wrong.

He first reminded us that the "New for old" clause is not a license for a shipowner to go out and buy new parts for their vessel whenever they get damaged. The first consideration is "what is the reasonable cost of repairs"? If the prudent uninsured owner would source and buy a reconditioned or second-hand engine, then the cost of doing that is the reasonable cost of repairs. Only if the repair requires the purchase of a new part, does the "New for old" clause come in to play and mean that the so called *"standard deductions"* (typically one third) which used to be applied for betterment do not need to be applied.

However, in this case, the old engine had been de-rated from 1,324kW to 749kW. This allowed the vessel to operate with a Periodically Unattended Machinery Space under her minimum safe manning requirements. This, in turn, allowed the owner to save on the employment of up to three engineers and still be compliant.

Due to changes in Class and other regulations since the time of the old engine having been de-rated, had the owners replaced the damaged engine with the similar second-hand replacement, they would not have been able to de-rate it and would therefore have been required to sail with additional engineers.

The judge therefore decided that the second hand engine was not a like-for-like replacement and the purchase of the new (lower powered) unit, which allowed the owners to maintain their unmanned machinery space accreditation, represented the reasonable cost of repairs.

Whilst the circumstances of the claim may be unusual, they remind us that:

1. Before the new for old clause can be engaged, the purchase of a new part has to be in itself the reasonable thing to do. If the prudent uninsured owner would look for a reconditioned or second-hand part then that will be the benchmark for the reasonable cost of repairs.
2. That the owner is entitled to be put back in the same position as he was before the casualty. If the proposed repair will not put the owner in the same commercial or technical position he enjoyed prior to the casualty then it will not be a reasonable repair.

The last area I would like to look at is the allowances for superintendence. As most of you will know, when a vessel is repaired it is common for a shipowner to send one of his technical department members to attend the repairs with a view to agreeing the scope of work required, negotiating with the repairers, ensuring the repairs are done correctly and liaising with Class and other surveyors. Where the repairs to an insured casualty the insurers will pay the fees and expenses of the superintendent.

Why and how much to pay?

On one level this is a very strange allowance. The superintendent's salary would be paid by the shipowner whether he was working on the repairs or not. Insurers are not expected to pay the cost of the finance team paying the repair invoices or for the shipowner's management team and other overheads. The superintendent's salary is not an additional expense as a result of the casualty.

Historically, where repairs were done at overseas ports, a master would engage the services of a local marine surveyor to assist him in arranging the repairs. The surveyor would be

familiar with the good repairers and what the appropriate local rates were for the work. It would be evident that the engaging of such a surveyor with local knowledge would be for the benefit of both the shipowners and the insurers.

With the advent of modern travel, it became common for the shipowners to send their own technical people to the repair. The advantage of this is that they are more familiar with the vessel, her history and the shipowner's requirements.

The allowance of the cost of a shipowners' superintendent is therefore as a quasi-substituted expense for the cost of a local surveyor. It is interesting to note that the United States and Canadian Association of Average Adjusters have a rule of practice which prohibits making allowance for superintendence where repairs are done at the vessel's home port. This is presumably on the basis that it would be unreasonable to hire a local surveyor when the superintendent himself is on the spot. There is therefore nothing to substitute for.

This issue came to relevance in the decision of Agenoria Steamships v Merchants Marine in 1903. A vessel had a casualty in New Zealand and went to Melbourne for repair. The owners sent their Superintendent from the UK at a total cost of around £750 on a £4,000 repair. This included a daily allowance of £3 3s which does not sound a lot until you figure out that it equates to around £1,200 a day in modern money.

The cost was deemed to be unreasonable on the basis that a competent local surveyor would have cost around 50 to 100 guineas. 100 guineas was allowed.

Should, therefore, the allowance be based on the cost of a local surveyor in the port of repair?

This would lead to a situation where the superintendent allowance for the same superintendent would be different depending on whether the repairs were being done in Europe or parts of Asia. I believe that we have moved on from this and the allowance for the superintendent now bears more relation to his cost than the historical substituted expense of a local surveyor. That said, however, I do not think we can completely lose sight of the comparative cost of a competent marine surveyor.

We are still left with the question, therefore, as to what is the appropriate allowance to make for a shipowners superintendent during casualty repairs? Should there be a standard allowance for instance?

My personal view is that they cannot be a one size fits all solution. I understand the Italian market do have a relatively standard amount (about $700-$750 a day) which the market is prepared to pay. That can potentially work where one is looking at relatively homogeneous insured fleet and where costs and wages are similar. Looking wider, however, it would not be appropriate for the same dollar allowance to be made to cover the cost of an expensive expatriate superintendent based in Dubai as compared to, say, the superintendent of a local

shipping company in parts of Africa, Asia or the Pacific Islands where salaries are significantly less. The allowance has to pay some relevance to the cost of the superintendent to the shipping company.

We are therefore left in the adjusters paradise of making an allowance which is reasonable given all the circumstances. Whether that amount is $500 or $1,000 a day will depend on the nature of the shipping company and the cost of the superintendent. It should be borne in mind however, that the allowance should not necessarily have to completely compensate the shipowner for the cost of the superintendent. The shipowner should certainly not be making a profit from his use after taking into account all overheads et cetera.

I understand that there have been some issues where shipowners have hired local marine surveyors as superintendents, occasionally at very generous rates, during damage repairs. As with any other cost of repair, one has to test whether the expense is reasonable.

Firstly, was the hiring of a superintendent a reasonable thing to do? In this, if the shipowner does not have his own technical department, does he normally hire a superintendent when doing work for his own account? This may be for a routine maintenance docking or for damage repairs for which insurers are not liable. If he does then it would help to suggest that the hiring of the surveyor was reasonable. If he does not and the repairs are not overly complex, then it would call into question whether the expense would be one incurred by a prudent uninsured.

Where a surveyor is reasonably engaged. The owner has the same duty to mitigate cost as he would with any other expense. This is both in relation to the daily fees charged and the time spent superintending repairs. Did the superintendent need to be there all day, every day? Being a local, presumably, it may have been possible for him to visit the yard for a few hours once or twice a day in order to effectively superintendent repairs and mitigate cost.

The reasonable cost of repairs is at the heart of all property insurance claims - be they marine or non-marine. What is reasonable, however, is not static. Changes in technology and communication as well as the judgements of the courts should constantly be prompting us to question what is reasonable in the current environment. This will not be static state and we need to be prepared to amend our views as the environment changes.

For those that want certainty I can only offer the advice which I have given the number of the underwriters I have worked with as well as a number of brokers over the years…… If you do not like the results that you are seeing in the policy wording - it is not that hard – change it or manuscript a wording.

Whilst strict compliance standards and IT system requirements can be blamed for stifling creativity in many of today's insurance and broking houses, my view is that insurers and brokers should not be frightened to make the policy fit their and their client's requirements rather than have their requirements shoehorned into what "the system" will allow. This is considerably easier to achieve in marine insurance (particularly hull and machinery) than in the more commoditised insurance products such motor or domestic property. If there are concerns about what the repercussions of a wording may be, ask and average adjuster – they are used to seeing issues from the claims side and picking through policy wording and thinking up the "what if" scenarios.

Thank you for your time and I will take in questions.

Willum Richards FAAA
Director
Willum Richards Consulting Ltd
30 Mataraki Place | Wanaka | Otago 9305 | New Zealand
T: +64 (0)3 443 5134 | M +64 (0)21 132 1863
willum.richards@wrconsulting.co.nz | www.wrconsulting.co.nz