LETTERS OF INDEMNITY:

SOME PRACTICAL CONSIDERATIONS

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1 Where a Letter of Indemnity ("LOI") is provided in relation to the cargo, it is invariably accepted in consideration of some act which is, at best, irregular – and, quite possibly, unlawful.

2 Because of this impropriety, the act or omission for which the LOI is provided will usually fall outside the scope of a shipowner's Protection and Indemnity ("P&I") cover. Typical situations are exemplified by the following extract from the Rules of the Standard P&I Club:

Extract from the Rules of the Standard P&I Club

20 The liabilities, costs and expenses … insured by the Club are the following …

20.20.1 Loss of cargo … arising out of any breach by the Member, or by any person for whose acts, neglect or default he may be legally liable, of his obligation properly to load, handle, stow, carry, keep, care for, discharge and deliver such cargo … or out of unseaworthiness or unfitness of the entered ship. …

PROVIDED ALWAYS THAT in relation to paragraph 20 of this Rule:

(i) There shall be no recovery … if the contract of carriage … is not subject to the provisions of the Hague Rules or Hague-Visby Rules or to equally wide exemptions of the carrier from liability …

(iv) There shall be no recovery … in respect of liabilities which arise out of … a deviation … by reason of which the Member may be deprived of the right to rely on defences or rights of limitation which would otherwise have been available to him …

(v) … there shall be no recovery … in respect of a Member's liability:

(a) arising out of discharge of cargo at a port or place other than that stipulated in the contract of carriage;

(b) arising out of the failure to arrive or late arrival … at a port of loading…;

(c) arising out of delivery of cargo carried under a negotiable bill of lading … without production of that bill of lading … by the person to whom delivery is made …;

(d) arising out of the issue of an ante-dated or post-dated bill of lading …;

(e) arising out of a bill of lading … issued with the knowledge of the Member or his Master with an incorrect description of the cargo or its quantity or its condition;

(f) for loss of … cargo [uncontractually] carried on deck …

3 It is no coincidence that these are the situations where the LOI comes into play. P & I Club cover is based on the principle of mutuality, and as a consequence will not normally respond where the member has voluntarily assumed unusual or additional risks. The shipowner or time charterer who acts in reliance on the LOI[1] must recognise that he is almost certainly doing so without benefit of P&I insurance.[2]

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[1] The person who issues the LOI is sometimes called the "*indemnitor*," and the person who receives the LOI and acts in reliance upon it, the "*indemnitee*."

[2] There is a common misconception that, if the shipowner obtains an LOI in "standard P&I Club wording", he has thereby repaired or reinstated his P&I coverage. This fallacy is discussed below.

4 In effect, the LOI replaces the P&I cover for the consequences of the act which it requires, and offers, at best, an imperfect substitute. Simply put, the act which is covered by the LOI is precisely the incident which closes the P&I umbrella. This means that the indemnitee must be very careful to ensure that the LOI will achieve its intended purpose – which, depending on the act which it covers, may well turn out to be legally impossible.

5 In practical terms, the effectiveness of the LOI's protection will usually depend on five main factors:

(a) the **enforceability** of the LOI;

(b) the **creditworthiness** of the entity issuing the LOI;

(c) the **legal capacity** of the entity issuing the LOI;

(d) the **terms** of the LOI; and

(e) the **beneficiary** of the LOI.

6 (a) **Enforceability** is a legal matter. As a matter of public policy, the law declines to give effect to a contract which involves the commission of a legal wrong. Because the LOI is being issued in return for a wrongful act, its enforceability will depend on the nature of that act, and the degree of knowledge which the shipowner possesses (or should reasonably be expected to possess) as to its consequences.

Where the wrongful act includes the fraudulent deception of an innocent third party,[3] the law will not enforce the LOI, but will set it aside in its entirety. The reason for this is easy to understand in theory, but sometimes difficult to remember in practice: as a matter of public policy, the courts will not enforce a contract where the *quid pro quo* is the commission of a wrongful act. Therefore, unless the shipowner can demonstrate that he did not know, and reasonably could not be expected to have known, the consequences of his wrongful act, the LOI is completely worthless to him. It is only where the shipowner can show that he did not know, and could not reasonably be expected to know, of the prejudice to a third party[4] that he will be able to enforce the LOI.

There are some circumstances where this difficulty will not arise – for example, where the owner delivers the cargo to a receiver identified by the charterer, and has no reason to believe that this is not the true receiver. The LOI will also be enforceable in certain cases relating to the issue of clean bills of lading – but only where there is honest doubt as to whether the clausing of the Mate's Receipt is appropriate.

Remember: it is not enough for the shipowner to say that he or his servant did not know for certain that the statement was untrue, or that he was unaware of whether it was true or not: he must be able to say with complete conviction: "Neither I nor my servants had any reason to suspect that it was not true." Given the existence of the LOI, this is likely to be a most difficult proof. As with "shut eye" negligence, the indemnitee's plea: "But I didn't actually know" is unlikely to be an effective defence. In the eyes of the law, commercial men are supposed to have a naturally suspicious mind and to be wise to any hint of fraud.

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[3] E.g. where a clean bill of lading is issued against a Mate's Receipt which is qualified ("claused") as to condition. The leading English judgment on this is the decision of the Court of Appeal in *Brown Jenkinson v. Percy Dalton*: see extracts attached as Appendix 1. There appears to be no more recent authority, and the case is always cited with approval.

[4] E.g. where he innocently delivers the cargo to the named consignee of an "Order" bill of lading on the instructions of a time charterer.

(b) **Creditworthiness** is ultimately a commercial matter. Will the party giving the indemnity be "good for the money" when the time of payment arises? If not, then additional security is probably required – typically, a bank guarantee. Bear in mind here that it may be years before the claim is raised against the indemnitee.

It is, of course, essential to ensure that the entity which issues the LOI is indeed the one with the deep pocket: a stranger to a contract is not bound by its terms. There is a very common mistake in this area. A time charter is negotiated with a solid and well-known "first class" charterer; but the contract is then finalised with a wholly owned subsidiary. The charter party allows the charterer to order the owner to deliver cargo without presentation of original bills of lading against an LOI signed by the charterer alone. It may be commercially reasonable to suppose that the parent will support its subsidiary – but it will only do this so long as its exposure is not too great. As soon as the going gets really rough, even the "first class" parent will cheerfully "drop" its child, leaving the owner with a worthless piece of paper.

Remember also that, just because a charterer is regarded as creditworthy for freight, this does not mean that he is automatically acceptable for the purposes of the indemnity: the owner usually has a contractual lien on cargo for unpaid freight, but no security for the LOI. As well, the freight is due fairly quickly, whereas the claim under the LOI may not arise for several years. The indemnitor who is sound today may be bankrupt in 5 years.

(c) **Legal Capacity** is related to, but distinct from, enforceability. Even if the LOI may be enforceable in the sense that it is not void for illegality, it may nevertheless have been improperly issued so as to become legally worthless (or, at best, costly to enforce). It is essential, therefore, that the LOI is executed by an individual having the power and authority to bind the legal entity in whose name it is given, and that it is dated prior to the commission of the act which it covers.

This aspect is easily overlooked. Having successfully focused on the terms of the LOI and the standing of the indemnitor, it is very natural for the owner to breathe a sigh of relief and forget to follow through on this important detail. Even worse, having obtained the charterer's promise to provide the LOI – quite possibly from a third party, such as its parent – the shipwner sometimes omits to follow through and make sure that everything is in place before he commits the act which is to be indemnified.

(d) The **Terms** of the LOI are crucial. In any event, the LOI can only be enforced in accordance with its terms, and indemnitors will not normally go beyond their strict liability.[5] As soon as a claim arises, the matter is put into the hands of their lawyers, and commercial considerations disappear. Even worse, the indemnitor itself turns out to be in receivership or liquidation, and the unsuspecting shipowner finds himself dealing with a trustee who has no power to depart from a narrow and legalistic interpretation of the LOI.

(e) Having the correct **Beneficiary** for the LOI may seem to be so obvious as to go without saying. But, as with any indemnity or damages claim, it is important that the entity claiming the benefit of the LOI is legally liable to pay the claim in the first instance, whether to an arms-length third party or to an associate or affiliate.

This is especially important where there is a time charter involved: in such case, the LOI must specifically identify all interested parties as direct beneficiaries.[6] In the first instance, the claim from the cargo interests will probably be raised against the shipowner, who will in turn claim against the time

[5] So, for example, some forms of "standard" LOI wording will protect the ship and its sister-ships against arrest, but will not provide similar protection to the property of the intermediate time charterer – typically, bunkers.

[6] Typically, the time charterer and the head owner. But this does not mean that the time charterer is obliged to pass on the LOI to the head owner if the latter will accept an undertaking which is less extensive.

charterer. If, as is most likely, this claim is valid, the time charterer will have to indemnify the owner; but he will only be able to claim under the LOI if he is a named beneficiary with the right to sue under its terms.

7 Some general points:

(a) It is essential to have the original signed LOI in hand[7] before doing whatever it requires. Otherwise, all you have to rely on is a promise (quite possibly only verbal) to issue such a letter, which, if the sums involved are large, will lead to expensive and uncertain preliminary litigation and may ultimately be unenforceable. It is very easy to fall into this trap.

(b) Remember that the consequences of the wrongful act required by the LOI may be much more serious than simply paying for the damage cited in the Mate's Receipt. Issuing a B/L which knowingly misdescribes the condition of the cargo may deprive the receiver of his right to reject the whole consignment. Do not be lulled into the belief that the shipowner's exposure is limited to the cost of making good the damage omitted from the clean B/L: the claim may be for loss of market on the entire cargo, or even for the full amount paid for the cargo by the innocent party.

(c) There is a common misconception that, if the LOI is issued in a form "approved" by the P&I Clubs, such as the so-called "P&I LOI for delivery of cargo without presentation of original Bs/L",[8] the shipowner's P&I cover is not prejudiced. This is quite wrong. In publishing their pro forma LOI, the Clubs are simply trying to provide practical guidance for their members in an area where they have prejudiced their cover.

(d) The decision to accept a Letter of Indemnity should always be taken at a senior level, and then only after discussion based on the principles set out above.[9] Remember, the fact that you are being offered the LOI at all is usually a very good indicator that you have no legal obligation to do what is being requested.

(e) It is no good trying to draft a proper LOI in a hurry. If you believe you are likely to be placed in this position, you should take legal advice in good time and have your own *pro forma* ready for use at short notice.

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[7] The LOI should always be dated prior to the action which it indemnifies.

[8] On which see further at §8 below.

[9] It is prudent to remember that the act which the LOI indemnifies may well have severe personal consequences for the individual who is directly involved.

For example, the House of Lords has recently held that the individual who knowingly issues a misdated bill of lading is personally liable for the consequences, regardless of his status in the company for whom he acted.

In the USA, the Pomerene Act states that: "*Any person who, knowingly or with intent to defraud, falsely makes ... any bill of lading purporting to represent goods received for shipment among the several States or with foreign nations, or with like intent utters or publishes as true and genuine any such ... bill of lading ..., or aids in making ... the same ... or issues or aids in the issuing or procuring the issue of ... a bill which contains a false statement as to the receipt of the goods , or as to any other matter, or who, with intent to defraud, violates ... any provision of this chapter, shall be guilty of a misdemeanor, and, upon conviction, shall be punished for each offense by imprisonment not exceeding five years, or by a fine not exceeding $5,000, or both.*" This certainly applies to export shipments. It may also apply to imports.

Section 1001 of 18 USC makes it a crime for anyone who, in any matter within the jurisdiction of any department or agency of the United States, knowingly and wilfully makes any false, fraudulent or fictitious statement or makes or uses any false writing or document containing such a statement. This statute has been used to prosecute corporate and ship's officers for false statements or omissions in log books or other documents presented to US Coast Guard or Customs, including the Oil Record Book.

(f) Owners sometimes carry an additional insurance known as Shipowner's Liability cover ("SOL"). From a quick reading of the policy, it might seem that this insurance is designed to cover just the sort of risks which the LOI deals with: for example, it usually refers to losses incurred where a clean bill of lading has been issued against a claused Mate's Receipt. Such a conclusion would be completely fallacious. The SOL cover is designed simply to repair the gap created in the P&I cover, and will respond only for liabilities for physical loss or damage as to which, but for the act which impaired the Club cover, the Club would have responded. As to the actual LOI, and the consequences of the act itself for which the LOI is issued, the SOL insurer will take exactly the same position as the P&I Club.

(g) Always bear in mind:

(i) that improving the security will do nothing to make the LOI more enforceable, nor will it repair any deficiency in the terms; and

(ii) that the indemnity will at best cover only those claims which fall squarely within the defined area of the indemnity: if the wording is not sufficiently wide, the LOI may apply only where there is a direct causal link.

8 The P&I Clubs publish a *pro forma* LOI for delivery of cargo without the presentation of original bills of lading. The current version reads:

> "*As soon as all original bills of lading for the above cargo shall have come into our possession to deliver the same to you, or otherwise to cause all original bills of lading to be delivered to you, whereupon our liability hereunder shall cease*."

This is obviously drafted with a specific situation in mind: the bills of lading are assumed to be delayed in passing through the banking system, and the receiver needs prompt delivery. The underlying assumption is that the receiver is indeed the true owner of the cargo.

But suppose that the receiver is not the true owner of the goods – for example, where the bank has not released the original bill of lading because it has not yet been paid, or has some other claim. The receiver (or the charterer) issues the LOI to the owner, and the owner delivers the cargo to the receiver. Subsequently, the bank's representative appears and presents the original bills of lading to the owner. By that act, he may well terminate the indemnitor's liability under the LOI – "*whereupon our liability shall cease*" – and this happens at precisely the moment when the shipowner needs to rely upon it.[10]

In this situation, the P&I wording is clearly defective; and owners and time charterers would be prudent to insist on deleting the offending last five words of clause 4 when they agree to accept an indemnity in this form.

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[10] Under the previous P&I form of LOI, which read : "*As soon as all original bills of lading … shall have arrived and/or come into our possession, to produce and deliver the same to you whereupon our liability hereunder shall cease*," the owner might have argued that such termination of the indemnity should apply only where the bills were delivered by the indemnitor itself, not by some other party falsely claiming to be the true beneficiary. But with the form in current use, the only argument open to the owner would seem to be that the surrender has not been made with the actual intervention of the indemnitor, - that is, that it did not actually "cause" this to happen.