

**LETTERS OF INDEMNITY IN
EXCHANGE FOR DELIVERY OF MARINE CARGO
WITHOUT PRODUCTION OF ORIGINAL
BILLS OF LADING**

By

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Shipowners who issue negotiable ("order") bills of lading are obligated by law to deliver the cargo only in exchange for an original bill of lading.¹ The same duty can be imposed on a shipowner by contract for non-negotiable ("straight") bills of lading.²

One of the most vexing problems facing shipowners today is the irresistible pressure to accept a letter of indemnity for delivery of the cargo without presentation of an original bill of lading. This dilemma is not new. It has persisted throughout much of the 20th Century.

I. Overview

The problem arises from the development of the ocean bill of lading as one of the world's most versatile trade documents. Simultaneously a bill of lading can have three distinct characteristics: first, it can be a contract of carriage; second it can be prima facie evidence that the goods were lifted by a vessel at a particular place on a specific date in apparent good order and condition for carriage to a named destination; third, it can be a negotiable instrument whose possession gives the holder bare title to the cargo and the sole right to take delivery of it. The last two characteristics of the bill of lading dovetail perfectly with another unusually versatile trade document, the letter of credit.

It is trite law that banks do not finance the purchase of goods; they furnish funds to buy documents. Principally bills of lading. So far, nothing has replaced them, although visionaries foresee a cyberspace solution which would eliminate the use in international trade of the bill of lading, if not the letter of credit as well.

In the meantime, the inherent delays from physical inspection, processing, and movement of paper documents, create a need for some device to avoid holding up the vessels actually

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¹E.g., 49 U.S.C. §80110(a)(2).

²Porky Prods. v. Nippon Express, 1 F. Supp. 2d 227 (S.D.N.Y. 1997), aff'd, 152 F.3d 920 (2d Cir. 1998) see C-ART v. Hong Kong Islands Line America, 940 F.2d 530 (9th Cir. 1991), cert. denied, 503 U.S. 1005 (1992); B.M.A. Indus. v. Nigerian Star Line, 786 F.2d 90 (2d Cir. 1986); Olivine Electronics v. Seabridge Transp., [1995] 3 Singapore L. Rep. 143.

delivering the goods. Especially in short sea trades, or when dealing in commodities like oil which can be resold a dozen times or more during a voyage, or in traffic with developing countries whose banking and communications systems as well as the skills of persons operating them, may be rudimentary. It is not unusual for several months to elapse before original bills of lading have traveled all the way down a long string of sales.

If ships were actually fixed with adequate demurrage rates, there would be no incentive at all for shipowners to accept a letter of indemnity in lieu of an original bill of lading. On the contrary, it is disadvantageous, if not dangerous to do so.

To begin with, the p. and i. clubs generally will not cover a misdelivery claim against one of their members who accepted a letter of indemnity in lieu of an original bill of lading. So, owners who take LOI's, instantly become uninsured for the consequences. In effect, the parties who give LOI's become substitutes for owners' p. and i. clubs.

Where an LOI pertains to a multimillion dollar cargo, and especially if the party who gave the LOI becomes insolvent, the magnitude of the shipowners' uninsured exposure could easily overwhelm even the most solvent shipping company. Moreover, the actual arrest of a ship for such a large uninsured claim may well deprive the owners of the use of their vessel -- and cut off her stream of revenues -- for months at a time. Even if the misdelivery claim eventually is resolved between the holder of the bills of lading and the receivers, owners will find themselves unable to obtain reimbursement of their own losses, for out-of-service time, if the party who gave the LOI is insolvent.³

What is perhaps most alarming is that LOI's are routinely accepted by relatively low level employees of owners, without the involvement of senior management. Indeed it is not customary for the financial officers of a shipping company to be consulted or even to be informed when an LOI is accepted for release of cargo to receivers. The values of cargoes covered by outstanding LOI's never show up on the company's balance sheet; nor are the company's major creditors kept informed.

Some shipping companies frequently and carelessly accept as LOI's, faxed documents which in common law jurisdictions might not satisfy the requirements of the Statute of Frauds for guarantees.⁴ Many shipping companies have no procedure in place to follow up on obtaining

³In The SAGONA, [1984] 1 Ll. Rep. 194 the shippers eventually recovered the sales price for the oil cargo, but the ship was tied up and out of service for more than two months.

⁴The Statute of Frauds requires that a contract must be in writing and signed by the party against whom enforcement is sought. It is not clear whether an LOI, as a form of guarantee, is subject to the Statute of Frauds. The law has been modified for sales of goods to allow for even unsigned documents, drafted by the party seeking enforcement, to be treated as evidence of a binding contract. The Statute of Frauds generally does not apply at all to maritime contracts -- i.e. oral charterparties -- are fully enforceable, as are fixture recaps sent by brokers. Accordingly, both shipowners and the parties offering them LOIs are used to making binding commitments routinely by telex and fax and are desensitized to the possible need for more formal documents like hard copies bearing personal signatures. Moreover, there have been reports in recent times about crudely forged signatures on faxed LOIs. J.R. Morris, Delivery of Cargo Without Production of Bills of Lading, a paper presented at the 26th Biennial Conference of the International Bar Association in Berlin, Oct. 1996; P. Smith, The Shipbroker, Feb. 1994.

original bills of lading in order to eliminate outstanding LOI's. As a result, a fair number of LOI's remain in force indefinitely until they are simply forgotten and overtaken by desuetude.

The situation is not much better for cargo interests. The broad guarantees provided by LOI's are routinely given to shipping companies by low level traffic employees of cargo traders. Receivers seem to assume that if they have already paid for the goods -- or are prepared to do so -- they do not expose themselves to any risk by giving an LOI. But, if the receivers are at the tail end of a chain of sales, and a party in the middle of the chain fails to make proper payment for the goods, the LOI would cover the claims by his seller above him in the chain. In effect, the receivers when they give an LOI are guaranteeing the solvency of all of the buyers of the cargo in the chain.

The heavy indemnity obligations which the traders assume toward the shipowners are not insured. The value of cargoes covered by outstanding LOI's never show up on the trader's balance sheet; nor are his major creditors kept informed. If a demand is made by a shipowner for a trader to honor his obligations under an LOI, the trader could easily be confronted with a mortal risk to the company. Indeed, the amounts involved are so massive, any prudent shipowner must assume that the guarantor who signed an LOI will not honor his obligations promptly, and may indeed seek to blame the shipowner for having created the problem supposedly covered by the LOI.

Where string sales are involved, there is generally no common practice for a CIF seller who has given an LOI, to get an original bill of lading back from the buyer to be used by the seller to retire the LOI. Nor are buyers, who take delivery by virtue of a seller's LOI, obligated to forward an original bill of lading to owners to retire the LOI. Even when an FOB contract is involved, and buyers who give LOI's end up taking physical delivery themselves, very often they will not bother to send owners the original bills of lading in order to cancel the LOI's.

Finally, banks who finance commodity purchases are also at risk when LOI's are used. In theory the goods represent security for the loan as long as the bank holds all three original bills of lading.⁵ But if the ocean carrier delivers the cargo in exchange for an LOI, the bank's security in the goods is impaired. There is no insurance to cover the bank's risk. At best, the bank gets as a substitute, a claim against the shipowner for misdelivery. For large value cargoes, however,

⁵The practice of issuing three original bills of lading in international commerce is very old. In the 17th Century, the Master kept one copy for himself and gave two copies to the Shipper. The Shipper, who often traveled with his own goods, kept one copy for himself. Especially for voyages among European, Middle Eastern and North African ports, the third copy was sent overland by horse to be given to the receivers in exchange for payment, and then used by them to collect the goods when the ship finally arrived. See G. Malynes, *Lex Mercatoria* 97 (London 1685). It is now customary for all three original bills of lading to be given to the shipper. When the bills of lading are negotiable (i.e., to order), the Master is obligated to deliver the cargo to whomever presents him with a properly endorsed original, an act which is said to accomplish -- i.e., void -- the other two originals. *Glyn Mills Currie v. East and West India Dock Co.*, 7 App. Cas. 591 (H.L. (E.) 1882). The potential for fraud in the use of three original bills of lading has been recognized and arguments have been made from time to time to abolish it. Indeed, the Comité Maritime International adopted a resolution in June 1983 that the "practice of issuing Bills of Lading in sets of two or more originals should cease." But centuries of custom die hard. *Id.* at 605; see Bonelli, *Delivery Without Production of Bills of Lading -- Legal Problems in Case of Fraud*, a paper delivered at the Colloquium of the Comité Maritime International in Venice, June 1983, p. 2. The practice continues to be almost universal, except in the United States domestic trades where only one original bill of lading is allowed. 49 U.S.C. §80112(a).

carried on much less valuable vessels owned by single shipowning corporations and flying flags of convenience, this could be cold comfort. The shipowner may have no reachable assets except the ship. The vessel could be highly mortgaged and, as noted above, the shipowner is himself uninsured for such misdelivery claims.

To be sure, often the bank's loss of security cannot come as surprise to it. In string sales of commodities, in order to enable all of the parties to pay for the goods on the same day, and therefore arrange for the efficient transfer of the bulk of the purchase funds from the ultimate buyer to the ultimate seller, the banks themselves give LOI's to each other in lieu of original bills of lading. In such circumstances, since the banks are giving and taking LOI's, often on a date after the vessel has already completed offloading at the discharge port (a fact which the banks rarely if ever ascertain), they know for sure and seemingly are indifferent that the original bills of lading will not be -- or in fact were not -- available to the receivers in time to exchange for the cargo when the ship arrived. It may be noted, however, that unlike ship and cargo interests, the banks are generally meticulous about forwarding original bills of lading down the banking chain in order to retire their outstanding LOI's.

Problems involving LOI's which the banks give to each other arise very infrequently. When they do, almost always it is because one of the traders in a string has become insolvent and his bank becomes unwilling to go through with financing the purchase by refusing, for example, to waive discrepancies in documents presented under a letter of credit.⁶ In the middle of the string the situation is awkward but not overly risky. The banks ordinarily work out an ad hoc arrangement amongst themselves simply to cut the trader in trouble out of the string. Only if that trader is the intended ultimate receiver do things become more complicated, since the need to find new receivers, perhaps at a remote location, can lead to much delay to the ship and perhaps negotiations with owners over new discharge port options.

Perhaps the most extreme variation of problems involving LOI's arises in a string of FOB sales, topped off by the last FOB buyer reselling the cargo on CIF terms. The middleman might well have to give an LOI to the CIF buyer's bank in order to collect under the CIF buyer's letter of credit, and the middleman would then have to give a second LOI to the shipowners in order to cause them to deliver the cargo to the CIF buyer. Having two LOI's outstanding from the same party for the same cargo not only multiplies the risk on that party, it also reduces the chance that, if anything went wrong, either the bank or the shipowner would be successful in getting the middleman to honor his overlapping indemnity obligations given to both of them at the same time to cover the same risk.

In short, the use of LOI's to obtain delivery of cargo, can create high anxiety, especially among shipowners who fear, quite rightly, that if a misdelivery occurs, they are exposed without insurance, without security and they are the most likely candidate for being left holding the bag.

II. Liability of Shipowners

Generally, a shipowner whose Master delivers cargo in exchange for an LOI instead of an

⁶See Mannesman v. Kaunlaran, [1993] 1 Ll. Rep. 89, 91; The SAGONA, [1984] 1 Ll. Rep. 194. It is said that in 50% of letters of credit, discrepant documents are presented. Fairplay, Aug. 22, 1991, p. 8.

original order bill of lading, has no defense to a timely claim for misdelivery asserted by the holder of the bill of lading.⁷ Unless the charter party contains a clause requiring the Master to deliver against an LOI, owners theoretically are entitled to cause the vessel to wait at the discharge port until the original bills of lading arrive.⁸ Or until owners receive an LOI in terms which are acceptable to them, such as countersignature by a bank.⁹ But, at least one commentator has observed that it is "commercially unrealistic" to hold up discharge because of a "technical delay in presentation of a bill of lading" and owners who demand that LOI's be countersigned by a bank would not be regarded as extending "reasonable cooperation" to charterers.¹⁰ In truth, in several trades, an owner who refused to agree to discharge against presentation of an LOI in lieu of an original bill of lading, or who insisted on a bank guarantee, could not find work for his ships.¹¹ Clause 16(d) of the printed text of the EXXONVOY 90 charter party expressly requires owners to

⁷Unimac v. C.E. Ocean Serv., 43 F.3d 1434, 1437n.6 (11th Cir. 1995); C-ART v. Hong Kong Islands Line, 940 F.2d 530, 533 (9th Cir. 1991), cert. denied, 503 U.S. 1005 (1992); Baretto Peat v. Luis Ayala Colon Sucre, 896 F.2d 656, 660 (1st Cir. 1990); B.M.A. Indus. v. Nigerian Star Line, 786 F.2d 90, 91-92 (2d Cir. 1986); Allied Chem. Int'l Corp. v. Companhia de Navegacao Lloyd Brasileiro, 775 F.2d 476 (2d Cir. 1985), cert. denied, 475 U.S. 1099 (1986); Porky Prods. v. Nippon Express, 1 F. Supp. 2d 227 (S.D.N.Y. 1997), aff'd, 152 F.3d 920 (2d Cir. 1998); Velco Enterprises v. S.S. ZIM KINGSTON, 858 F. Supp. 36 (S.D.N.Y. 1994), aff'd, 47 F.3d 1158 (2d Cir. 1995); International Knitwear Co. v. M.V. ZIM CANADA, S.D.N.Y. Dkt. No. 92 Civ. 7508 (PKL), Apr. 10, 1996; Sze Hai Tong Bank v. Rambler Cycle Co., [1959] A.C. 576 (P.C. (Singapore)); The HOUDA, [1994] 2 Ll. Rep. 541 (C.A.); Barclays Bank v. Commissioner of Customs, [1963] 1 Ll. Rep. 81, 88; The INES, [1995] 2 Ll. Rep. 144, 154; The SORMOVSKIY 3068, [1994] 2 Ll. Rep. 266; The FUTURE EXPRESS, [1992] 2 Ll. Rep. 79, 97-99, aff'd, [1993] 2 Ll. Rep. 542 (C.A.); The SAGONA, [1984] 1 Ll. Rep. 194; Strathlorne S.S. v. Andrew Weir, 49 Ll. Rep. 306 (1934), aff'd, 50 Ll. Rep. 185 (C.A. 1935); London Joint Stock Bank v. British Maritime Agency, 16 Com. Cas. 103 (1910); The JAG DHIR, [1986] 1 Ll. Rep. 1; Kamil Export v. N.P.L., [1996] 1 Victoria Rep. 538 (App. Div. 1993); The ZHJIANG KOU, [1989] 1 Ll. Rep. 413 (N.S.W. Sup. Ct.), rev'd on other grounds, [1991] 1 Ll. Rep. 493 (N.S.W. Ct. App.); Nissho Iwai v. Malaysian Int'l Shipping Corp., 167 C.L.R. 219 (Aus. 1989); ICC Arb. Award No. 6573 of 1991, XX Yearbook Commercial Arb. 110, 120; cf. Dorland Mgmt. v. M/V MSC DANIELA, S.D.N.Y., 96 Civ. 6747 (JSM), Dec. 31, 1997. Cargo owners have been awarded a recovery for misdelivery against a bond posted by an NVOCC. Axess Int'l v. Intercargo Ins. Co., 1998 A.M.C. 1022 (W.D. Wash.) Where a holder of a bill of lading settled with the receivers, the release did not protect owners from the former's claim for the balance. Impact v. International Freight Express, S.D.N.Y. 96 Civ. 5204 (DLC), Sep. 11, 1997; Bridgeport Mach. v. Concord Express, D. Conn., 3:96 Civ. 1145 (GLG), Mar. 26, 1997.

⁸The RICH DUKE, S.M.A. No. 3444 (1997); The HOUDA, [1994] 2 Ll. Rep. 541 (C.A.); The SIAM VENTURE, [1987] 1 Ll. Rep. 147, 150; Carlberg v. Wemyss, 1915 S.C. 616, 622-27. There were, however, disturbing reports in 1994 about Algerian courts awarding damages against shipowners who insisted on waiting for original bills of lading to arrive.

⁹A complicating factor is that American banks are not permitted to give such guarantees. Farmers' and Miners' Bank v. Bluefield Nat. Bank, 11 F.2d 83 (4th Cir.), cert. denied, 271 U.S. 669 (1926). An American bank could issue a standby letter of credit as a substitute for a guarantee but the paperwork and time involved make the letter of credit impractical for LOI's.

¹⁰W. Packard, Time to Give Industry Clean Bill of Health, Lloyds List, Feb. 20, 1995.

¹¹Where a time charter did not require Owners to accept LOIs from charterers, arbitrators ruled that owners were entitled to stop taking LOIs unless in the future they were countersigned by a bank, notwithstanding that it made charterers' efforts to employ the ship very difficult. The RICH DUKE, S.M.A. No. 3444 (1997). Before ruling the arbitrators did, however, review charterers' financial records and found them insubstantial.

accept such an LOI.¹² The standard riders of major tanker charterers go further and eliminate any requirement for the LOI to be countersigned by a bank.¹³

III. **Enforceability of LOI's**

Letters of indemnity are also used in the shipping industry in connection with issuing clean bills of lading for cargo not received by the vessel in good order and condition.¹⁴ The courts frequently regard such LOI's as unlawful, because the bills of lading often are used to trick buyers into paying full value for damaged goods, especially under letters of credit requiring clean bills of lading for drawdowns. Owners can, therefore, find themselves unable to enforce the LOI's, which are characterized as illegal contracts.¹⁵

But not all such LOI's are invalid. In cases where the Master and the shippers legitimately disagree whether the cargo is or is not in good order and condition, an LOI for a clean bill of lading may be enforced.¹⁶

The validity of LOI's given in lieu of original bills of lading to obtain delivery of cargo is not completely clear. Where the bills of lading are not just delayed, but have actually been lost, there are procedures for obtaining a court order at the discharge port, which authorizes release of the cargo in exchange for security from the receivers.¹⁷

¹²In The HOUDA, [1994] 2 Ll. Rep. 541, 557 (C.A.) Lord Justice Millett in dicta seemed to endorse the enforceability of such clauses. See also The SORMOVSKIY 3068, [1994] 2 Ll. Rep. 266, 274 [describes an LOI as "commonplace"]; A/S Dampskibsselskabet Torm v. Beaumont Oil Co., 927 F.2d 713, 720 (2d Cir.), cert. denied, 502 U.S. 862 (1991); The RICH DUKE, S.M.A. No 3444 (1997). Some members of the legal profession found this "surprising," since it could result in a contractual obligation of a shipowner to breach a statutory duty owed to the holder of a bill of lading. T. Howard and B. Davenport, The "Houda" Revisited, Lloyd's List, Sep. 9, 1994.

¹³E.g. Emerald Clause 6(A) republished in 2D Benedict on Admiralty Doc. No. 26-25A; see The DELFINI, [1990] 1 Ll. Rep. 252, 256 (C.A.). Arbitrators recently observed that where a charter gave charterers the option to assign the charter with owners' consent, which was not to be unreasonably withheld, owners could refuse approval of the assignment to a company without the equivalent financial standing of the original charterers, since owners were obligated to deliver cargoes against LOI's which were not countersigned by banks. Canadian Arb. No. 1/98, LMLN 494.

¹⁴M.M. Cohen, Letters in Exchange for Clean Bills of Lading, Fairplay, Jan. 27, 1994.

¹⁵Hellenic Lines v. Chemoleum Corp., 29 N.Y. 2d 904, 328 N.Y.S. 2d 858, 279 N.E. 2d 602 (1972); Metal Transp. Corp. v. Compania National Naviera, 268 F.Supp. 456 (S.D.N.Y. 1965); Brown, Jenkinson v. Percy Dalton, [1957] 2 Q.B. 621 (C.A.). In Demsey v. S.S. SEA STAR, 461 F.2d 1009, 1019 (2d Cir. 1972), where an LOI for clean bills of lading was enforced, the issue of illegality was not raised. See The LUX CREATOR, S.M.A. No. 3089 (1994); The MEXICAN TRADER, S.M.A. No. 1247 (1978).

¹⁶See Hamburg Rules art. 17(3), republished in 6 Benedict on Admiralty Doc. No. 1-3; cf. Canficorp v. Coromant Bulk-Carriers, 1985 A.M.C. 1444 (Can. Fed. Ct. App.).

¹⁷49 U.S.C. §80114(a); Eng. Sup. Ct. Order 17 and Order 29 Rule 2(a).

Rather than delay the ship or incur additional expense to store the cargo ashore pending the outcome of court proceedings, owners often will accept LOI's countersigned by a bank in lieu of the misplaced bills of lading and will then offload the cargo even without the benefit of a court order.¹⁸ The enforceability of such an LOI would appear to be unquestioned.¹⁹

But lost bills of lading are an imperfect analogy for delayed arrival of documents. It is always a surprise when bills of lading are truly lost. Owners would be expected to contact the shippers in order to be satisfied that the party seeking delivery of the cargo is entitled to receive it. Delays to the vessel awaiting responses to those inquiries would be for charterers' or receivers' account. Just the investigation alone alerts the shippers to the danger that the receivers might be trying to obtain possession of the cargo without paying for it.

By contrast, the delay of bills of lading is no surprise. It occurs frequently.²⁰ Although it has been suggested by one Court that before acting on an LOI, it must be shown to the Master's "reasonable satisfaction that the person seeking delivery of the goods is entitled to possession,"²¹ actually in practice Owners who are offered and are willing to accept LOI's rarely if ever engage in such an investigation unless they receive instructions from some third party not to offload the cargo.²² Indeed they might rightly fear that any inquiries by them would be resented as officious and burdensome. Charterers and receivers would almost certainly regard delay to the vessel while awaiting responses as wasteful and would refuse to accept the economic consequences of delay for their account.

But the failure of Owners to inquire eliminates a warning to sellers or factors about the need to protect their interests in the bills of lading as documents of title, lest delivery occur before they get paid. In such cases the LOI could facilitate a fraud on the receivers' creditors.

The potential for fraud is very much less for these LOI's than for LOI's given in exchange for clean bills of lading. But when enforcement is sought of an LOI for delivery of cargo without presentation of an original bill of lading, most often it is precisely because someone hasn't been paid for the cargo and his security interest in the goods was destroyed by the delivery of them to the receivers. There are no reported cases in which such LOI's have been invalidated -- or

¹⁸See Richardson, The Merchants Guide 75-76 (1998 ed.).

¹⁹In The SORMOVSKIY 3068, [1994] 2 Ll. Rep. 266, 274, the Court referred to the obligation of a shipowner, if the bills of lading have been lost, to release the cargo to the receivers, as an "implied" term of the contract of carriage.

²⁰In The SAGONA, [1984] 1 Ll. Rep. 194, 201 a Master testified that during 14 years of service in the oil industry, he had never seen an original bill of lading presented for delivery of cargo.

²¹The SORMOVSKIY 3068, [1994] 2 Ll. Rep. 266, 274; see R. Hewett, Securing a Clean Bill of Lading, Seatrade Weekly Newsfront, May 5-11, 1995, p. 13.

²²Where a putative holder of original bills of lading attempts to exercise a right of stoppage in transitu, which conflicts with charterers' orders to deliver the cargo to receivers, an appropriate solution for shipowners is to interplead both of them. Hanjin Shipping v. Procter & Gamble, [1997] 2 Ll. Rep. 341.

enforced.²³ Accordingly, there is still a shadow over their validity.²⁴

IV. P. and I. Club Rules

Historically, as their exposure to liability increased, shipowners protected themselves by expanding cover available to them from the mutual insurance of their p. and i. clubs. LOI's are the principal exception.

For about a century, p. and i. club rules did not refer at all to the practice of delivering cargo against an LOI in lieu of an original bill of lading. The clubs simply assumed that liability was not covered for owners' intentional breach of the contract of carriage.²⁵ In 1971, all of the clubs in the International Group revised their rules to exclude cover for misdelivery in connection with such LOI's except in some unusual circumstances, most often requiring discretionary approval of the club's directors.²⁶

The clubs take the position that an LOI is worth no more than the person who signs it.²⁷ Hence, cover for misdelivery under an LOI would be, in effect, insurance of creditworthiness of a third party; i.e., the risk that a stranger with whom some owners choose to deal will honor, and have the means to honor, his LOI obligation. Not all club members operate in trades where LOI's for delivery of cargo are commonly needed. Such members can make certain that in their own operations, delivery of cargo takes place only against presentation of an original bill of lading. They are, therefore, unwilling to share a great risk which they do not themselves encounter, in order to facilitate the operation of others who voluntarily take, or may be forced by commercial pressure to take, a more laissez-faire attitude about misdelivery of cargoes.²⁸

Under the pooling agreement of the International Group of P. and I. Clubs, LOI's for delivery of cargo fall within the category of "excluded losses" -- i.e., generally not subject to pooling

²³Cf. The ANTWERPEN, [1994] 1 Ll. Rep. 213 (N.S.W. Ct. App.). Where a [clause enforced which specifically protected Owners against misdelivery arising from a "fundamental breach"].

²⁴See Hewitt, Securing a Clean Bill of Lading, *Seatrade Weekly Newsfront*, May 5-11, 1995, p. 13. [If owners simply accept an LOI for delivery of cargo without presentation of original bills of lading and they do not make any enquiries into who actually owns the cargo, "then the indemnity will remain unenforceable as a matter of law.] It may also be noted that owners are unable to assert claims under an LOI if the cargo was not actually delivered under its terms, The AEGEAN SEA, [1998] 2 Ll. Rep. 39, 56 [ship sank enroute discharge port], or once the LOI has been cancelled. A.S. Dempskibsselskabet Torm v. Beaumont Oil, 927 F.2d 713 (2d. Cir.), cert. denied, 502 U.S. 862 (1991); cf. Chilewich v. N.V. ALLIGATOR FORTUNE, 853 F. Supp. 744, 756 (S.D.N.Y. 1994).

²⁵J.R. Morris, Delivery of Cargo Without Production of Bills of Lading, a paper delivered at the 26th Biennial Conference of the International Bar Association in Berlin, Oct. 1996, p. 8.

²⁶Id. at pp. 9-10.

²⁷Fenton, Covering the Danger Areas Over Bills of Lading, Ll. List, Jan. 25, 1995.

²⁸A similar conflict among owners in different trades prevented the p. and i. clubs from agreeing to issue Certificates of Financial Responsibility to meet the requirements of the U.S. Oil Pollution Act of 1990.

unless a majority of clubs in pool agree that club directors "properly exercised" their discretion in a particular case to pay a misdelivery claim involving an LOI.²⁹

In 1979, the clubs warned their members against accepting LOI's in lieu of presentation of original bills of lading. But by 1984, the clubs recognized that their members needed guidance about how to protect themselves in the ever increasing number of situations where the commercial pressure for them to deliver cargoes without presentation of original bills of lading was irresistible. Accordingly, while still warning members against engaging in the practice and noting particularly that misdelivery claims arising from doing so were not covered by p. and i. club rules, the clubs nonetheless printed a "standard form letter of indemnity" which notably required countersignature by a bank.³⁰

In 1988, the Steamship Mutual Club recognized that an innocent owner could be deprived of p. and i. cover as a result of fraud or carelessness by an agent who accepted an LOI for delivery of cargo. The club offered special insurance up to \$10 million against owner's vicarious liability for misdelivery arising from an agent's breach of obligations under bills of lading. Since the new insurance was not subject to pooling, it was reinsured in the market.³¹

The p. and i. clubs will not officially go on the record, but it is commonly believed that if an owner inquires and receives independent confirmation that a receiver is the proper party to take delivery of the cargo, and owner then accepts an LOI countersigned by a first class bank, he will be regarded as having acted reasonably and club directors would exercise their discretion to cover him for a misdelivery claim.

V. **Efforts by Trade Organizations to Help**

In the 1980's, the Chase Manhattan Bank organized a "registry" called SEADOCS which called for deposit of the original bills of lading and electronic transfer of rights to dispose of the cargo.³² It failed to attract widespread support, among other reasons, apparently because of the reluctance of other banks to promote a competitor's service.

²⁹J.R. Morris, *supra* at p. 12.

³⁰Copy of most recent text (November 1998) attached. During World War II, the United States Government printed a similar standard form "Guaranty for Delivery of Cargo or Issuance of Carrier's Certificate Without Surrender of Properly Endorsed Negotiable Bill of Lading" for use on ships operated by the War Shipping Administration. Copy of text attached. It too required countersignature by a bank. In 1994, the British Chamber of Shipping circulated for comments a proposed draft of an "Undertaking to be Given by Cargo Owners on the Delivery of Cargo Without Surrender of an Original Bill of Lading." Copy of text attached. Like the others, it too provides for countersignature by a bank. But in practice, it is actually quite rare for an LOI to be countersigned by a bank.

³¹Steamship Mutual Circular to Members, Nov. 1988. In 1992-1995, the biggest proportion of claims against ship agents entered in the International Transport Intermediaries Club, involved delivery of cargo without presentation of original bills of lading. P. Smith, Making Claims, 10 Ship Agent 35. See London Arb. 19/95, LMLN 419.

³²Gram, Registration of Bills of Lading As a Possible Solution, a paper delivered at the Colloquium of the Comité Maritime International in Venice, 1983.

In the mid-1990's, the Baltic and International Maritime Council took a look at the problem but concluded that emerging electronic data interchange (EDI) was the only likely solution. The International Chamber of Commerce reportedly is working on such an EDI project called E-100.

In 1995, a new cooperative banking scheme named BOLERO was set up to use EDI as a means of eliminating the need altogether for paper bills of lading and providing for orders to deliver cargo to be transmitted over the Internet.³³ At the moment, it seems to be an idea slightly ahead of its time.

In 1997, the International Maritime Bureau of the International Chamber of Commerce offered to establish a registry similar to SEADOCs,³⁴ but nothing has yet come of it.

Most recently, there was a news release about an EDI project, limited to single sales and not for string transactions, that was being organized under the name Trade Card.³⁵

VI. Entrusting an Original Bill of Lading to the Master.

About 20 years ago, in order to avoid using LOI's, some traders adopted the practice of endorsing one of the original bills of lading in blank, and putting it in a sealed envelope for the Master to give to the ship's agent at the discharge port.³⁶ The cargo would be traded afloat and by the time the voyage was completed, the identity of the ultimate buyer would be known. The ship's agent would then be instructed by the charterer to open the envelope when he received it, and to give the original bill of lading inside back to the Master in exchange for delivery of the cargo to the ultimate buyer.

The Standard Club sought an opinion of counsel about the validity of the practice from Anthony Evans, then a Q.C., now a Lord Justice of the Court of Appeal. In 1981 Mr. Evans advised that he did not regard the practice as illegal.³⁷ He did, however, see it fraught with danger,

³³BOLERO is a joint venture between SWIFT, the global entity for transfer of funds electronically among thousands of banks, and the Through Transport Club, a mutual underwriter. See Banks Revel in BOLERO, Fairplay, Dec. 10, 1998, pp. 24-26; TT Club Is A Step Closer to Electronic Bills of Lading, Ll. List, Dec. 18, 1997; Ake Nilson, "Bolero" - Paperless Bills of Lading, BIMCO Bulletin, June 1997, p. 39. Although the International Group of P. and I. Clubs is "sympathetic to the aims of Bolero," recently all of the clubs changed their rules to exclude liabilities which arise under "paperless trading systems" such as Bolero which would not have arisen if a shipment had been made "on the basis of conventional documentation." See e.g. Gard Circular to Members No. 10/98, Dec. 1998.

³⁴Ll. List, October 31, 1997.

³⁵Trade Card is an initiative of General Electric Information Services based on the use of seaway bills in single sales and seemingly will not, at least in its early stages, be available for string transactions. Banks Revel in BOLERO, Fairplay, Dec. 10, 1998, pp. 24-26.

³⁶This practice was particularly feasible for delivered sales -- i.e., ex-ship at the discharge port -- since the buyer did not require an original bill of lading as part of the sales documents.

³⁷In Mobil Shipping & Transp. Co. v. Shell Eastern Petroleum (The MOBIL COURAGE), [1987] 2 Ll., Rep 655, the third original bill of lading was left on board for carriage with the ship's papers but the Master forgot to sign it. 00640ZST.WP5

because the ship's agent could have difficulty in identifying the representatives of the ultimate buyer at the discharge port. If the agent were to give the bill of lading back to the Master on behalf of the wrong party, a misdelivery would occur for which owners would be liable.

The International Group of P&I Club thereafter repeatedly recommended that owners not engage in the practice. But if commercially compelled to do so, the Master was advised by the clubs to endorse the other two bills of lading with the warning:

"One original bill of lading retained on board against which bill delivery of cargo may properly be made on instructions received from shippers/charterers."

It has not, however, become customary for Masters to add such endorsements, most probably because traders fear banks might treat the bills of lading as unclean and refuse drawdowns under letters of credit.

Despite the misgivings of the p. and i. clubs, it is believed that the practice of giving an original bill of lading to the Master for carriage with ship's documents is commonplace. There have been no reported cases of a misdelivery because the wrong receivers were identified at the discharge port. If shippers or charterers are willing to engage in the practice, Owners are probably quite safe following it, although the lack of p. and i. cover for misdelivery is bound to be disquieting.

Particularly cautious owners might request an LOI in which the party giving the LOI acknowledges that the Master, in carrying and disposing of the third original bill of lading, is acting as a "borrowed servant of the shippers and that owners have no liability for his actions or defaults."

The charter contained a clause obligating charterers to give a letter of indemnity ("LOI") to obtain delivery without presentation of an original bill of lading. Charterers refused to give an LOI because the Master had an original bill of lading against presentation of which Charterers intended to take delivery. Owners, however, announced that the vessel would not make delivery against the third original bill of lading carried among the ship's papers, noting among other things that it was unsigned. In an extraordinary display of obtuseness, discharge of the ship was delayed three weeks until the other two original bills of lading, which had been signed by the Master, arrived at the discharge port. Owners claimed demurrage which charterers resisted. Owners and charterers stipulated that "a vessel is bound to discharge its cargo against an original bill of lading, including a signed triplicate, even though it is carried on board." *Id.* at 657. The Court held that owners were in breach of charter when the Master refused to sign the third original bill of lading, so delivery could be made against presentation of it, and accordingly demurrage did not accrue during the delay.

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VII. Living With the System

It goes without saying that owners are better off if they can avoid taking LOI's in lieu of presentation of original bills of lading for discharge of cargo. But they could well find LOI's unavoidable in today's weak freight market.

A. Seawaybills and Mate's Receipts

One way to find out if LOI's can be avoided is to ask whether bills of lading could be dispensed with. For example, if charterers are buying cargo FOB on open account for their own consumption, they may not need bills of lading at all. Instead of agreeing to accept an LOI, owners might propose instead that only seawaybills or mate's receipts be issued by the vessel. Discharge would then take place at charterers' own facility simply in compliance with the voyage orders and without the need for any documentation at all.

B. Carriage of One Original Bill of Lading by the Master.

If charterers are selling the cargo on a delivered basis --ex-ship at the discharge port -- owners could suggest that the Master carry one original bill of lading to the discharge port. See part VI, supra.

C. Endorsement of the Bills of Lading

If charterers are buying cargo for their own consumption and therefore control the wording of the letter of credit, they might agree to allow the bills of lading to be endorsed:

"Master authorized to release cargo against tender of a letter of indemnity but owner and vessel to remain responsible for misdelivery until Master receives original bill of lading."

Such an endorsement would at least make certain that the LOI was enforceable by owners against the guarantors, and eliminate the risk of the Brown, Jenkinson case. See part III, supra.

D. Making the Text of the LOI More Effective.

The p. and i. clubs have provided draft terms for an LOI, a copy of which is attached to this paper. There are some amendments to the p. and i. club wording which owners could insist upon in order to make the LOI more effective.

1. **Identity of the Guarantors**

Since the LOI will be a substitute for p. and i. cover, it makes sense for owners to do what they can to get it signed by the most solvent guarantors. The clubs recommend that the LOI be countersigned by a bank. But in many trades, especially in today's market, this is simply not feasible.

On the other hand, owners all too frequently agree in their charters to accept an LOI from the charterers. But in making delivery of the cargo, owners will already be acting in compliance with charterers' orders. Charterers promised in the charter to give only lawful and proper orders. If they fail to do so, they will be liable to owners for any damages owners thereby incur.³⁸

An LOI from charterers, then, is simply a second promise from the same person. Two such promises are no better than one.

Moreover, often named charterers are just insubstantial subsidiaries of larger enterprises. Owners would be better advised to require that the LOI be given by the charterers' parent company, especially if it is a publicly traded entity.

Where the charter does not require owners to accept an LOI, but they feel commercially forced to do so, they should always at least look to see whether they would be better off taking the LOI from the receivers (or a parent company of the receivers) rather than from the parent company of the charterers.

There is also a risk in cases where owners "voluntarily" accept an LOI from a third party, that charterers may argue they only requested and never ordered delivery without presentation of original bills of lading. Hence, they will say, they cannot be held liable to owners for breach of charter if a misdelivery occurs since owners were free to turn down the request.³⁹ To guard against this possibility, owners should require charterers to agree, as a condition upon owners willingness to accept the LOI from the third party, that charterers' request will be deemed the legal equivalent of orders by charterers to deliver the cargo without presentation of original bills of lading.

2. **Security From the Guarantors.**

Since owners' property (the delivering vessel) is subject to arrest as security against misdelivery of the cargo, it would be fair to subject the property of charterers' affiliate, as LOI guarantor, to similar seizure as security for the obligations in the LOI. This can be done by creating maritime liens in a contract,⁴⁰

³⁸London Arb. 19/95, LMLN 419.

³⁹See The Vessel "S" Arbitration Award, Japan Shipping Exch. Bull. No. 34 p. 1 (1997); but see London Arb. 19/95, LMLN 419.

⁴⁰Cf. Textainer Equip. Mgmt. v. Baltic Shipping Co., 1995 AMC 840 (Can. Fed. Ct. App. 1994).

and using the guarantor's own vessels, or marine cargoes, and freights owed to the guarantor, as the security for the LOI. The following clause would be suitable:

"If this indemnity is not countersigned by a bank acceptable to you, we hereby grant you a maritime lien on all vessels as well as their appurtenances, marine cargoes, freights, hires, subfreights, subhires, accessories, and marine insurance proceeds belonging to us."

3. Avoiding Multiple Lawsuits.

Most charterparties provide for arbitration in London or New York. But the clubs' draft LOI provides for claims and disputes to be adjudicated at the High Court of Justice in London.

Hence, whenever a problem arises under such an LOI, owners usually must proceed in two separate fora in order to claim against both charterers and the guarantors. Apart from the extra expense caused by such an arrangement, there is always the risk that owners, as the common party in both proceedings will end up with the worst of all possible worlds, trapped by inconsistent findings.

Owners ought not to subject themselves to such double burdens. They can avoid them by requiring in the text of the LOI that claims against charterers under the charter party shall be consolidated in the same forum with claims against guarantors under the LOI. A suitable substitute for paragraph 7 of the club text would read:

"This indemnity shall be governed by the law of the place where the charter party provides for arbitration of disputes. Any dispute arising out of or in connection with this indemnity shall be subject to arbitration as provided in the charter party, with Charterers and every person under this indemnity appointing the same arbitrator. Arbitral proceedings under the charter and under this indemnity shall be consolidated."

E. Motivating the Guarantor to Step Forward Promptly

The formal procedure to force a guarantor to live up to his obligations under an LOI would be to sue or demand arbitration against him. But if the free movement of the ship is threatened by a misdelivery claim, it is unlikely the courts or arbitrators would move fast enough to provide owners with effective relief.

Considering what an oil cargo is worth, just the sheer multimillion dollar size of a misdelivery claim, is daunting. A guarantor who gives an LOI might well find it difficult to come up with the funds needed to release the vessel from arrest. In many cases, his credit could get so tied up generating those funds that his own ability to carry on business would be seriously impaired.

But traders, if they intend to stay in business, need to have their LOI's accepted by

shipowners, if possible, without bank guarantees. Publicity that a trader does not honor his LOI's would cause him major problems, if not greatly increase his cost of doing future business. Sometimes just an indication that owners intend to issue a press release, protesting the failure of a guarantor to honor an LOI, might be sufficient to cause the guarantor to step forward.

F. Shipowner Defenses.

Where a misdelivery actually occurs, owners have some, but only very few defenses to claims by the holders of original bills of lading.

1. Standing

Where an agent held on to the original bills of lading as security for his agency fees, the Dutch Supreme Court ruled that he was not entitled to require owners to deliver the cargo to him and, therefore, had no claim against owners when they delivered it to the receivers against an LOI.⁴¹

It is not unusual for a sales contract to provide that the buyer be shown as the shipper in the bill of lading. If the buyer's bank rejects the documents as discrepant under the letter of credit, the unpaid seller will end up holding the original bills of lading but without any documentation, showing his interest, on the face of the bill of lading or by endorsement. A Chinese court held that such a shipper lacked standing to sue owners for delivering the cargo to the buyer.⁴²

2. Ratification

Where cargo was released to the receivers against their LOI but later found to be contaminated, and the buyer's bank rejected the sales documents under the letter of credit, the seller (holder of the bills of lading) sued both the supplier for shipping nonconforming goods, and shipowners for releasing the cargo without production of original bills of lading. A Chinese court ruled that owners were not liable because the aborted sale was caused by nonconforming goods, not misdelivery, and when the seller sued the supplier for the damage, it acted as a "ratification" by the seller of owners' misdelivery.⁴³

⁴¹The HELIOPOLIS STAR, Netherlands Sup. Ct., Jan 27, 1995, summarized in 1996 Uniform L. Rev. 756.

⁴²H.X. Yao and H. Lin, On the Identity of the "Shipper" Under the Maritime Code of the People's Republic of China, 6 Int. Maritime L. 196, 197 (1998); Japan Shipping Exch. Bull. No. 32, pp. 20-21 (1996). The Chinese courts are split on this issue. H.X. Yao and H. Lin, *supra* at 197; see also Bridgeport Mach. v. Concord Express, D. Conn. 3:96 CV 1145 (GLG), Mar. 26, 1997 [shipper granted standing to sue by showing that the party named as "shipper" in the bill of lading was the shipper's subcontractor].

⁴³Y. Liu, On Carrier's Liability for Delivery of Cargo Without Production of Original Bills of Lading (The KOTA MAJU), [1996] Ll. Mar & Comm. L. Q. 30; Japan Shipping Exch. Bull. No. 32, p. 21 (1996). In yet another matter, a Chinese court protected owners from liability because the seller had negotiated and accepted partial payment from the buyer which the court once again regarded as a ratification of the misdelivery. *Ibid.* But American courts have held that where a holder of a bill of lading settled with the receivers, the release did not protect owners from the former's claim for the balance of the misdelivery losses. Impact v. International Freight Express, S.D.N.Y. 96 Civ. 5204 (DLC), Sept. 11, 1997; Bridgeport Mach. v. Concord Express, D. Conn., 3:96 Civ. 1145 (GLG), Mar. 26, 1997.

3. **Estoppel**

Owners can escape liability if they can prove that the holders of the bills of lading were estopped from making claims, because they expected the cargo to be delivered without presentation of original bills of lading.⁴⁴

4. **Shipowner Recoupment**

If owners are exposed to liability for misdelivery, they are entitled to sue the receivers for conversion of the cargo.⁴⁵

VIII. **Ending the Practice**

The situation is, of course, completely ridiculous. Shipowners' sole interest in world trade is to transport the goods. Whether or not sellers get paid is of vital interest to sellers. But it is not a natural concern of owners.

Yet, by taking advantage of a weak freight market, and threatening not to charter ships of owners who refuse to "cooperate," sellers have been able to force owners into acting, in effect, as quasi-sureties that sellers will get paid. What is more, sellers thereby avoid exposure to high demurrage charges for time that would otherwise be lost while the ships waited for the bills of lading to arrive. Not only is the practice convenient, but it is exceptionally cost effective, since it is free.

By contrast, even when fully collateralized, banks and bonding companies charge about 0.75% premia for similarly acting as sureties.

If the shipping industry wants to relieve the pressure on owners to accept LOI's, owners should be encouraged by their p. and i. clubs to charge for the service and to use the fees they collect to buy misdelivery insurance. The Steamship Mutual initiative establishes that there is insurance available in the market. Owners could, of course, pass on to charterers the actual cost of the insurance, as is done now with war risk and oil pollution insurance.

Or, if the shipping industry wanted to eliminate LOI's altogether, then owners could simply

⁴⁴Chilewich Partners v. M.V. ALLIGATOR FORTUNE, 853 F. Supp. 744, 755 (S.D.N.Y. 1994); cf. David Crystal v. Cunard S.S. Co., 339 F.2d 295, 298-99 (2d. Cir. 1964), cert. denied, 380 U.S. 976 (1965) [negligence of consignee's customer broker]; Mac Andrews and Forbes Co. v. United States, 23 F.2d 667, 668 (3d. Cir. 1928) [shipper's negligence misled delivery clerk into assuming that receiver was authorized to take delivery].

⁴⁵Evergreen v. Six Consignments of Frozen Scallops, 4 F.3d 90 (1st Cir. 1993); Westwood Shipping Lines v. Geo Int'l, Can. Fed. Ct., Dkt. T-359-98, June 24, 1998; cf. Mannesman v. Kaunlaran, [1993] 1 Ll. Rep. 89, 91 [suit against bank which received the proceeds of a string sale but refused to pay the supplier under a letter of credit because of discrepant documents]. Owners are not, however, entitled to sue agents of the party who caused the misdelivery where the agents were only carrying out the orders of their principals. Interocean S.S. Corp. v. New Orleans Cold Storage and Warehouse Co., 865 F.2d 699 (5th Cir. 1989).

charge a very high sum like 2% -- i.e., \$200,000 on a \$10 million oil cargo -- in much the same way that common carriers offer to issue ad valorem bills of lading for greatly increased freight rates. The market would quickly adjust to find a less costly way to deal with the risk of misdelivery, like seawaybills or EDI. While LOI's would remain available for a high price, as with ad valorem bills of lading, they would rarely be used.

CONCLUSION

The LOI is yet another example of how the shipping industry uses private contracts to achieve practical solutions to common problems. They are certainly convenient and easy to use. But, in effect, owners have been pressed into service against their will and exposed, solely as innocent bystanders, to enormous risks.

At the end of the day, steps to change the practice in order to get owners off the hook must come from the banking industry. Right now, the banks have no incentive to make a change. Money talks. If owners charge for the service, the banks' customers -- cargo interests -- will complain about the expense. The banks will then find a way to get the job done another way and cheaper.