The impact of insurance practices on liability conventions

By Erik Røsæg, Scandinavian Institute of Maritime Law

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1 Introduction

For some years, I have been involved in negotiations on maritime liability conventions in the Legal Committee of the International Maritime Organization. Being a member of and advisor to the Norwegian delegation, I am far from a neutral observer. However, some observations from this work, and from the study of texts to which I have or have not contributed, may still be of general interest. The theme of my observations is the impact insurance practices have when liability conventions are negotiated.

2 An outline of the problems

2.1 The interests

Among the relevant liability conventions are, of course, those that require that one of the parties take out insurance for the direct or indirect benefit of another ("compulsory insurance"). The basic interests are then those that warrant the insurance requirement, such as victims of pollution and cruise passengers. Insurance practices are taken into consideration in the negotiation of such conventions to ensure that the compulsory insurance later can be obtained at a not exorbitant price, and to evaluate the effect on the remainder of the insurance market.

However, insurance practices are also taken into consideration when liability conventions without an insurance requirement are considered. The potential *liable parties* will lobby to ensure that their insurance costs are kept to a minimum, and to avoid potential holes where the liability exceeds the available cover. Potential *claimants* will have the same interests to the extent that they feel that it is important not only to have a claim, but also to increase the chances that it is backed by insurance. Finally, the *governments* – the negotiators themselves – would balance the claimants' interests with the governments' commercial interests, including the protection of the national or international insurance industry.

Seemingly, insurers would not have any interest but the commercial interest in enhancing the demand for insurance. However, insurers surprisingly often intervene to warn against law reforms that would increase the demand for insurance or alter current insurance practices.

2.2 The conventions

It is well known that there is a plethora of multinational maritime liability conventions. Insurance practices may have different bearings on different types of conventions. Here, some typical groups will be presented.

1
Paradoxically, the more important maritime liability conventions have been *conventions for the global (general) limitation of maritime claims*,[1] which leave to national law all other liability questions but limitation. An analysis of insurance practices would reveal whether or not insurance can provide a rationale for limitation.

2
Conventions on the carriage of goods or passengers[2] include provisions on basis for liability as well as limitation of liability. Together with other clauses, they tend towards creating an almost coherent liability system within their scope. Insurance considerations may then affect the tenor of certain provisions, but most of all the limit of liability. In these conventions, both the part that benefits form limitation (the carrier) and the other part (the cargo owner or the passenger) have taken out insurance. Limitation is therefore used to delimit the risks of the two insurers.[3] Insurance considerations may be relevant when determining the best delimitation. E.g., the cost of liability insurance as compared to the cost of cargo insurance may be relevant. Such considerations are of another nature than insurance considerations used to limit the overall insurance exposure of an accident.

3
Pollution liability conventions, such as the Bunkers Convention, include traits from both of the groups of conventions referred to above. To some extent, they are comprehensive liability systems, where insurance considerations may affect certain clauses and the risk distribution between the parties. An example of a clause that is lobbied manly by insurers

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[1] International Convention for the Unification of Certain Rules of Law Relating to the Liability of Owners of Sea-Going Vessels, 1924; International Convention Relating to the Limitation of the Liability of Owners of Sea-Going Ships, 1957; International Convention for the Limitation of Liability for Maritime Claims, 1976; all with protocols.

[2] The more important ones are the International Convention for the Unification of Certain Rules of Law Relating to Bills Of Lading, 1924 (Hague Rules); Protocol to Amend International Convention for the Unification of Certain Rules of Law Relating to Bills Of Lading, 1968 (Visby amendments); Athens Convention Relating to the Carriage of Passengers and Their Luggage by Sea, 1974 (Athens Convention; with protocols), United Nations Convention on Carriage of Goods by Sea, 1976 (Hamburg rules).

[3] Erling Selvig: The Hamburg Rules, the Hague Rules and Maritime Insurance Practice. In: Journal of Maritime Law and Commerce 1981 p. 299 et seq. at p 308.

is the navigational aids exception in CLC[4] and all the conventions that use that convention as a pattern.[5] Victims of pollution, however, are – unlike cargo owners – frequently uninsured.

Insurance considerations in relation to pollution liability conventions also include what is considered the maximum insurable liability. When negotiating, one would make sure that there is insurance available. Frequently, the CRTD Convention[6] is set out as an example of conventions that have been negotiated without this sensitivity in mind, and has therefore never entered into force.

Several of the pollution liability conventions are supplemented by a second layer, financed independently of insurance.[7] It is a second layer in the sense that it is only brought into play when the first, insured layer of liability is insufficient. This second layer is financed by levies on the cargo, and organized around an international compensation fund.

When such a layer exists, it does, of course, influence the impact of insurance considerations in the first layer. First, exceptions from liability triggered by insurance considerations in the first layer may be more acceptable if the second layer compensates the victims anyway. Thus the navigational aids exception (referred to above) may be acceptable when there is a second layer, but it is much more difficult to defend where there is no such second layer (as in the Bunkers Convention). Furthermore, the existence of a second layer makes the ceiling of the liability (first layer) dependent on what is considered a fair risk distribution between the contributors of the two layers, rather than a question of which amounts are insurable. Still, however, insurance considerations may be relevant in the first layer if one gets close to what can reasonably be insured.

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4 International Convention for Civil Liability for Oil Pollution Damage, 1969 (CLC), article III(2)(c).

5 International Convention for Civil Liability for Oil Pollution Damage, 1984; International Convention for Civil Liability for Oil Pollution Damage, 1992; International Convention on Liability and Compensation for Damage in Connection With the Carriage of Hazardous and Noxious Substances by Sea, 1996 (HNS Convention); International Convention on Civil Liability for Bunker Oil Pollution Damage, 2001 (Bunkers Convention). The insurance provisions of a Protocol to the Athens Convention now being negotiated in the Legal Committee of the IMO also rely on the same precedent, but do not include the navigational aids exception.

6 Convention on Civil Liability for Damage caused during Carriage of Dangerous Goods by Road, Rail and Inland Navigation Vessels, 1989.

7 International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage, 1971 (Fund Convention); International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage, 1984; International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage, 1992; HNS Convention.

4
What is said about pollution liability conventions in general, to some extent also applies to the *nuclear liability conventions*.[8] These conventions, however, also include layers of state liability, and the state may have a particular interest in the activity. It is however likely that, although there is a second layer, one does not seek any kind of risk distribution between the first and the second (and further) layers. The State only covers what cannot reasonably be insured by the liable party in the first layer. Insurance considerations are, of course, of paramount importance for finding this maximum.

2.3 The problems as presented

For those having a special interest in the outcome of negotiations on a maritime convention, insurance considerations are, of course, used to support their argument. In particular, such arguments are useful to prevent the widening or enhancement of liability, given that responsible shipowners must be given a chance to insure their liability.

1
First, there is a *cost argument*. Insurance premiums demonstrate the cost of liability much more clearly than any estimates of future liabilities, and they focus on the costs of responsible shipowners rather than on those who, through carelessness or bad luck, have caused an accident. The problem is often that relevant insurers do not operate with public or general tariffs; each premium is separately negotiated. Therefore, the cost argument sometimes lacks the persuasive effect of figures.

2
Often, an argument is presented that regardless of cost, there is not enough *insurance capacity* in the market to cover the liability lawmakers[9] would like to have covered. The exposure is seen as all claims arising out of one incident, even if based on different conventions. One claims that even with the best will and the best premium offered it is not possible to get sufficient underwriting, neither in the short run nor in the long run.

The concept of insurance capacity is in itself unclear.[10] More important is the fact that the capacity is not determined in a way that can be scrutinized by others. The decisive factor seems to be the educated guesses of some selected London underwriters, or perhaps the opinion of the Boards of the P&I Clubs. In negotiations, this can both serve as the anchor in rough seas on which government negotiators choose to depend, or it can be seen as a bid in an auction where the limits can be pressed higher.

3
Even if insurance capacity is available, there is often a question of whether the convention under negotiation will create a lot of unnecessary administration, or indeed

[8] The basic conventions are the Convention on Third Party Liability in the Field of Nuclear Energy, 1960 (Paris Convention) and the Convention on Civil Liability for Nuclear Damage, 1963 (Vienna Convention), both with numerous amendments.

[9] In this article, the terms “lawmakers” and “legislators” include those state representatives that negotiate and conclude international conventions.

[10] See below 4.5 on limitation.

can possibly work at all. One example is warnings that the Bunkers convention would require a lot of new staff to administer compulsory insurance certificates.[11] Another is alleged delays in the settling of passenger claims caused by the multiple jurisdictions in the Athens Convention on carriage of passengers.[12] In all these cases the insurers sit on the relevant experience, and in practice determine to what extent they will participate in solving the problems.

4
A last group of insurance considerations that regularly are put forward, concerns *the effects on P&I Club Rules*. Quite often legislators are told that certain proposed articles of a Convention must be mended because they do not fit well with club rules. An example of this type of argument is that a group of persons should not be required to take out insurance unless they can be enrolled in a P&I Club together, or that the number of liable subjects should be limited to limit complicated recourse actions between clubs.[13] Surprisingly often, governments listen to such arguments instead of referring clubs to adapt their rules to the legislation. Paradoxically, the club rules enjoy a privileged position that is not enjoyed by national legislation in relation to conventions.

3 How insurance works

In order to evaluate these lines of argument, one must know something about the liability insurers.

3.1 P&I Clubs of the International Group

1
In international shipping, almost all vessels of a given size have taken out liability insurance with a mutual insurer called a protection and indemnity club. The clubs agree to reimburse the member, the shipowner, for his costs in relation to certain specified liabilities, and may also reimburse him or her in other cases. The member undertakes to pay a premium on an annual basis according to his or her tonnage and risk profile, and also to pay additional premium if the first estimate of the club was too optimistic.

More than 95% of the tonnage is entered in one of the major clubs, which are loosely organized in the International Group of P&I Clubs. The clubs of the International Group are the following:[14]

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11 See, e.g., IMO document LEG CONF.12/10 paragraph 8.

12 IMO document LEG 80/3/6.

13 See below 4.2 on channelling.

14 Official Journal of the European Communities L 195, 1999, p. 13. For a more detailed analysis, see JLT Risk Solutions: The Protection and Indemnity Review (London 1999).

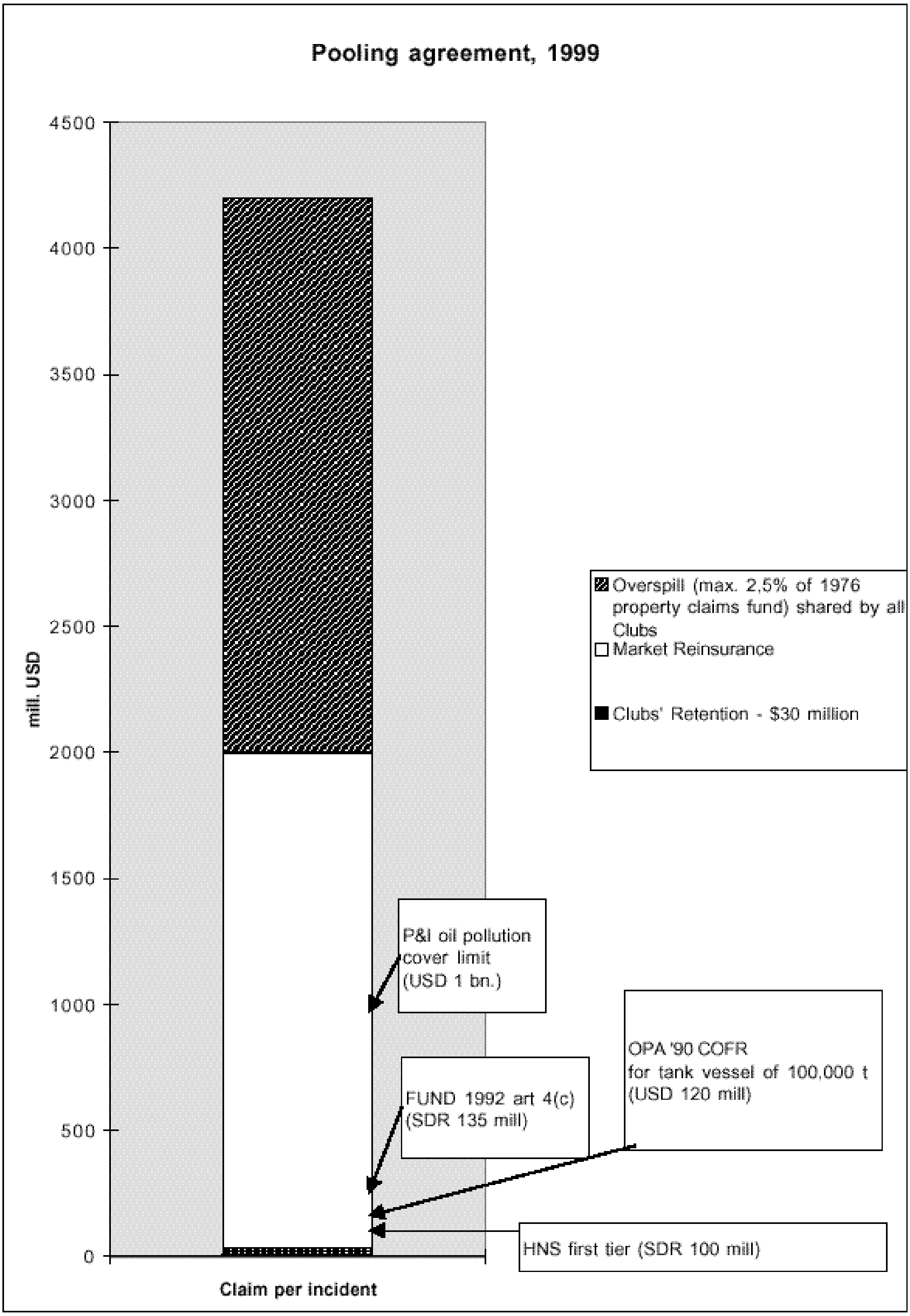
P&I Club	Tonnage insured (million GRT)	Market share (%)
American	5,3	0,98
Britannia	58,6	10,78
Gard	52,9	9,73
Japan Club	41,7	7,67
Liverpool & London	6,5	1,2
London	25,9	4,77
North of England	21,8	4,01
Skuld	42,5	7,82
SMP	6,9	1,27
Standard	29,5	5,43
Steamship Mutual	52,8	9,72
Swedish Club	11	2,02
UK Mutual	88,8	16,34
West of England	39,5	7,27
Total International Group	483,7	89

Most of the clubs are operated from England.

2
The most important part of the co-operation in the International Group is the Pooling Agreement. While only the clubs themselves are liable to pay towards their members, the clubs have agreed to pool the more significant losses. In that way, each club can insure much greater losses than its own members could be willing to contribute to. The effect of the agreement is that when there is a major maritime liability, most shipowners of the world would carry a small portion of the risk.

Graphically, the pooling arrangements may be illustrated by this column:[15]

[15] The chart has been made by the author, and has been used by the P&I Clubs in IMO Document LEG 81/5/3.


Pooling agreement, 1999
4500
4000
3500
3000
2500
2000
1500
1000
500
0
mill. USD
Claim per incident
Overspill (max. 2,5% of 1976 property claims fund) shared by all Clubs
Market Reinsurance
Clubs' Retention - $30 million
P&I oil pollution cover limit (USD 1 bn.)
OPA '90 COFR for tank vessel of 100,000 t (USD 120 mill)
FUND 1992 art 4(c) (SDR 135 mill)
HNS first tier (SDR 100 mill)

I use the 1999 agreement for illustration here for reasons of business discretion.[16] The principles have remained the same in subsequent agreements.

Some markers are put in to illustrate the relative size of the insurance compared to some limitation conventions.

The amounts are per incident. Which regime shall apply thus depends on the club's total payments in respect of any one incident, and not of the annual payments. This is important, because the small claims are the more frequent. Thus most claims, which in sum add up to a significant amount, belong in the first tranche. Claims of the last tranche ("overspill" claims over about USD 2 billion) are rare; indeed this part of the pooling agreement has not yet come into operation.

3

Particularly in the lower part of the figure, the scale does not allow sufficient detail.

The first layer goes up to USD 5 mill. Losses within this range are paid by the club where the ship that incurred the liability is entered, without any recourse to other clubs.

If the loss exceeds the first layer, the clubs distribute the exceeding loss among themselves and, therefore, among their members. The distribution of losses is by entered tonnage, claims statistics and other factors. This is called pooling, but is indeed a simple form of reinsurance. This layer goes from USD 5 mill to USD 30 million. There are two sub-layers. In the lower sub-layer (less than USD 20 million), the clubs share equally, while in the upper sub-layer, the club in which the loss occurred carries a greater part of the loss than the others do. Because of the first layer, the sharing formula and the extra share of the upper pooled sub-layer, the clubs have reasons to ensure that their tonnage and their members keep a certain standard, so that accidents are avoided.

On top of the pooled layer is the reinsured layer. It goes from USD 30 mill to USD 2 billion. This is external reinsurance, bought at Lloyd's of London. The magnitude of the contract – said to be the largest in the world – gives the club some negotiation power, but otherwise the effect is similar to reinsurance bought by the clubs individually. However, as the premium most likely is influenced by losses of previous years, this layer also includes some solidarity between clubs.

One should note that most major incidents end up in this layer. Insurance considerations in respect of the maximum amounts that can be reasonably insured (the insurance capacity) therefore, under the present arrangements, appear to be a question of what can be reinsured at Lloyd's of London.

Beyond the reinsured layer, the clubs share the losses by tonnage. This is called overspill. It provides great nominal insurance amounts, but it will not be easy to enforce the calls

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16 The 1999 agreement is described in the Official Journal of the European Communities L 195, 1999, p. 14 et seq.

on virtually the whole world fleet if such a loss should ever occur. And at this level, the clubs are no better than the contributions of their members.

There is a maximum on the overspill layer that is calculated on the basis of the limitation amounts pursuant to the 1976 LLMC for the entered fleet. It is presently calculated to USD 4,25 billion – a considerable amount.

4
Pooling requires some co-operation. Thus, clubs and members would not like to reimburse other clubs for claims that would not have been accepted in their own club. Therefore, the clubs have a certain co-operation on their conditions (club rules). It is remarkable that pooling works without more detailed conditions and claims control.

The pooling agreement has been scrutinized by the European Commission in many respects. After some minor adjustments, it now has the blessings of the competition authorities of the European Community for another ten-year period.[17]

3.2 Alternatives to the International Group Clubs

1
While the clubs of the International Group dominate the market, there are *some smaller P&I Clubs that are not members of the Group*. It may be that they would like to offer other conditions than the Clubs of the International Group offer, that they would not like the exposure arising from the pooling agreement or that they do not have the financial standing and membership base required for acceptance in the group.

Some of the independent clubs have reinsurance arrangements and other co-operation agreements with the clubs of the International Group. In this way, they may indirectly benefit from the co-operation in the Group. However, this would also tend to link them up with Group practices and conditions.

Although the non-group clubs represent an alternative to the major clubs, this alternative is quite limited. Therefore, when insurance practices are considered, the independent clubs are most often rightfully disregarded.

2
There are, however, insurers that are not organized as clubs. These are often called *fixed premium facilities*, because they do not retain the right, as do the P&I Clubs, to call for extra premium if the premium they originally charged was too small. They are, in other words, not mutual insurers, but ordinary insurance companies.

The following is a quite recent list of some major fixed-premium facilities for maritime liability insurance:[18]

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17 Official Journal of the European Communities L 195, 1999, p. 12 et seq.

18 From Bankassure Services Limited: The Bankers' Guide to Insurance Aspects of Ship Financing p. 110-111.

Short name	Maximum insured amount
DARAG (Germany)	USD 100 mill
Dragon (UK)	USD 500 mill
HIH (UK)	USD 500 mill
Axa (France)	USD 500 mill
Jonathan Jones (UK)	USD 500 mill
Osprey (UK)	USD 30 mill
Southern Sea (UK)	USD 500 mill
Terra Nova (UK)	USD 30 mill
Trampfhart (Germany)	ECU 500 mill

The maximum insured amounts are much lower than in insurance under the pooling agreement. However, the amounts are high enough to cover, e.g., the compulsory insurance under the HNS Convention.

It is likely that most of these insures are reinsured at Lloyd's of London. Thus, the capacity is not independent of that of the P&I Clubs: They all pour from the same sources.

There has been some skepticism towards the fixed premium facilities, because one does not know if they really are reinsured at all, or otherwise can carry a substantial loss. While the experience in this respect with the P&I Clubs of the International Group and Lloyd's of London is considered good, I believe that in all quarters, these facilities are considered unstable. Indeed, I am told that several of the entities in the list above already have ceased business. However, such entities are subject to the same solvency surveillance by governments as other insurers, e.g., under EC law.

3
A third group of independent insurers are the *providers of Certificates of Financial Responsibility under the US Oil Pollution Act*, 1990. These provide cover for risks that the P&I Clubs do not, for a number of reasons, wish to insure, although the amounts are moderate. (There is only a limited insurance requirement in OPA, and there is no provision to make the insurer liable over and above the limited amount.) However, these providers insure with recourse to the P&I Clubs. Thus, their actual exposure is limited to

what the P&I Clubs do not cover, which is very limited indeed. These providers are thus in reality not alternatives to P&I, but only tools to extend P&I coverage to the legally rough US waters. Therefore, their practice can hardly be relevant when designing liability conventions, unless, of course, one contemplates that such devices will be used in other areas.

3.3 Insurance costs

1
The insurance considerations of any lawmaker will at some stage regularly turn to the basic question: What is the price tag?

A price tag for proposed legislation is, however, difficult to produce. First, the P&I is a package with wide cover, where the effect of one single new convention is difficult to ascertain. Secondly, it may take years before the new convention enters into force, and the insurance market may have changed considerably in that interval. It is also likely to change during the lifespan of the convention. Thirdly, premiums are regularly negotiated individually based on previous claims, trading area, size of fleet etc. This makes the industry reluctant towards revealing premiums, and it would in any event be difficult to ascertain the effects of any specific governmental action.

2
The best way to estimate the costs would be to consult brokers. This was done at one stage of the current negotiations of a Protocol the Athens Convention on passenger claims.[19]

The broker first estimated the current passenger element of the reinsurance cost. He made the assumption that there was a 3000-passenger vessel of 100,000 gross tons. Realistically, this would operate with paying passengers, say 300 days a year. The relative part of the reinsurance cost of the International Group would then be about USD 0.88 per passenger per day. This is a fraction of the total operating costs of the vessel.

Enhancing the limits from SDR 175,000 per passenger to, say, SDR 350,000 per passenger, would make it more likely that claims would be made that would affect the reinsured layer of the P&I insurance, and thus expose the reinsurers. (If all passengers claimed the full limitation amount, this would add up to SDR 1,050,000,000; that is half way up the reinsured layer with the current USD:SDR exchange rates.) The broker who was consulted, suggested that the reinsurance costs in that case would be increased to USD 1.10 per passenger per operating day, that is an increase of USD 0.22 per day.

The estimate has been presented in the Legal Committee of the IMO and at a number of other occasions, and its realism has not been challenged. It does suggest that an increase of the limitation amounts is *not* very costly for the industry. But it also makes it clear that underwriters do not expect exorbitant increases in payments because of an enhancement

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19 The broker consulted was JLT Risk Solutions, on the recommendation of the International Group of P&I insurers.

of the limitation amount, and this may again suggest that the need for the new rules is moderate.

The costs of the smaller claims (below the reinsured layer) are not within the scope of this calculation. Arguably, an increase in maximum per passenger amounts, or similar per kilo amounts for cargo, will have significant effects on the payments at this level – that is, when the loss concerns only a limited number of passengers (or a limited amount of the cargo). This is an insurance consideration in so far as these expenses are pooled, and not borne by the carrier as a deductible under his or her insurance.

4 Insurance considerations and some key issues

After this overview of the insurance system, it is possible to examine more closely a few central insurance related concepts. To what extent have insurance considerations been important in developing and maintaining them? The analysis will focus on IMO conventions and IMO debates.

4.1 Sharing

1
The concept of sharing was first developed in the 1969 and 1971 Oil Pollution Convention, which again was based on the voluntary schemes TOVALOP and CRISTAL. The risk of pollution damage was to be shared between the carriers and cargo owners to the extent that damages were to be paid (and the victims were, in the same operation, secured that damages should be paid up to higher limits than before).

This very pragmatic solution to an acute problem (arising after the Torrey Canyon incident in 1967) has since then been adopted in quite a number of states, and has been followed in revisions of the oil pollution conventions and in the HNS Convention. In a way, the precedence is also followed in the Bunkers Convention and the Athens draft now being negotiated. The reason why there is no second tier in these conventions may very well be that the CLC/Fund Convention precedent suggests that the cargo should finance the second tier, and that there are no relevant cargo contributors in the context of these conventions.

2
On the surface, the widespread ratification of the CLC/FUNDC may simply be attributable to the fact that states can get hold of contributions form the IOPC Fund only by ratifying, and that the conventions are also acceptable otherwise. The success of the CLC/FUNDC as precedents may be due to reluctance towards redrafting texts, and that it is felt fair that shipowners should not be the sole responsible party when also the cargo owners profit from the fact that the goods are being transported.

3
A further analysis, however, demonstrates that insurance considerations have played a role in the formation of these schemes. The division between carrier's liability and the liability of the IOPC Funds – the second tier funds under the oil pollution Fund

Conventions – is obviously also a distinction between insurance and other financing of the claims payment. For the larger claims, one has designed a second tier[20] based on what one believes insurance cannot do. For the smaller claims, one could have used the same solution. However, one opted for a first tier that took benefit of the advantages of the insurance system.

It is generally believed that the amounts covered by the second tier are over and above what could have been insured, because they exceed the capacity of the insurance market. Thus the second tier creates capacity that was not there in the first place, because it is financed in a way that does not affect the insurance market at all (because it is financed by contributions by receivers of cargo). Thus, the limits of the insurance capacity makes the second tier necessary, and is therefore perhaps a motive for this arrangement.

It would be very possible to use the fund solution for all claims, and this was indeed considered by some in the HNS negotiations.[21] However, there is perhaps no reason to change an insurance system that functions well within the range of its capacity. The advantages are that claims are handled at a low level in the organization (while the international bodies of the IOPC Funds go into quite a lot of detail), there are few tendencies that claims handling gets political overtones, there is some competition in the market and the administrations is fairly simple, without contributions based on the receipt of cargo.

4

Although it is quite clear that the advantages and disadvantages of the insurance market have had some influence on the design of the two tier system, it not clear whether insurance considerations or other considerations have been decisive when determining the limit between the tiers in different regimes; the ceiling of the first tier. There are indications that some undefined notions of fairness have been decisive, rather than the assumed insurance capacity.

One such indication is the HNS Convention. When it was negotiated, there was for many years a debate on linkage; that is, possible techniques to prevent that the insurer should be exposed to both the full LLMC limitation amount and the full HNS limitation amount in the same incident. Linkage would enhance the conceived insurance capacity for HNS claims. However, at the diplomatic conference, the HNS first tier limitation amounts were set so low that there was no need for linkage.[22] Thus, the second tier was extended downwards more than strictly necessary, so that it also covers some levels of claims for which insurance capacity would have been available. Insurance considerations were in the end not decisive for the borderline between the first and second tier.

This becomes even clearer when one focuses not on the maximum liability under the first tier, but on the liability for smaller ships. This liability is very small, in particular in CLC.

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20 At this time, a third tier based on the same system as the second tier is also being negotiated.

21 IMO document LEG 62/4/3.

22 The proposal was turned down for other reasons as well, before the actual amounts were agreed upon.

In the HNS Convention, very few vessels carrying such substances are of a size that would put them in the highest liability categories. Although tonnage based liability limits to some extent correspond to the ways premiums are calculated in P&I, the reason why the full insurance capacity has not been utilized must be some notion of fairness.

If the first tier ceiling had been set to utilize the full insurance capacity, there would inevitably have been questions of shipowner contributions to the second tier. This was proposed during the HNS negotiations (in respect of vessels in ballast with HNS remains on board),[23] but was turned down. It has also been proposed in the ongoing negotiations for a third tier, but this is certainly not caused by a desire to let the shipowners' tier exceed the insurance capacity (but rather because the notion of fairness has changed more rapidly than it is possible to revise the first tier convention). One can therefore safely assume that the limiting factor for the first tier is not the insurance capacity.

5
Also in respect of the first tier itself (as opposed to its upper limit), insurance considerations were soon to be forgotten. One of the advantages of utilizing insurance for this tier was the simplicity in establishing cover. One simply had to issue documentation (certificates) for almost the same P&I coverage that most ships already had. However, when one introduced the same system in the HNS and Bunkers Conventions, one apparently forgot to take into consideration that this convention affects a number of ships of a different magnitude than the precedents. Therefore, the use of a first tier based on insurance should have been seriously reconsidered. Luckily, the use of electronic certificates and electronic inspection of certificates now seems to be a solution to the problem.[24]

6
Altogether, it seems like insurance considerations have come somewhat in the background despite the fact that the two tier liability systems originally were a practical arrangement most likely found by an analysis of the insurance market. The considerations that has come in the foreground are, as already mentioned, some undefined considerations of fairness. But what has actually been achieved by not utilizing the first tier insurance cover fully?

It is, of course, not possible to argue that the risk distribution between the first and the second tier, between shipowners and cargo owners, is unfair.[25] However, it is possible to argue that the risk distribution has no effect. In that case, one can hardly say that is it fair either, and the rationale for fixing the first tier ceiling fails.

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23 See, e.g., IMO document LEG 65/8, paragraph 46-48.

24 There are express clauses on the use of electronic certificates and electronic inspection (and other ways to facilitate certificate handling) in the Bunkers Convention, article 7, but similar practices are probably not disallowed in the HNS Convention either.

25 The actual effect of the risk distribution system in CLC/Fund Conventions is discussed in IOPCF paper 92FUND/WGR.3/8/3.

The reason why the risk distributions between shipowners and cargo owners based on sharing fails is that the prices adjust to the same result whenever either of them has to pay further expenses (increased insurance premiums or second tier levy on cargo receipt).[26] This result depends on the relative slope of the demand and offer curves (the elasticities) and not (to reiterate the point) on who had to pay the expense in the first place. It is rare that the result is that either the ship or the cargo will carry the total weight of the increased expenses.

This point can be illustrated by a simple offer and demand graph with freight equilibrium in B. If the shipowners' liability is increased, that may increase their insurance costs. The shipowners naturally wish to recover the increased costs, and there is therefore a shift in the offer curve, where the distance AB is equal to the increased insurance costs. The new freight equilibrium will be in C, which means that the shipowners have recovered about 50% of their increased insurance costs by an increase of the freight.

Had the relative slope of the curves been different, the shipowners would have recovered a different percentage. The steeper the demand curve, the less the owners recover. In other words: the greater the tendency for cargo owners to use other means of transport when the freights increase, the less the shipowners will recover.

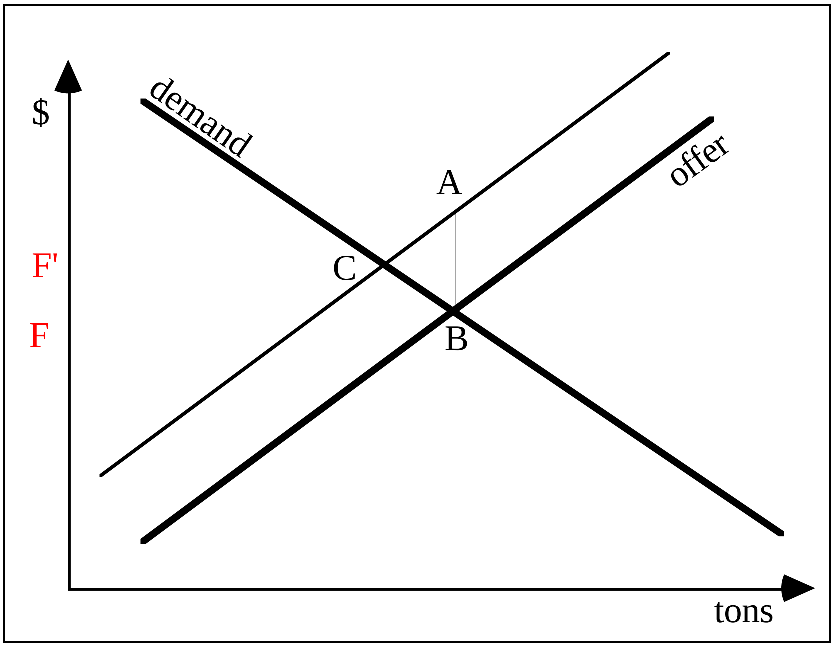

Figure 1

This analysis is contrary to the popular belief that a new expense can be recovered by a price increase. If the offeror could have increased the prices, he or she would have done so, regardless of whether there was a new expense. It is also contrary to the equally popular belief that a new expense *cannot* be recovered by a price increase. For even if the

[26] This is called the Coase theorem.

price could not have been increased before the new expense was introduced, it may be recoverable afterwards, because the new expense changes the market if it is relevant for most offerors.

What, then, happens if the new expense is levied on the demand side, as when liability is attributed to the cargo-financed second tier rather than to the shipowners?

In that case, there will be a shift downwards of the demand curve rather than a shift upwards of the offer curve. The cargo owners will try to negotiate a freight reduction to compensate for the new expense. Again, they are likely to succeed partially (figure 2), and the new freight equilibrium will be in B.

It then appears that the cargo owner must pay the freight B plus the levy to the second tier (AB). His total costs will be A. That is exactly the same as C in figure 1, that is the freight payable if the shipowners, and not the cargo/second tier, were liable towards the third party. Who is liable in the first place does not matter.

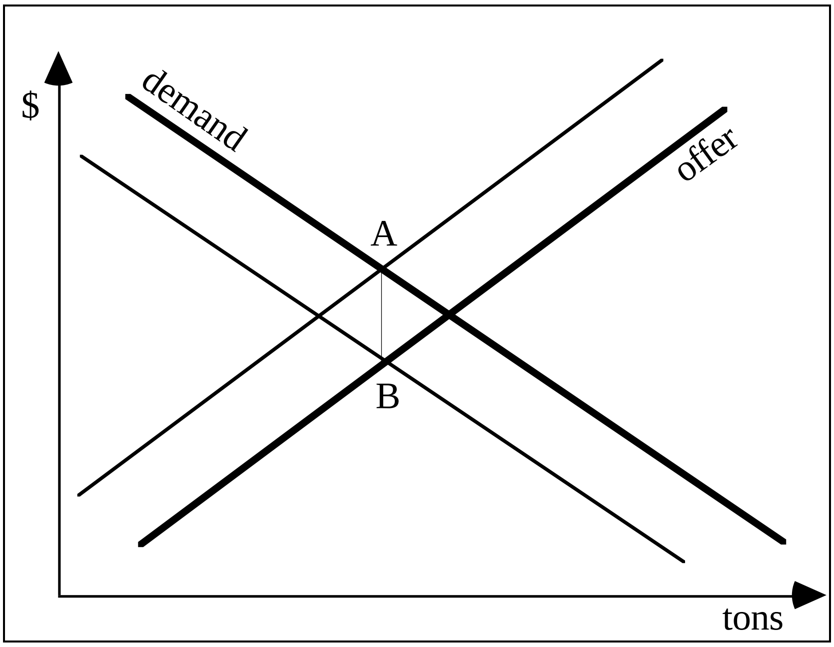

Figure 2

A similar reasoning is also valid in respect of the shipowners. Because this is so, it is meaningless to fix the ceiling of the first tier based on fairness. The result will be the same whatever one does. Therefore, insurance considerations should play a relatively greater role when determining the borderline between the first and second tier.

Obviously, the model above will not work if the freight rates cannot be fixed freely. However, this is quite unusual in shipping. And in the few instances where this is so, it is not necessarily so that the distribution of liability between the first and second tier provides the desired result. One would not know this until all the sub markets without free price fixing had been analysed. Therefore, unless this exercise is carried out, fixing the first-tier ceiling based on fairness is meaningless also on this assumption.

7
From an insurance perspective, a second tier makes sense to the extent that insurance is not available for all claims arising out of one incident. From a fairness perspective – fair distribution of risk between ship and cargo – it does not make sense. It then appears that the first tier should be extended as much as possible rather than be limited based on some notion of fairness.

One may fear that a high first tier limit may cause a problem if the availability of insurance is reduced in the lifetime of the convention. This risk could easily be eliminated if the fund was empowered to reinsure P&I Clubs in such situations. For the contributors to the fund, this must be a much better alternative than if the fund itself were to be liable.

4.2 Channelling

1
Channelling means that only one person is made liable for certain claims, while others are exempt from liability. The point is that only one person then needs to prepare for claims, perhaps by taking out insurance (except for recourse claims).

While channeling obviously saves the defendant side some expenses and avoids a waste of resources, it also has the effect that one puts all the claimant's eggs in one basket. It is therefore necessary to secure that the claimant really is paid if he has a valid claim. In CLC and conventions based on it, this is achieved by requiring the liable person (to whom the liability is channelled) to take out insurance that gives the claimant a right of direct action on the insurer. Paradoxically, this makes the number of liable subjects two rather than one.

The idea of channelling first appears in the conventions on nuclear liability, notably the convention of 1971 that has channelling of liability from the shipowners to the nuclear operator as its only purpose.[27] In the 1969 CLC, the strict liability for pollution damage is channelled to the registered owners of the vessel.[28] In the 1984/1992 Civil Liability Conventions, this is further developed, so that a wide range of persons involved with the transport are exempted from liability (with some notable exceptions, such as the shipper).[29] In the 2001 Bunkers Convention, however, the idea of channelling of liability was already passée.[30] Not only were the exemptions of liability removed, but also a group of persons was made strictly liable. The duty to take out insurance, however, still rests

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27 Convention Relating to Civil Liability in the Field of Maritime Carriage of Nuclear Material, 1971.
28 1969 Civil Liability Conventions, article III (4).
29 1984/1992 Civil Liability Conventions, article III (4).
30 Bunkers Convention, article 3(1).

only with the registered owners, and they have to take out insurance only for their own liability.[31]

2
For all these solutions, insurance considerations have played a role. Thus, the *choice of the liable person* has little to do with who ought to bear the risk, possibilities of prevention of accidents etc. The registered owner may very well be, and is likely to be, a company without substance and which does not operate the vessel. It is only chosen as the liable party because it is easily identifiable, and one expects any claims to be brought against the insurer anyway. Without insurance considerations, the choice of where to place the liability does not make sense.

If this is so, one may ask why the insurer is not made the sole liable subject. It may be that some people thought it would look bad to exclude shipowner liability altogether. It seems unlikely that the symbolic liability of the registered owner actually played such a role. However, it is more likely that this was a concession to the P& I insurance system. The indemnity club could simply not undertake this task unless there was an insured person to indemnify from liability. The legislation was adapted to the insurance practice rather than the other way around.

3
Also, the *exclusion clauses* are inspired by P&I practice. If the idea was to save insurance expenses by avoiding that several persons had taken out insurance in respect of the same incident, they could co-insure under the same policy. However, some of those involved in a transport and exempted from liability under 1992 CLC, are perhaps excluded from membership of a P&I Club,[32] or are members of a different club than the shipowners. Therefore, this solution is inefficient under current club practice.[33] And rather than interfering with commercial practices, the legislators have taken the radical step of exempting several persons from liability.

One may question how efficient this alternative solution is, because those exempted would in any event need some insurance cover for recourse actions and for other parts of their activities. For the claimant in respect of a ship that because of its small size does not have to take out insurance, the exclusion is a definite detriment.

4
Even the *Bunkers Convention* has its concessions to insurance practices. As mentioned, there is no channelling in respect of liability in this convention. But when only the registered owner has a duty to take out insurance, it is based on the same considerations as the exclusion clauses; that the rules for P&I membership should not be affected.

This has hardly any adverse effects for the claimant. There would not be additional funds available for the claimant if the other liable persons had also taken out insurance. The

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31 Bunkers Convention, article 7(1).
32 See Gard Handbook on P&I Insurance (London 1996) p 48-49.
33 See in this direction IMO documents LEG 80/4/2, paragraphs 4-5 and LEG 80/11, paragraph 88.

available defences are the same for all the liable persons, and they shall (at least in most jurisdictions) only pay the loss or limitation amount once. However, if the insurance is invalidated because of wilful misconduct on the part of the owners, but the other liable persons have not been party to the misconduct, the claimant would have been better off had all the liable persons been obliged to take out insurance. Again, it appears that insurance considerations have been decisive.

5
Apparently, channeling means that insurance considerations in some respects have been given priority over the interest of the claimant.

4.3 Wilful misconduct defence

1
In all the conventions that are based on CLC insurance provisions, there is an exception that the insurer does not have to pay if the loss was caused by the wilful misconduct of the assured.[34] This means that a third party claimant can lose his claim based on the compulsory liability insurance of the misconduct of the shipowners. The principle has only been seriously challenged in the current negotiations of a protocol to the Athens Convention on passenger liability.

The English Marine Insurance Act, 1906,[35] has obviously inspired the exception. Some other states have adopted similar legislation.

2
Even if English law is important in maritime and insurance matters, it is, of course, not decisive for the tenor of conventions. If there is a conflict, the states with legislation on wilful misconduct must either stay out of the Convention or change their legislation. Insurers could avoid these jurisdictions altogether by moving their business. And those required to take out insurance can either avoid these jurisdictions or take out accident insurance for the benefit of the claimant. This alternative is almost identical to liability insurance with direct action, except that the wilful misconduct exception in English law does not apply. Thus, national legislation that requires a wilful misconduct exception is avoidable in an international context.

However, far from avoiding this type of legislation, the conventions make the wilful misconduct exception general. Also states that would otherwise not require the wilful misconduct exception, must accept that insurance with this exception complies with the requirements of the CLC, etc.

3
It is indeed difficult to argue that a claimant that deserves the protection of a compulsory insurance scheme shall be deprived of this protection if there is wilful misconduct of the registered shipowner. To the extent there is a second tier, this will cover for the failed

[34] CLC article VII(8), HNS Convention article 13(8), Bunkers Convention article 7(10).
[35] Marine Insurance Act, 1906 (57 & 58 Vict c 60) section 53.

insurance. But why should the second tier cover for the bad shipowners more than for the good ones?

The reason is, of course, found in insurance practices. The wilful misconduct exception is considered essential in P&I insurance because of its mutual character. Shipowners can agree to pool claims against colleagues that keep a certain standard, but not those guilty of misconduct. However, the risk that the shipowners will not take is then left with others. Can insurance practices really warrant that the claimant shall carry the risk that shipowners will not take? In particular, this is problematic when the claimants are not likely to be governments (as in the Bunkers Convention), but rather private individuals (as in the Athens Convention).

4
Abolishing the wilful misconduct exception might obviously lead to some serious disturbances of the P&I insurance marked. One strategy could be to exercise stronger discipline, so that shipowners likely to be guilty of misconduct were expelled. That would only be beneficial, because expulsion would mean that these shipowners could not sail because of lack of compulsory insurance. Another possible development would be that insurance could be limited at much lower figures than today, or part of the cover could be referred to special clubs, to fixed premiums facilities or to the accident insurance market. Obviously, no legislator would be happy to trigger such changes. However, in this case, it might be worth it. One does not change a winning team, but if the team refuses to play a game, one perhaps has to change it anyway.

4.4 Direct action

1
Direct action means that a person that has a claim on a person with liability insurance can sue the liability insurer directly. This may have some advantages for the claimant in respect of availability of funds, jurisdiction, professionalism in handling claims and to avoid that the liable person's trustee in bankruptcy takes the insurance money. Direct action, therefore, is allowed in all the compulsory insurance schemes based on CLC.[36]

This is not in accordance with P&I practice. Far from allowing direct action, they have explicitly stated that the assured shipowner must pay the claimant before they are liable to indemnify him or her.[37] In the club jargon, insurance with direct action is often called an up-front guarantee, as opposed to indemnity insurance the clubs usually provide.

2
Even if insurance practices have been overruled on this point, there are limits to what the insurers can accept. And these limits have been accepted by lawmakers. Seen in this way, insurance practices prevail to some extent.

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36 CLC article VII(8), HNS Convention article 13(8), Bunkers Convention article 7(10).

37 E.g. Gard's Rule 87. This rule prevents direct action; see Firma C-Trade SA v Newcastle P & I Association (The Fanti) and The Padre Island (both [1990] 2 Lloyd's Rep 191 HL). It therefore cannot be invoked in the CLC type compulsory insurance, see the previous footnote.

First, the clubs will not accept direct action to the extent of the insurance. While the limit of the P&I insurance is more than USD 4 billion, direct action is never imposed in an IMO convention for more than a fraction of this (in fact, of the magnitude 1:40). The legislators have obviously taken into account the advice of insurers of what could be done within current insurance practices, and the insurance considerations have prevailed over the claimants' need for even better cover.

Second, the insurers will not issue certificates of insurance with direct action unless the requirement for these certificates is based on an international convention. This clearly influences the negotiations in international fora, because all states know that there will be no direct action in co-operation with the clubs unless one can agree on a convention. Some states may then prefer to agree to a less than perfect convention rather than to take the struggle of establishing direct action in national law. Once again, insurance considerations prevail.

Third, insurers would usually insist that any provision of compulsory direct action insurance be coupled with provisions on the basis of liability, jurisdiction, etc., even if the legislators themselves do not feel the need for harmonization. This enlarges the negotiation effect described in the previous paragraph. And indeed, up to this point, the desires of insurers have been decisive in all IMO liability conventions in this respect.

It is not obvious that it is a bad thing that legislators listen to advice from the (insurance) industry. However, in respect of direct action, it is likely that the insurance considerations have been taken into account to an extent that has led to sub-optimal results, seen from the claimant's side, in the ways described above. The adverse effects of direct action on the clubs, or the adverse effects on the reorganization of the insurance market if direct action is imposed to an extent not acceptable to the clubs, can hardly outweigh these sub-optimal results.

3

If direct action were imposed to an extent the clubs could not accept, then this part of the market would most likely be taken over by accident insurers. In accident insurance, the conduct of any person who caused the damage is irrelevant, and wilful misconduct of the insured – the claimant – is unlikely. However, attempts in the ongoing Athens negotiations to open up the convention, so that accident insurers could compete, met strong opposition. Some forces simply desired the restrictions and the limits of the P&I system in respect of direct action.

4

Even within the P&I system, the adverse effects of direct action are exaggerated. It is the same amounts – the loss of the claimant – that shall be paid, and the authorities that monitor the solvency of clubs do not even ask if there is direct action or not. Norway has had a general statute on direct action by statute for years, which also makes it possible to involve foreign insurers that would not otherwise be subject to Norwegian jurisdiction,[38] and this has never been a problem for insurers. Indeed, if the insurers were more exposed because of direct action, this would only have proven that direct action would have been necessary in order that the claimants should get what was rightfully theirs.

5
After this, it seems like the limits on the direct action provisions of the international conventions are unjustifiable concessions to insurance practices.

4.5 Limitation of liability

When determining limitation amounts for shipowners' liability the notion that there is a limited capacity in the insurance market has played an important, if not decisive role. This is based on two ideas.

1
The first idea is that one does better to limit the liability, so that the shipowners can obtain indemnity insurance for their total exposure, and thus manage the risk.[39] Alternatively, it is said, shipowners might limit their risk by using limited companies and perhaps sail uninsured in an irresponsible way. Either one must accept limitation, or there will be no indemnity insurance, as we know it today. In either case, the USD 4,25 billions P&I insurance will not be available to the claimant.

Whether or not this is acceptable or desirable is a policy question that shall not be discussed here. In this context, it suffices to point out that the question itself accepts that it is for the lawmakers to put limits on liability rather than for the insurers to adjust the limits on the insurance according to the liability regime that applies. In this respect, the question is a concession to insurance practice. And so is the answer: The insurance cover is virtually unlimited, assuming the existence of conventions that limits liability.

2
The second idea is that there is a limit to the available insurance capacity. The capacity relates either to the overall limit on the insurance cover or to the part of it that is subject to direct action, if any. The reasoning is, however, quite similar in both respects, and the two sides of the capacity will not be kept separate in the discussion here.

A fundamental distinction, however, in respect of insurance capacity, is whether it relates to the reinsured layer or another layer.[40] The layer structure can, of course, be altered if necessary. In order to establish that there is no insurance capacity, one must therefore establish that neither of these methods will work.

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[38] Insurance Contract Act, 1989, section 7-9. The legislation must be read in conjunction with the Lugano Convention on jurisdiction and enforcement, 1988 art. 12 and 12A.

[39] Robert Seward: The Insurance Viewpoint. In: Nicholas Gaskell (ed.): The Limitation of Shipowners' Liability: The New Law (London 1986) p. 161 et seq. at p. 163-165.

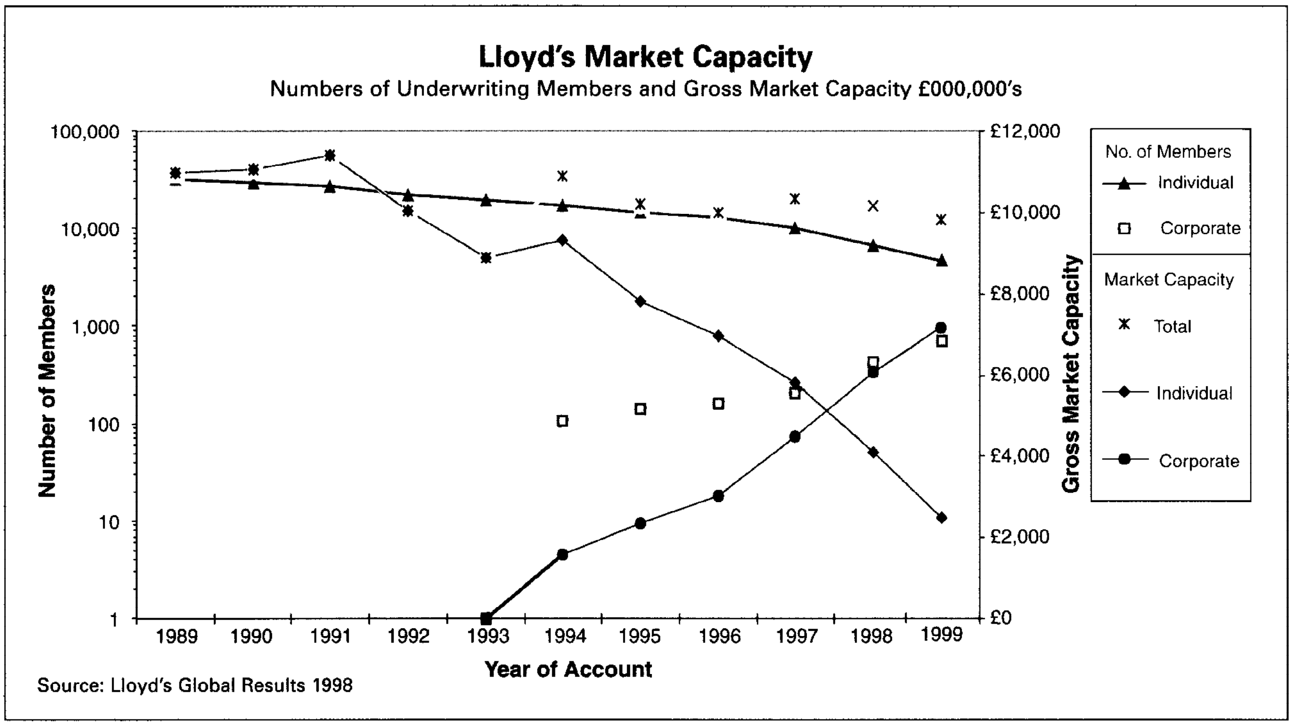
[40] See 3.1 above on the different layers.

3

In respect of the *reinsured layer*, it is not difficult to demonstrate that underwriters will hesitate to underwrite insurance of a certain level, or, more rarely, on certain conditions. It is not necessarily the case that even an offer of a better premium or finding a syndicate whose profile suits exactly the needs will solve he problem – the potentially interested parties may be tied up elsewhere, and new investors are not immediately available. In this situation, it is fair to say that the market lacks capacity.

However, when the market is evaluated for the purpose of negotiating conventions, the perspective changes. Usually, it is not realistic to expect that the new convention will enter into force until several years after its adoption at a diplomatic conference. Furthermore, any estimate of insurance capacity must relate to the lifetime of the convention, which may be decades. Obviously, this makes the estimates less accurate and it may call for conservative estimates to be on the safe side. However, it also gives ample time for the market to adjust. Therefore, one can expect that new investors can be attracted, or old investors be interested in the new type of insurance, if only the premium offered is high enough. There is simply no reason why they should not go into the more profitable market.

The following graph shows how the capacity of the market varies with the investors:[41]



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41 The graph has been copied from JLT Risk Solutions: The Protection and Indemnity Review (London 1999).

When this is so, it is not correct to say that the capacity of the market is limited. Insurance is available; the question is at what premium. To some extent, it may also be relevant to look into which alternative investments will suffer from lack of investors if new investors are attracted to the marine insurance market. But there is capacity.

The increase in what must be sacrificed in order to get the insurance is gradual. No point of that curve can therefore rightfully be called the limit of the capacity.

Viewed in this way, the capacity for compulsory insurance with direct action is the same as for voluntary indemnity insurance. However, if the insurance is compulsory, the bargaining position of those who shall buy it suffers. The other party knows they must have insurance. Therefore, making insurance compulsory in a market with strained capacity may trigger premium increases.

It is for legislators to decide whether to utilize the capacity that can be created in a long-term perspective. Except for the US government in the Oil Pollution Act, 1990, this possibility has not been utilized. Shipowners' liability is limited well within what is thought to be the capacity of an unaltered insurance market. Perhaps one has wished not to disturb current insurance practices, in order to keep insurance costs down and to avoid unknown or undesired effects in other parts of the market. This is another example of the impact of insurance practices on liability conventions.

4
For the claims *not reinsured in the market,* the capacity problem is different. These claims are pooled between shipowners according to different keys varying with the size of the total claims in any one incident. Therefore, the clubs and their member shipowners are stuck with the risk. The only to transfer the risk to others, is to purchase market reinsurance.

In effect, this means that it does not make any more sense to talk abut the capacity in the non-reinsured part of P&I insurance than to talk about the capacity of the individual shipowner to be held liable. The fact that claims are pooled, does not provide an argument to limit liability. On the contrary, the individual shipowner's ability to carry a loss is increased by means of the P&I pooling system.

However, the P&I pooling system may have a capacity problem in the sense that it is not a rubber band that can be stretched without limit. If shipowners feel that their exposure in the system is too great compared to their benefits, they may withdraw. This may be considered undesirable by legislators, because it may cause more ships to run without full liability insurance and often cause shipowners' ability to pay their liabilities to be diminished. Some governments may also wish to protect their P&I insurers. Capacity in this sense is then a question of which strains the P&I system can take while still being considered the best alternative for most shipowners.

Such strains are obviously not caused by new or increased liabilities imposed on all shipowners. In that case, the need for P&I cover increases, and the exposure increases only proportionally with the increased need. The problem is if certain groups of shipowners are exposed to increased liability. In that case, the remainder may not be prepared to pool the risks with them.

The tolerance in the P&I system seems, however, to be large in this respect. There has not been serious questioning of the pooling of HNS claims or bunkers claims, or of pooling of the claims on shipowners who regularly trade on high liability states, such as the USA. Liability from oil tankers – a relatively small group of ships – has, however, reached the limit of tolerance. The claims have therefore excluded oil pollution coverage when trading on the US, and limited the oil pollution liability cover at a much lower level than the general cover. In both cases, shipowners are referred to the market insurance for the part not covered by the clubs. All these examples show that the legislators do not need to worry too much about the ability of P&I to adapt to new liability regimes. Still, the legislators have not challenged P&I very much, perhaps in the fear that the insurance system could not adapt.

This capacity argument has been put forward in the debate on the revision of the Athens Convention on passenger liability. It is said that if the exposure on the clubs is too great in respect of this very small group of shipowners, other shipowners may not accept pooling liability with them. Indeed, some of the clubs have already ceased to accept owners of passenger ships as members. It remains to be seen which impression this line of argument will have when the Athens Protocol is finalized. Looking at the history, it seems likely that at least some delegations will put unproportional emphasis on preserving the current P&I coverage, and therefore limit the liability at a fairly low level.

5

The discussion above has shown that the P& I system will be strengthened rather than weakened by increases of liability. There is no capacity problem as such. However, increases that concern only a small group of shipowners can strain the systems more than other shipowners tolerate. In that case, the excess exposure must be excluded from ordinary club pooling in one way or another, and be referred to market coverage.

One may say that some claims must be referred to market coverage, if the capacity of club pooling has been exceeded. However, the analysis also shows that in a long time perspective, there is market coverage. Therefore, capacity problems that the legislators must take into consideration do not exist.

Still, legislators of international liability conventions tend to look to what they conceive of as a quite limited insurance capacity when making liability rules. What they in fact do is to presuppose that the current insurance practices will not change, and that the new convention will not cause changes in the insurance market. In this way, current insurance practices get quite an impact on liability conventions.

5 Conclusion

The role of the legislators is to legislate. It is justified to make decisions that will make it necessary for the industry to adapt. It appears, however, that legislators of liability conventions in the IMO have used this power only to a very limited extent. They let current insurance practices prevail.