

**Why is LOF seen as expensive and an analysis of
possible alternative funding methods**

LSLC, 2 February 2016

It is well recognised that there is a general view that LOF salvage is an expensive undertaking. Certainly, the statistics indicate that there have been fewer LOFs and that the decline continues. Conversely, the cost of wreck removal has increased and the natural assumption must be that there are a number of casualties which in prior years would have been performed on LOF services, but more latterly, are pursued under some form of modified wreck hire, probably with adjusted SCOPIC rates.

However, the idea that salvage is expensive reflects a misunderstanding of the nature of the awards for services and what they are for.

In the first instance it is as well to consider what is the basis of payment. Certainly it is not a commercially negotiated fee. No one party can exert commercial pressure over the other, rather it is left to an independent assessor to determine the sum payable. It is not a question of one party seeking to exert market influence over the other, rather the idea is that it is a contract in its purest form, namely if I carry out the services to your satisfaction and save something, then you will pay me, but if I fail, then you will not. Arguably a more reasonable form of contract could not be found.

Having decided that the Arbitrator should determine quantum, what is it that he is required to do? You will all be familiar with the factors set out in Article 13 of the Salvage Convention, and these are of course the prime factual issues that the Arbitrators must consider. However, over-arching all of those is the admonition that:

“The reward shall be fixed with a view to encouraging salvage operations...”

Thus Arbitrators are bound at law to be encouraging. That is reflected in the common law whereby Sir John Nicholl held that after taking into account what are in effect now the Article 13 factors, the Arbitrator must go on to consider:

*“another principle to encourage enterprise, reward exertion and to be liberal in all that is due to the general interests of commerce and the general benefit of owners and underwriters, even though the reward may fall upon the individual owner with some severity.”*¹

There are two main points to consider, the first is that the concept of encouragement has got little to do with the service that has just been provided. Encouragement is not about encouraging somebody to do something they have already done. That is an oxymoron. Rather it is to make them much more likely to do it again. A definition is that it is *“persuasion to do or to continue something”* alternatively, *“the act of trying to stimulate the development of an activity”*. Thus the purpose is both to say thank you for the services carried out, but also to make it worthwhile for the salvor to go out and do it again. Indeed it is an encouragement for others to go out at different times and in different places in the future and do the same as this particular salvor has done.

Furthermore, and this is the second, it is recognised that such encouragement may not be to the benefit of the particular ship owner who has just had his ship saved. No, that is why it will fall on that individual owner with *“some severity”*.

It follows that it is axiomatic that the reward may appear disproportionate with respect to the particular service because the express intention is to encourage services of the shipping industry at large. It also follows that an analysis of any particular service in relation to the particular ship and value is misleading. A Salvage Award awarded at 35% of a US\$70 million fund may seem excessive in respect of that fund, but that is because the encouragement has fallen with some severity on the individual owner. Thus it is much more useful to consider salvage as an industrial concept giving rise to an industrial reward.

An estimate of the value of goods shipped in 2013 gave rise to a rough figure of US\$5 trillion.² Similarly, the value of ships at sea was estimated at US\$29 billion. Therefore, the total value of the shipping industry in 2013 was around US\$5.03 trillion. These are estimates and as we will see it matters not whether they are a little out. What is important is to recognise that there is a high value worth of goods being transported per year.

¹ The “INDUSTRY” [1835] 3 Hag. Adm. 203

² Extrapolated from figures in 2007 from Worldtrade.Org.

It is that value of goods and vessels that the salvage industry is there to protect and it is to that property that the awards are to be encouraging.

The ISU report that around US\$202 million was paid in LOF or other settlements in 2013. Of course, these figures relate in the main to prior services, but it is nevertheless a useful figure on which to make comparisons.

Therefore if the value to the industry was US\$5 trillion, and the encouraging rewards to salvors amounts to US\$200 million, then this equates to 0.004% of the value of the shipping industry. This is a far cry from the 35% or higher awards which can be achieved.

Put another way, if that entire US\$5 trillion was stuffed into the containers of a 20,000 teu container ship which sets sail from Australia to Europe, and along the way got into difficulty, and the entire world's salvage industry poured forth in order to rescue her, then, at the end of that operation, the Arbitrator's Award would have amounted to less than the value of one container on that ship!

In those circumstances, I would suggest that salvage is neither excessive or expensive, but is actually rather cheap. I am sure that no underwriter would turn his nose up at paying the average value of less than one container the next time there is salvage of a container vessel.

Therefore it follows that if the "*severity principle*" causes concern in the modern insurance world, it is necessary to consider other alternatives such that the severity of the reward does not fall disproportionately on an individual, but on the industry at large.

Recently there have been a number of initiatives relating to salvage and casualties generally. Landmark is one well known example. This of course is intended to deal with large container casualties and the GA elements arising from that. Other suggestions have been for a levy on containers shipped. Again, this essentially addresses large container casualties. Another suggestion has been in relation to environmental salvage with the proposal for a salvors' environmental protection trust³; this was initially proposed in relation to the now rejected environmental salvage issues, in the main these initiatives require global agreement.

³ Aleka Mandaraka-Sheppard 'Modern Maritime law', page 577

An alternative non-mandatory proposal is the establishment of a salvage fund. Those that contribute to the fund get the benefit of it, those that do not contribute, rely upon their hull insurance in the usual way.

The essence of such a fund is that it removes standard insurance from the equation and spreads the risk amongst its participants – a throwback to the original concept that there is benefit to the industry in salvors providing such services.

Thinking further on how that might be funded, the insurance premia for ships and cargo in 2013 amounted to just under US\$28 billion⁴. It follows that 1% of that would create a fund of US\$280 million. This would be more than necessary to pay for all the salvage in that year as we have seen. However, it would be inappropriate to ask underwriters simply to pay over 1% of their insurance premia into a separate fund as that is not the way that life is.

Nevertheless, it seems to me that owners could decide to opt into the fund by paying ostensibly an extra 1% of their premia independently of the insurance aspect. That 1% would then go direct to the fund. Now it will be said that owners won't pay as they would be seen to be paying twice and to a certain extent that may be correct. However, hull insurance would still cover salvage, just not fund salvage, i.e. any salvage services outside of the fund, e.g. lump sum contents on common law.

However, it is also possible that through negotiation, whilst there might be some additional payment by owners, but this could be offset by a reduced risk for hull underwriters. But should the owner opt into the salvage fund and his ship then get into difficulty requiring salvage, it is inevitable that an LOF would be signed both because owners have paid but also because underwriters would not want to take responsibility themselves when they don't have to.

Should that ship, or a ship with cargo who have similarly paid into the fund, get into difficulty, then the fund would pay the salvage reward for those contributing parties in full in the usual way. Such payment would not form part of the assureds' record, and should not affect its underwriter's premium thereafter.

Such a fund does not require global agreement, it simply requires some agreement with some parties.

⁴ IUM1 website, excluding P&I risk

It is not suggested that salvage claims would be paid on demand. Rather the fund would act as security in the first instance in the sense that salvors would not need to obtain separate security elsewhere, for those participants in the fund. It also means that the fund must have the right and duty to settle Salvage Awards, appoint lawyers to advise them on levels as appropriate, send to arbitration in the usual way if settlement is not possible, and even to challenge the validity of a Salvage Contract if necessary. In short, all the rights that currently reside with property interests. In this sense, the fund changes nothing of the existing procedure, its just that underwriters would no longer be a part of it.

Of course the success of the initiative depends entirely upon market perceptions both within the brokerage market, and with owners and cargo interests. Indeed if underwriters are against it, then it is unlikely to gain any traction. However, as it removes the bone of contention that underwriters feel about salvage, it would seem slightly odd were they to be actively against such proposals.

Even so, there are difficult issues to deal with, and one such issue of course relates to the possibility (or and indeed likelihood) that there would be insufficient monies in the fund to cover the particular Salvage Award. This has been investigated and in such circumstances, it should be possible to purchase a Guarantee for the fund for any shortfall that there may be. Furthermore, the fund at least initially would not cover all salvage, common law or contractual, but would be limited to LOF salvage. The management structure needs to be considered and this has been put to various industry individuals for comment. There is a fairly long lead time before it could be properly up and running to take account of establishment of the management organisations, and also policy documentation.

Nevertheless, the benefits are clear in that it spreads the load removing the severity from the individual ship owner or insurer, and similarly, would likely lead to an increase in LOF which would assist the salvage industry in general.

A possible benefit could be that if a particular ship owner and his particular cargo were to find themselves both in the fund (which is possible for a bulk carrier, but unlikely for a container vessel), then the fund would be paying the whole salvage reward settled or agreed due to salvors. In other circumstances, cargo underwriters would then seek to recover the money paid in salvage from the P&I Club who would defend the case and/or end up paying cargo accordingly if there was breach of the Contract of Carriage. That payment would then

sit on their Member's record and deplete their reserves. However, where both ship and cargo are in the fund, then I see no reason why the fund should seek to recover from the owner who was also in the fund, the monies paid by way of salvage. Thus there is a direct benefit to Club reserves and a direct benefit to the particular ship owner as his record remains unaffected. This is a very clear benefit outside of the traditional underwriting sector.

Conversely, if cargo was in the fund and ship was not, then I see no reason why the fund should not seek to recover from the particular ship. This would act as an encouragement to vessel owners to participate in the fund.

Of course not everything is straightforward, and there are still some hurdles to clear. The first of these is a natural conservatism in the industry and reluctance to change. A separate and important consideration is capitalisation of the start-up. Two new companies would need to be formed, systems aligned and ultimately managed. Who would pay for this? Finally, the elephant in the room, which is would it actually be attractive to ship and cargo owners? I suspect the answer to that is that it would be to some and may be not to others. However, 1% of a hull premium for a fleet of US\$2 million is only US\$20,000. Even in these straitened times, such an extra payment may not be unachievable particularly with the potential benefits.

Watch this space!

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LSLC, Demystifying salvage – changing perceptions in a changing world
2 February 2016