The Terror of War Risks, Passengers and Certification

P&I War Risks

War risks is an arcane subject, from the point of view of both lawyers and insurers. Even the area of Marine War risks insurance, which is relatively developed and sophisticated, tends to be regarded as an unimportant and uninteresting side issue, until once every ten or twenty years some international conflict brings the issue back into the spotlight for a brief period before another relapse into obscurity. However, in this area, as in many others, the events of 9/11 may have introduced a permanent change because we now speak of War and Terrorism Risks. The War Risk was, and primarily still is, a problem of damage to property but the terrorist risk (which no one can define) may be of considerable significance also from a liability point of view. Shipowners have not normally been expected to dodge falling bombs or exocet missiles fired by hostile forces, but they are now expected to protect their ships from other forms of attack by "terrorists", whoever a "terrorist" may be. The situation has therefore changed and with it both the potential liabilities and the insurance needs of shipowners.

The Clubs have traditionally excluded War Risks. Cover for War Risks liabilities is usually included within Hull War Risks policies up to the hull value insured and in any event P&I type liabilities arising out of War Risks have generally been considered to be highly unusual (i.e. there is usually an Act of War defence), with the exception of crew risks which are normally governed by contractual arrangements.

During the 1980's a gap opened between the War Risks cover provided by the market and the P&I War Risks exclusion when, as a result of changes in the market War Risks wordings, the P&I Clubs moved to judging War Risks by the nature of the causative event (e.g. use of explosives, bombs, etc.) rather than the motivation of the perpetrator, which it was not always easy to determine and seemed to lack logic as a test. In order to avoid any gap in War risks cover between the P&I exclusion and the cover provided by the market, the P&I Clubs in 1985 offered a "difference in conditions" reinstatement of the War Risks excluded under the standard P&I cover. In addition to filling any possible gap between market cover and the P&I exclusion, this cover also provided an excess War Risks P&I cover additional to the hull value cover purchased by the shipowner. The limit of this cover was USD100 million and Clubs did not charge Members for the cover, which was reinsured back into the market by the International Group on

behalf of each individual Club excess of a minimum retention of USD50,000.

The events of 11 September 2001 have had a profound impact on the whole War Risks and reinsurance markets. As a result of changes in the reinsurances available to the International Group Pool, the P&I Clubs have been forced to make two significant changes in their cover. First, they have introduced a "terrorist exclusion" into the normal P&I War Risks exclusion so that the standard Club War Risks exclusion now reads as follows:

EXCLUSION OF WAR RISKS

General Exclusion 25

(1) Unless otherwise agreed in writing there shall be no recovery from the Association against any liabilities, costs or expenses incurred as a result of:

(A) An incident caused by war, civil war, revolution, rebellion, insurrection or civil strife arising therefrom, or any hostile act by or against a belligerent power, or any act of terrorism;

Provided always that in the event of any dispute as to whether or not any act constitutes an act of terrorism the decision of the Committee shall be final.

(B) Capture, seizure, arrest, restraint or detainment (barratry and piracy excepted) and the consequences thereof or any attempt thereat;

(C) An incident caused by mines, torpedoes, bombs, rockets, shells, explosives or other similar weapons of war (save for those liabilities, costs or expenses which arise solely by reason of the transport of any such weapons whether on board the Entered Ship or not).

Provided always that this exclusion shall not apply to the use of such weapons, either as a result of government order or with the agreement of the Managers or the Committee, where the reason for such use is the avoidance or mitigation of liabilities, costs or expenses which would otherwise fall within the cover given by the Association.

PROVIDED ALWAYS THAT the exclusion set out in this Rule 25(1) shall apply irrespective of whether a contributory cause of any liability, cost of expense being incurred was negligence on the part of the Member or of his servants or agents

P&I 25(2) cover
War Risks

Where the Association has agreed in writing to provide against any or all of the risks set out in Rule 25(1) above the Association shall have the power to declare Prohibited Areas; which

(i) may at any time and from time to time be changed by the Association giving seven days notice of such change;

(ii) shall automatically extend to all areas, ports and places upon the hostile detonation of a nuclear device, the outbreak of war between any of the following countries United Kingdom, United States of America, France, The Russian Federation, The People's Republic of China, or upon requisition either for title or use of the Entered Ship, and there shall be no cover in respect of the event giving rise to such automatic extension.

It is important to note the Proviso to Rule 25(1) which has the effect of excluding the results of any terrorist attack even if a partial cause of the attack might have been negligence on the part of the shipowner or crew, for example by failing to take adequate steps to prevent a terrorist attack.

The second change is that the War Risks P&I extension is now an excess policy only and provides cover only excess of the actual market War Risks cover taken out by the owner with a deemed minimum underlying cover equal to the hull value of the ship (or USD100 million, whichever is the less). In addition, this extended cover is subject to a new exclusion the "cyber" exclusion, which reads as follows:

CHEMICAL, BIO-CHEMICAL, ELECTROMAGNETIC WEAPONS AND COMPUTER VIRUS EXCLUSION CLAUSE:

This clause shall be paramount and shall override anything contained in this insurance inconsistent therewith.

In no case shall this insurance cover loss damage liability or expense directly or indirectly caused by or contributed to by or arising from:

(a) any chemical, bio-chemical or electromagnetic weapon;
(b) by use or operation, as a means for inflicting harm, of any computer virus.

The Clubs have been successful in persuading market underwriters to agree that this clause is not as far reaching as might at first sight appear and the brokers have issued the following statement with the approval of underwriters:

"The Chemical etc., Exclusion Clause (MM Clause No.2249(a)) was introduced to this placement for the first time at 20th February 2003.

It is our understanding that the phrase 'any chemical, bio-chemical.....weapon' was intended by Underwriters to exclude neurological or viral agents such as sarin, mustard gas, anthrax, smallpox, etc. It is not intended to refer to explosives, or methods of their detonation or attachment. Nor does it refer to the use of a vessel or its cargo as a means of inflicting harm, unless such cargo is itself a chemical or biochemical weapon within the scope of the clause. We understand the phrase 'electromagnetic weapon' to refer to highly sophisticated devices designed to disable computer software, and not to methods of detonation or attachment of explosives.

The exclusion of 'the use or operation, as a means of inflicting harm, of any computer virus' is relevant in the context of this policy only if it is used as an act of war or terrorism."

The International Group have submitted a revised wording for the clause which incorporates these principles and it is hoped that the wording of the clause for the next year will be clearer.

This interpretation is a marked improvement on the bare wording of the clause but nonetheless it does leave a significant uninsured exposure. On the positive side this excess War Risks P&I cover increased to USD400 million, but Clubs now include a charge for this cover within the general reinsurance cost passed on to Members.

The effect of these various changes creates difficulties in the following areas.

(1) Potential gaps in cover and uninsured risks. An owner has an uninsured risk for incidents falling within the cyber exclusion set out above and a potential gap in War Risks cover for that part of the War Risks deemed to be placed in the market for the hull value of the ship, since not all market War Risks covers will exactly match the incidents excluded from normal P&I.

(2) Claims handling. The claims handling position for a War Risks incident is unsatisfactory. The lead underwriter will be a potentially unknown market underwriter with little or no knowledge of liability claims. Finally, even the excess War Risks P&I, which the Clubs do cover, is fully reinsured, which will inevitably affect the claims handling freedom given to the Clubs.

Certification

In addition to the unsatisfactory situation outlined above, a further problem arises where the Clubs give direct action certificates. At present this is confined to the Civil Liability Convention for oil pollution and the US Federal Maritime Commission undertaking in respect of passenger liabilities in the United States. However an identical problem will present itself for certificates which will be required under the proposed Bunker Convention, HNS Convention and the Protocol to the Athens Convention.

The point is best illustrated by the War Risks defences available to an owner under the CLC which is as follows:

CLC 1992 - Article III

2. No liability for pollution damage shall attach to the owner if he proves that the damage:

(a) resulted from an act of war, hostilities, civil war, insurrection or a natural phenomenon of an exceptional, inevitable and irresistible character, or

(b) was wholly caused by an act or omission done with intent to cause damage by a third party, or

(c) was wholly caused by the negligence or other wrongful act of any government or other authority responsible for the maintenance of lights or other navigational aids in the exercise of that function.

3. If the owner proves that the pollution damage resulted wholly or partially either from an act or omission done with intent to cause damage by the person who suffered the damage or from the negligence of that person, the owner may be exonerated wholly or partially from his liability to such person.

It should be noted that the defence against the deliberate acts of a third party (the terrorist) is not absolute in that an owner has to demonstrate that he was not in any way at fault and that the damage was wholly caused by the act of the third party. In addition there is no "cyber risks" defence. The wording of the other Conventions mentioned above and OPA 90 have a similar effect. The position under FMC Passenger guarantees is significantly worse in that there is no War Risks defence available to the owner at all.

The effect of this is that the Clubs are being required to give direct action certificates for risks which they do not cover and for which reinsurance cover is doubtful. The FMC undertakings are currently a maximum of around USD32 million though this is expected to rise considerably, and the maximum CLC guarantee will rise to around USD135 million from this November.

US Oil Pollution Act 1990 (OPA 90)

Although the Clubs do not provide Certificates of Financial Responsibility (COFRs) under OPA90, the defences available to an owner in respect of War Risks do not coincide with those available to the Club under its War Risks exclusion. The specialist organisations which provide OPA90 COFRs do so on the basis that the cover provided by the Clubs is in all respects equal to, or greater than, the requirements of OPA 90. This is now clearly not true in the area of War Risks and Terrorism where the Club defences are wider than those allowed under OPA 90. The relevant section of OPA 90 is 1003, which reads as follows:

SEC.1003. DEFENSES TO LIABILITY

(a) COMPLETE DEFENSES - A responsible party is not liable for removal costs or damages under section 1002 if the responsible party establishes, by a preponderance of the evidence, that the discharge or substantial threat of a discharge of oil and the resulting damages or removal costs were caused solely by--

(1) an act of God;
(2) an act of war;
(3) an act or omission of a third party, other than an employee or agent of the responsible party or a third party whose act or omission occurs in connection with any contractual relationship with the responsible party (except where the sole contractual arrangement arises in connection with carriage by a common carrier by rail), if the responsible party establishes, by a preponderance of the evidence, that the responsible party-

(A) exercised due care with respect to the oil concerned, taking into consideration the characteristics of the oil and in light of all relevant facts and circumstances; and
(B) took precautions against foreseeable acts or omission of any such third party and the foreseeable consequences of those acts or omissions; or
(4) any combination of paragraphs (1), (2) and (3).

(b) DEFENSES AS TO PARTICULAR CLAIMANTS. - A responsible party is not liable under section 1002 to a claimant, to the extent that the incident is caused by the gross negligence or wilful misconduct of the claimant.

(c) LIMITATION ON COMPLETE DEFENSE - Subsection (a) does not apply with respect to a responsible party who fails or refuses-

(1) to report the incident as required by law of the responsible party knows or has reason to know of the incident;
(2) to provide all reasonable cooperation and assistance requested by a responsible official in connection with removal activities; or
(3) without sufficient cause, to comply with an order issued under subsection (c) or (e) of section 311 of the Federal Water Pollution Control Act (33 U.S.C. 1321), as amended by this Act, or the Intervention on the High Seas Act (33 U.S.C. 1471 et seq.).

It does not take an unduly quick witted US attorney to spot that these "complete defenses" are really nothing of the kind, particularly with a probably foreign flag ship, with a foreign crew and foreign insurer in front of a US court following some atrocity in the US. The burden of proof in (a)(3)(A) and (B) above is on the responsible party and the wording is very wide and general. The responsible party is required to take proper precautions "in the light of all relevant facts and circumstances" and against "foreseeable acts or omissions of any such third party and the foreseeable consequences of those acts or omissions". There is little doubt that "foreseeable" will be reviewed with the benefit of 20x20 hindsight.

The P&I Club defence is much tighter and applies "irrespective of whether a contributory cause … was negligence …", this is precisely to avoid the long drawn out and indeterminate investigation which is invited by the wording of OPA 90.

If we then consider the exception to the complete defenses contained in section 1003(c)(2) and (3), we also find that the responsible party must "provide all reasonable cooperation and assistance requested by a responsible official in connection with removal activities" and must comply with "orders issued". Does "reasonable cooperation" extend to spending money which perhaps the responsible party does not have and his insurance does not cover?

There is a very real gap in cover.

The Changed Risk

The problem is made more significant by the increasing requirements on shipowners to take security precautions under the ISPS Code and similar regulations. Thus, while the risk of a War (terrorist) incident is significantly greater, it is also becoming more likely for shipowners to incur liability as a result of such an incident, and simultaneously it is becoming increasingly difficult for them to defend themselves against any such liability. It will, for example, be problematical for a passenger ship operator to claim that he has no fault in the event of passengers dying as a result of some poisonous substance brought on board by an individual or group of individuals.

Terrorism Risk Insurance Act (2002) (TRIA)

It might be thought that TRIA was intended to fill gaps of this sort, at least as far as incidents in the USA are concerned; unfortunately this is not the case.

Traditionally property and casualty policies in the USA have not had either a War Risks or a terrorist exclusion. Following 9/11 many property and casualty underwriters in the USA moved to insert such exclusions, which could only be bought back for low limits at high prices. The meant that many high profile and valuable buildings were uninsured for what was perceived as a substantial risk, the financiers were concerned and the US government acted. The intention of TRIA was to jump start a new (for the USA) War Risks and Terrorism insurance market for property and casualty insurance. This was to be done by providing federal "reinsurance" for ninety percent of the risk for a period of three years. The detail was somewhat less generous in that it provided for substantial deductibles for the insurer and a potential levy on the participating insurers if the claims got too big. Equally the precise method of providing the funds and the requirements for insurers to access the federal largesse were left to regulation. It was therefore somewhat less than a watertight reinsurance contract, and looked rather more like a vague offer to pay at some time in the future on conditions to be announced.

TRIA was extended to include insurances on all ships in the US Economic Zone and all US flag ships anywhere in the world plus Disney cruise ships.

TRIA operated by requiring insurers to effectively abandon the War Risk and terrorist exclusions they had inserted into their policies since 9/11 and offer such cover to their insureds at a price and in reliance on the federal offer of a ninety percent reinsurance of the risk.

Although the P&I Clubs are (with two exceptions) not subject to regulation in the USA, they were caught up by the long arm of TRIA because they are

almost all approved by a federal agency, namely the US Maritime Administration (MARAD). The Clubs therefore were required to offer to provide full P&I cover (USD4 bn) for terrorist risks in accordance with TRIA, but at premiums which were unattractive due to the need for each Club to retain ten percent or USD400m, unreinsured and unreinsurable. The Clubs later visited the US Treasury (who were charged with producing regulations under TRIA) and explained the nature of the War Risks and terrorism cover offered by the International Group. In effect the type of cover required under TRIA was already in place. At 20th February renewal in 2003 the Clubs complied with TRIA in offering the new cover set out above.

The US Treasury has now issued Final Regulations in July 2003, which have the strange effect of undoing the work of TRIA itself by promulgating that the TRIA requirements only apply to those insurances actually approved by a federal agency. This means that they will only apply to MARAD financed ships or approximately half of the US flag fleet. This is probably less than one percent of the ships trading in US waters.

The final position is therefore that the regime for War Risks and terrorism cover as regards shipowners liabilities is the same in the USA as the rest of the world.

It is worth briefly illustrating the way in which the US Treasury achieved this somewhat surprising result as an example of pure and skilful political expediency and muscle.

TRIA defines "insurer" to include any entity which is approved by a federal agency for the purpose of offering property and casualty insurance in connection with maritime, energy or aviation activity. MARAD was identified by the Treasury as such an agency.

Under TRIA insurers (the Clubs) are then required to offer cover, which is in turn eligible for Federal ninety percent indemnification for all "insured losses" occurring within the United States, including US territorial waters and the US continental shelf, or to US flag vessels "wherever located". The Treasury's Final Rule restricts the indemnification to losses arising from the particular business written pursuant to their federal approval.

The reasons given by the Treasury are that the national interest is not served by giving a backstop to policies which are not subject to federal approval and they cite difficulties of data collection, enforceability and the need to treat all federally approved insurers alike. The logic is not impressive and it seems likely that they have decided that the shipping

sector is already well served and protected and that there is no reason to expose the Federal Government to losses in this area. Understandable and perhaps even a compliment!

Problems

There are therefore these problems.

1. A gap in the cover required by shipowners. This is exemplified by the difference between the cover required to meet liabilities imposed under domestic and international legislation and the cover available from the P&I Clubs. This is of particular concern to US operators and focuses on the OPA 90 and potential passenger liabilities.

2. A gap in the reinsurance available to Clubs. This would make it impossible under present arrangements for the Clubs to continue to supply direct action certificates from next 20 February.

3. Confusion in the cover available. Even where War Risks P&I cover for shipowners does exist, it is far from clear which underwriter would be providing it in any given situation and there is no agreement (and probably none possible in advance) on how any claims should be handled. This problem becomes exaggerated if the facts surrounding an incident are not immediately apparent.

Solutions

There would seem to be four possible solutions:

1. Change the law. The Conventions will take at least six or seven years to change and it is unlikely that a limited protocol to each Convention dealing only with War Risks defences would be received with enthusiasm by the International Maritime Organisation (IMO), who would have to undertake the work. It is possible that the HNS Assembly could agree that the upper tier fund, financed by the chemical industry, could "drop down" in the case of War risks (terrorism), but this solution is not certain and is not available for the other Conventions. This would still leave problems with the CLC, Bunkers and Athens Conventions, together with various other governmental requirements which do not call for certification, but do require insurance cover complying with certain conditions.

2. Not give certificates. This would resolve the problem from the insurability point of view but it would create significant problems for

shipowners and governments as more that 95% of all CLC certificates are issued in reliance on International Group guarantees (Blue Cards). It would also leave the gap in shipowners cover.

3. Market cover. The structure of the present cover is outlined above and it may be worth considering first the possible ways in which the existing cover could be adapted to meet the problems described above. Under the terms of the main P&I reinsurance contract, underwriters currently agree to follow the Pool in responding under CLC certificates and FMC undertakings. Thus, regardless of the War Risk exclusion in the Pooling Agreement (which also excludes terrorism) and regardless of the "cyber" exclusion clause which will probably apply to their own reinsurances, reinsurers agree to respond if a claim arising from an act of terrorism should exceed the Pool limit - provided that the claim is brought under, for example, a CLC certificate. The same result would not follow in the absence of a certificate since the risk would have been excluded under the War Risk exclusion in the Pooling Agreement. Underwriters' commitment in this respect enables Clubs to honour the certificates that have been issued in the 2003 policy year and it has been suggested that this arrangement may also be possible for future years. The Group's brokers have confirmed that reinsurers will not be compelled to incorporate the "cyber" exclusion clause in the Group's reinsurance cover since this is not a War Risks insurance and the "cyber" exclusion will not therefore be required by their own reinsurers. Thus it should be possible to buy the necessary levels of cover through normal excess of loss cover on the main contract, provided that suitable changes are made to the Pooling Agreement and, perhaps, the reinsurance contract so as to clarify the position. In addition it will be necessary to introduce changes to Club Rules to qualify the effect of the War Risks exclusion by providing, for example, that the Club will respond in respect of CLC and FMC liabilities even though the substantive risk may be excluded under the War Risk exclusion. However, although in the short term this may provide an adequate solution so far as the exposure of individual Clubs under certificates is concerned, the exposure of the individual member would remain outside the certified risk. In addition, the willingness and ability of market underwriters to continue giving this cover is uncertain, particularly if it expands to other, new, certification requirements.

4. Mutualise the risk. Although some of the problems can be dealt with in the short term, others remain and it might be a more complete solution to mutualise the risk. The War (terrorist) Risk is common to

all tonnage, even if the consequences of an incident may vary. There is a common gap in cover which it has been the traditional task of the P&I Clubs to fill. Mutualisation of the risk would greatly simplify claims handling particularly if this was done up to a level which enabled the giving of certificates (say USD150-200 million to cater for the new levels of CLC).

The LIMBURG case demonstrates that it is not always easy to tell whether an incident is a War Risk or normal P&I and this difficulty will become still more pronounced in a situation where the owners defences are uncertain. For example, the difficulty of demonstrating that the owner was not even partially to blame. This uncertainty will lead to considerable claims handling difficulties, particularly in a situation such as oil pollution under OPA 90 where early action and expenditure of funds by the shipowner is essential. If a single insurer (the P&I Club) was responsible for both heads of cover at the primary level, it would make the resolution of these problems relatively simple.

A USD200m Pool for both P&I and War Risks P&I would also considerably alleviate the gap in cover for shipowners as War Risks P&I would then go to USD600m (assuming the same additional cover as at present) with the first USD200m free of any "cyber" exclusion. The same USD200m Pool would also enable the International Group P&I Clubs to provide full certification up to USD200m, a position which would be unique in the insurance world. Finally, the Clubs would have brought the insurance they were certifying fully into line with the reinsurances they could obtain; a situation which makes it much easier for Club mangers and directors to sleep easy at night.

If the International Group does decide to mutualise the risk it will have significant knock-on effects, potentially leading to a restructuring of the International Group Pool reinsurances and almost certainly to radical changes in the P&I War Risks market. Watch this space.

R C Seward
September 2003