UNDERWRITING THE KIRBY DECISION

Presented by

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to

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Thank you for giving me the opportunity to share some thoughts about the supreme court's decision in Norfolk southern railway vs. James n. Kirby Pty limited, the issues that challenge us, and the work of AIMU in representing the interests of the American marine insurance market. it's a special privilege to address the maritime law association of the united states. both the association and AIMU share the common goal of developing an environment in which marine underwriters can grow and prosper. Underlying that goal is a shared commitment to continuing education and enhancing professionalism. The outstanding program you have assembled illustrates that commitment. I'd like to review the basic facts of the case, the district and circuit courts' rulings, the supreme court's, opinion and provide some perspective on the industry's reaction going forward on this significant legal precedent.

I. The Case

James n. Kirby, Pty ltd., an Australian manufacturer, is the largest wholesaler for refrigeration and air conditioning equipment in Australia. Kirby is a division of Heatcraft Australia Pty ltd, a wholly owned subsidiary of Lennox Industries Inc., a U.S. company based in Dallas, Texas. Lennox has operations throughout the world and is an industry leader in commercial refrigeration, air conditioning and heat transfer products. Kirby hired freight forwarder international cargo control (ICC) to arrange for delivery of 10 containers of machinery sold to the general motors plant located outside Huntsville, Alabama.

ICC issued a "through" transportation bill of lading to Kirby. The bill of lading designated Sydney, Australia, as the port of loading; savannah, Georgia, U.S.A., as the port of discharge; and Huntsville as the final destination for delivery. ICC hired ocean carrier Hamburg Sud to perform the ocean transportation from Sydney to Huntsville. Hamburg Sud issued a bill of lading that named Hamburg Sud as the carrier and ICC as the shipper. Hamburg Sud's American subsidiary hired rail carrier Norfolk southern to perform the inland transportation from savannah to Huntsville. In route from savannah to Huntsville the train derailed, which caused $1.5 million dollars in damage to the machinery.

The bill of lading ICC issued to Kirby set ICC's liability limitation lower than the cargo's true value, using the liability rule in the carriage of goods by sea act ($500 per package) for the sea leg. The bill of lading also contained a "Himalaya clause" which extends liability limitations to "any servant, agent, or other person (including any independent contractor)." The ocean carrier, Hamburg Sud, issued its own bill of lading to ICC, which adopted COGSA's default rule for liability limitations with respect to any land damages and extended it in a Himalaya clause again protecting all "agents…including inland carriers… and all independent contractors."

II. District Court's Decision

After Kirby's cargo insurer Allianz Australia limited insurance reimbursed Kirby for the loss they then joined with Kirby in suing Norfolk southern railway co. in the United States district court for the northern district of Georgia, asserting diversity jurisdiction and alleging tort and contract claims. One of Norfolk's replies to the suit sought liability limitation protection under the two bills of lading. The district court granted Norfolk's motion for partial summary judgment, holding Norfolk's liability was limited to $500 per container or $5,000 total.

III. Circuit Courts Decision

A divided panel of the United States eleventh circuit court of appeals reversed the district court's ruling and held that Norfolk could not claim protection under the ICC bill's Himalaya clause because it had not been in privity with ICC when the bill was issued and because linguistic specificity was required to extend the clause's benefits to an inland carrier. It also held that Kirby was not bound by the

Hamburg Sud bill's liability limitation because ICC was not acting as Kirby's agent when it received the bill. The court of appeals concluded that the language of the ICC bill's Himalaya clause was too vague to clearly include Norfolk.

IV. Supreme Court Decision

Taken from the supreme court of the United States' delivered opinion. "In negotiating the ICC bill, Kirby had the opportunity to declare the full value of the machinery and to have ICC assume liability for the value. The COGSA "package limitation" provides: "neither the carrier nor the ship shall in any event be or become liable for any loss or damage to or in connection with the transportation of goods in an amount exceeding $500 per package lawful money of the United States...unless the nature and value of such goods have been declared by the shipper before shipment and inserted into the bill of lading." For the land leg of the trip the bill limits the carrier's liability to a higher amount. the bill provides that "the freight forwarder shall in no event be or become liable for any loss of or damage to the goods in an amount exceeding the equivalent of 666.67 sdr per package or unit or 2 sdr per kilogram of gross weight of the goods lost or damaged, whichever is the higher, unless the nature and value of the goods shall have been declared by the consignor." An sdr or special drawing right, is a unit of account created by the international monetary fund and calculated daily on the basis of a basket of currencies. Liability computed per package for the 10 containers, was approximately $17,231 when the goods were damaged on October 9, 1997 and $9,763 when the case was argued, October 6, 2004. There is no record of the machinery's weight.

Discussing the issue of jurisdiction, the court quoted Justice Harlan, that "the situation presented here has a more genuinely salty flavor..." When a contract is a maritime one, and the dispute is not inherently local, federal law controls the contract interpretation. Our cases do not draw clean lines between maritime and non-maritime contracts. We have recognized that the boundaries of admiralty jurisdiction over contracts – as opposed to torts or crimes – being conceptual rather than spatial, have always been difficult to draw." the court goes on to say, while it may once have seemed natural to think that only contracts embodying commercial obligations between the "tackles" (i.e. from port

To port) have maritime objectives, **the shore is now an artificial place to draw a line**. Maritime commerce has evolved along with the nature of transportation and is often inseparable from some land-based obligations. The international transportation industry "clearly has moved into a new era – the age of multimodalism, door-to-door transport based on efficient use of all available modes of transportation by air, water and land." Contracts reflect the new technology, hence the popularity of "through" bills of lading, in which cargo owners can contract for transportation across oceans and to inland destinations in a single transaction.

The court had more to say about its finding of federal jurisdiction: a maritime contract's interpretation may so implicate local interests as to beckon interpretation by state law. But when state interests cannot be accommodated without defeating a federal interest, as is the case here, the federal substantive law should govern. **Our touchstone is a concern for the uniform meaning of maritime contracts**...applying state law to cases like this one would undermine the uniformity of general maritime law. Confusion and inefficiency will inevitably result if more than one body of law governs a given contract's meaning. In protecting the uniformity of federal maritime law, we also reinforce the liability regime congress established in COGSA. And the apparent purpose of COGSA, to facilitate efficient contracting in contracts for carriage by sea, would be defeated. This is a simple question of contract interpretation.

This clearly is an important point and may have benefits for marine underwriters going forward. As you all know, federal jurisdiction, with cases heard before judges more familiar with complex business issues and maritime subjects in particular, is usually our preferred forum.

Having settled the jurisdiction issue in favor of applying federal law, the court moved on to contract interpretation: "when an intermediary contracts with a carrier to transport goods, the cargo owner's recovery against the carrier is limited by the liability limitation to which the intermediary and carrier agreed. The intermediary is certainly not automatically empowered to be the cargo owner's agent in every sense. That would be unsustainable. But when it comes to liability limitations for negligence resulting in damage, an intermediary can negotiate reliable and enforceable agreements with the carriers it engages." For the limited purpose of binding the cargo owners to liability limits agreed to by its intermediary, the court saw no need for a formal agency relationship.

The court gave three reasons for its interpretation: "First, we believe that a limited agency rule tracks industry practices. In intercontinental ocean shipping, carriers may not know if they are dealing with an intermediary, rather than with a cargo owner. Even if knowingly dealing with an intermediary, they may not know how many other intermediaries came before, or what obligations may be outstanding among them. If the eleventh circuit's rule were the law, carriers would have to seek out more information before contracting, so as to assure themselves that their contractual liability limitations provide true protection. That task of information gathering might be very costly or even impossible, given that goods often change hands many times in the course of intermodal transportation. Second, if liability limitations negotiated with cargo owners were reliable while limitations negotiated with intermediaries were not, carriers would likely want to charge the latter at higher rates. Finally, our decision produces an equitable result. Kirby retains the option to sue ICC, the carrier, for any loss that exceeds the liability limitation to which they agreed. And indeed, Kirby has sued ICC in an Australian court for damages arising from the Norfolk derailment. It seems logical that ICC – the only party that definitely knew about and was party to both of the bills of lading at issue here – should bear responsibility for any gap between the liability limitation in the bills. Future parties remain free to adapt their contracts to the rules set forth here, only now with the benefit of greater predictability concerning the rules for which their contracts might compensate."

The Kirby Decision needs to be understood and considered as part of our underwriting process. The fact that it is a Supreme Court decision adds untold weight to any potential outcomes going forward. Our hope is that it underscores the importance of recovery actions against responsible third parties and underwriters do more investigation on recovery potential prior to writing a risk.

V. Underwriters' and Claims' Decisions

In a booklet on the website of AIMU entitled "guide to u.s. cargo insurance" we say ocean cargo insurance is concerned primarily with international commerce. Basically, anyone who has an insurable interest in a cargo shipment (i.e. anyone who would suffer a loss if the cargo were damaged or destroyed or who would benefit from the safe arrival of the cargo) has a need for an ocean cargo policy. we further go on to say about the cost of insurance that the loss experience developed on an assured's own account heavily influences the judgment of the underwriters as respects rating. How will the assured's cargo insurance premium be calculated when $500 per package (or other liability limitations) is the maximum recovery?

An underwriters' decisions are contingent upon information he or she gathers about the risk, the terms and conditions sought or available to the client, which are manifest in the insurance policy or

contract written, and their projections of the financial consequences expected. This last item is largely driven by past experience.

I've displayed a copy of the American Institute of Marine Underwriters current Cargo Clauses for illustration. All cargo policies contain language that subrogate the insured's rights against third parties to the underwriter when a claim is paid. This is a critical component in our financial results.

It obviously varies from company to company and from year to year but I would estimate that 15% of cargo losses paid are recovered through subrogation. If you reflect that the American Marine Market writes about $800 million in Ocean Cargo premium annually and further estimate a 60% loss ratio, this translates into $480 million in annual losses. 15% of these paid losses is $72 million in annual recovery. This is a critical piece of our financial puzzle and we must take any threat to this balance seriously.

This element of our business is unique to marine insurers. You only need look at the actuary's face as he is sure he has made a mistake in his calculations when the loss development for ocean cargo is negative over time.

We as underwriters are capitalized, most often as public companies, where stockholders are anticipating a reasonable return on their investment, commensurate with the risk to other capital. It's our role to manage and spread the financial risk of our clients and provide additional risk management, claims and assessment services. And in the end make a profit.

If our financial model for cargo insurance, which currently includes subrogation recoveries changes, we will simply change our pricing or terms. Whether the Kirby decision will have an effect on our pricing will only be apparent over time.

To those of you who represent cargo underwriters' interest, your income, or share of that $72 million estimate may be threatened. If $500 per package is all we can expect to collect from a negligent third party, is there still a need to retain attorneys to pursue these recoveries? Obviously, the value maritime law Association members bring to marine insurers is far broader than just recovery actions. Our common goals, which I Mentioned in our opening, will continue to evolve.

VI. Loss Prevention

A final thought about loss prevention. The AIMU guide book states that all those concerned with world trade are jointly interested in the delivery of merchandise in sound condition and in the avoidance of economic waste and dissatisfied customers as a result of loss or damage to goods in transit. Good business practice therefore dictates that any insurance plan must be combined with a comprehensive program for preventing or controlling losses. Identifying and understanding the susceptibilities of a particular cargo to various transportation hazards is an important first step in loss prevention. It is an accepted fact that approximately 70% of losses sustained during transportation could have been prevented by effective use of loss control measures. What incentives does a responsible party, such as a carrier or shipper, now have to avoid negligence? Remember, reduced losses contribute to insurers' ability to maintain premiums at affordable levels?

VII. Conclusion

I would like to start a "wishful" thinking list about the Kirby decision with a few versions: 1. it can't possibly be that bad. 2. Luckily, we don't have any of that kind of Exposure. 3. If it hadn't been for that (insert your choice of "claim" "contract" "agent") our results would be just fine. 4. We can't get

hurt too badly, because we only take a tiny piece of the risk; and finally, 5. Relax, we only insure good risks that never have losses! Besides our reinsurers will cover us above our retention!

While ocean marine insurance is perhaps the oldest form of insurance and ocean marine underwriters adapt to and serve the needs of modern international business, this Supreme Court decision will cause us to adjust our sails!