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**BRIDGE  
LOOK-OUT**

EDITION  
NO. 1/19

LOF – MIND THE CAP

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## DEAR CLIENTS AND BUSINESS PARTNERS

We are very proud to present the first edition of our Georg Duncker Bridge Look-out, designed for the shipping industry, in which we aim to provide you with informative and practical up to date information.

The marine sector remains one of the most challenging industries, requiring both broad and in-depth knowledge in order to ensure the smooth and safe operation of a vessel. For Shipmanagers, experience is required not only for a successful technical operation of a vessel, but also to handle the ever increasing regulations and to understand the various international legislations whilst participating in a competitive environment. The evolving nature of the shipping industry and its connected activities most certainly keeps working in this sector unique and interesting.

An example of changes in the sector can be seen in how growing environmental awareness of the general public has begun to effect on the industry over the past years. This has in turn influenced the IMO, who have introduced new regulations in order to reduce pollution and even decrease vessels' sulphur emissions.

To do so, the IMO adopted new regulations with regard to ballast water treatment, which came into force on 8th of September 2017, as well as provisions related to the global Sulphur limit. In order to comply with regulations, Shipmanagers had to respond in an incredibly short timeframe which led to an increased financial burden.

Alongside the requested measures to fulfill the IMO's latest provisions, Shipmanagers need to consider further potential challenges as a result of new regulations already in place, such as running ship's engines on low sulphur fuel or on LNG only.

Amongst the environmental aspects, the public's awareness for humanity has also increased in recent years, leading to an increase in health & safety standards at work and beyond. In this respect, the ILO has agreed to new regulations to enhance the standards on ocean going vessels to improve the seafarers' working conditions on board. As a result of this, the Maritime Labor Convention commonly known as MLC 2006 was adopted and came into effect in 2013. Once again, Shipmanagers had to find solutions to comply with the prescriptions which were ultimately fulfilled with the assistance of the P&I Clubs.

Further to the above-mentioned exemplary international hurdles, Shipmanagers are additionally confronted by special international regulations and requirements, particularly during vessels' port calls in China or the USA.

As Insurance Brokers, we are supporting in various areas of Shipmanagers' business, ranging from the placement of required insurance covers,

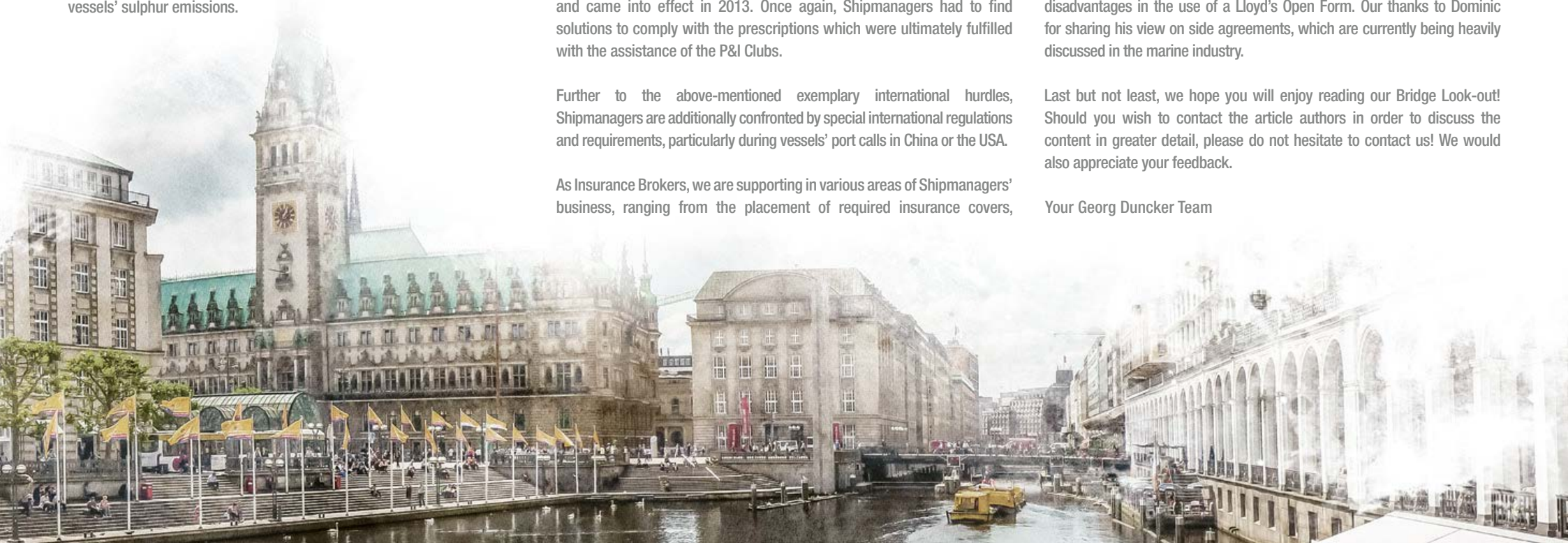
assistance with the issuance of insurance related certificates and the handling of underlying claims such as damage to the vessel, third party liability claims or disputes under charter party contracts. We have a good insight into the insurance issues Shipmanagers are confronted with and we are best placed to recognize trends at an early stage.

Our newsletter is intended to provide Shipmanagers with an overview on current developments which may be linked to marine insurance and claims, technical trends, legal developments and new requirements. We will be asking industry experts such as lawyers, surveyors, adjusters and underwriters to participate and contribute to the publication, bringing their experience and knowledge to our Newsletter.

For this first edition of our newsletter, we are pleased to have Dominic Johnson, partner at the law firm HFW of London, as guest author for the current interesting developments in the use of the salvage contract Lloyd's Open Form. This leading article deals with the advantages and the disadvantages in the use of a Lloyd's Open Form. Our thanks to Dominic for sharing his view on side agreements, which are currently being heavily discussed in the marine industry.

Last but not least, we hope you will enjoy reading our Bridge Look-out! Should you wish to contact the article authors in order to discuss the content in greater detail, please do not hesitate to contact us! We would also appreciate your feedback.

Your Georg Duncker Team



## LOF - MIND THE CAP 1

The Lloyd's Open Form of Salvage Agreement (LOF) is a well-established salvage agreement which has been in existence, in various forms, for over a century. The LOF provides a regime for determining the amount of remuneration to be awarded to salvors for their services in saving property at sea and minimising or preventing damage to the environment. The standard form, which is accompanied by the Lloyd's Standard Salvage and Arbitration (LSSA) Clauses and procedural rules, enables the parties to enter into the salvage agreement without the need for negotiation thus ensuring immediate intervention by salvors in emergency situations.

The LOF is based on the „No Cure No Pay“ concept and a salvor's salvage remuneration will be assessed by a specialist LOF Arbitrator with reference to a list of criteria set out in Article 13 of the Salvage Convention 1989 with a view to encouraging salvage operations. The criteria includes, amongst others, the value of the salvaged property, the measure of success, the degree of danger, the skill of the salvors and the time and expenses incurred by the salvors.

The payment of the LOF salvage award is made by all of the vessel and other property interests (such as the owners of the cargo, bunkers, stores and freight at risk) in proportion to their respective salvaged values. The ship's proportion of the LOF salvage award will generally be covered by the shipowner's H&M insurance. If the LOF is entered into in order to prevent a loss by perils insured against, as is commonly the case, then the shipowner should be covered in full for the salvage remuneration which they are obliged to pay to the salvors. This drastically reduces their financial exposure for the incident which has brought about the need for salvage. The urgent nature of a casualty may require the immediate agreement to an emergency salvage contract such as a LOF. However, if time permits,

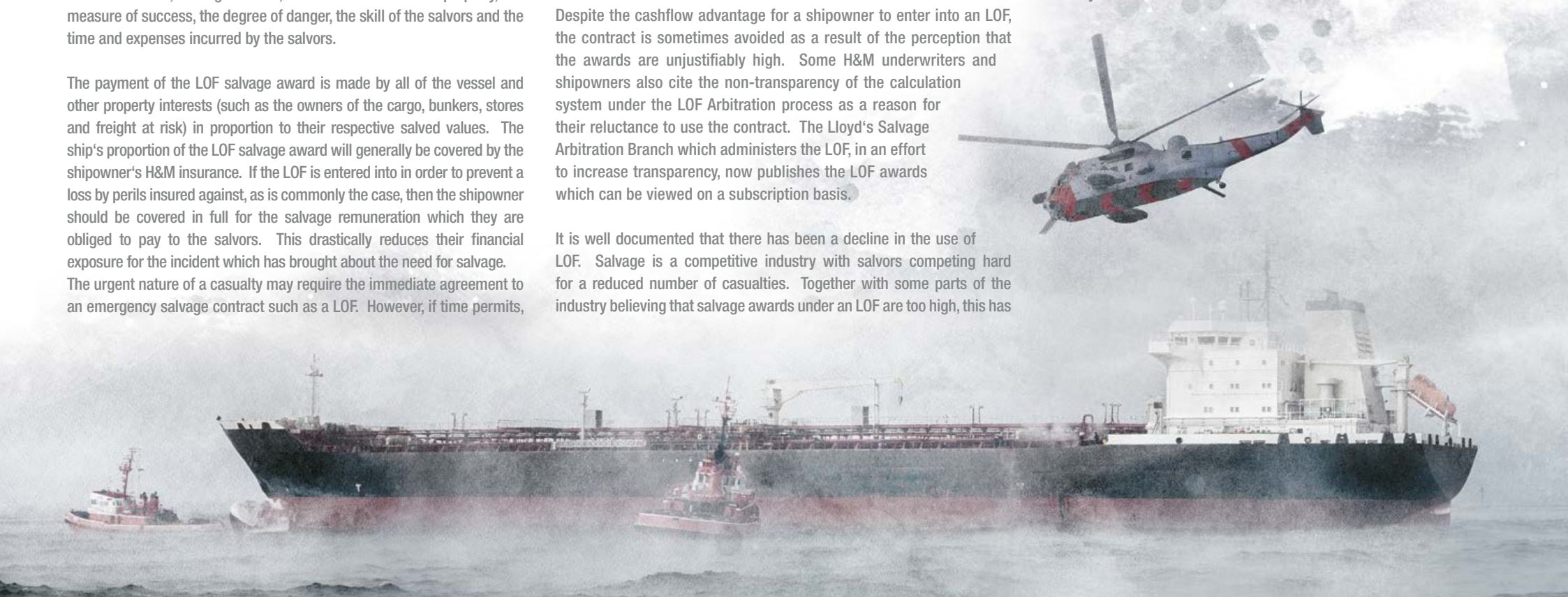
a shipowner may negotiate commercial terms for an alternative contract in the form of the BIMCO standard templates such as a Wreckhire / Wreckfixed, Towhire or Supplytime or agreement. These contracts, unlike the mechanism under an LOF, do not provide for the direct contribution of payment from other property interests. The shipowner will therefore be required to fund the full amount for the services rendered. General Average (GA) may well provide the shipowners with the ability to recover a contribution proportionate to values from cargo (and other property) interests. The recovery from cargo interests may take a significant amount of time. The shipowner's H&M underwriters will only cover the shipowner's proportion of GA unless shipowners have a GA absorption clause and the sums fall within it. A shipowner may therefore face a temporary financial gap to cover their expenditure until the GA Adjustment is finalised and funds are collected from the relevant interests.

Despite the cashflow advantage for a shipowner to enter into an LOF, the contract is sometimes avoided as a result of the perception that the awards are unjustifiably high. Some H&M underwriters and shipowners also cite the non-transparency of the calculation system under the LOF Arbitration process as a reason for their reluctance to use the contract. The Lloyd's Salvage Arbitration Branch which administers the LOF, in an effort to increase transparency, now publishes the LOF awards which can be viewed on a subscription basis.

It is well documented that there has been a decline in the use of LOF. Salvage is a competitive industry with salvors competing hard for a reduced number of casualties. Together with some parts of the industry believing that salvage awards under an LOF are too high, this has

brought about the evolution, in some cases, of amendments to the LOF remuneration terms, usually through a „side letter“ or „side agreement“. Salvors, in some instances reluctantly, are prepared to agree to these eroded terms in order to win the work. This is combined with improved communication which enables shipowner's and insurers to explore what options are available within the market and for salvors to chase potential contracts and offer such terms.

The form of the side agreement can vary. Most commonly it will cap or fix the amount of the award that can be received by the salvor under the Article 13 criteria. Alternatively it may apply a tariff based calculation for the craft, personnel and equipment used during the salvage services. The tariff is usually based on the SCOPIC rates with or without an uplift. There could be a mechanism to retrospectively apply SCOPIC even if not formally invoked.



## LOF - MIND THE CAP 2

The intention of the side agreement is usually a simple one – to reduce the amount of money that a shipowner or their H&M underwriter has to pay for the salvage services. There may also be initial uncertainty on what danger is faced by the vessel and what types of services are required which can limit the ability to enter into a negotiation whilst still putting in place an immediate response. The many advantages of the LOF remain, such as the ability to enter into it quickly, a best endeavours obligation on the salvors and the provision of security (and ultimately contribution) by the various property interests. There can, however, be unintended consequences to entering into a side agreement.

A LOF will incorporate the SCOPIC clause in most cases. The SCOPIC clause can be invoked by the salvor to introduce a tariff based calculation for the craft, personnel and equipment using pre-specified rates together with an uplift fixed at 25%. A salvor will seek to operate this clause when the salvaged fund is insufficient to allow adequate remuneration under Article 13 and/or if the danger to the property is very high. SCOPIC remuneration is then paid by a shipowner's P&I insurer but only in the amount that it exceeds the Article 13 award.

The intention of a side agreement which caps the Article 13 LOF award may be to manage an H&M underwriter's exposure to costs under LOF but if SCOPIC is later invoked then the agreement may prejudice the

P&I insurers position by increasing the amount of SCOPIC remuneration payable. Any amendment to the terms of an LOF, particularly the basis on which the Article 13 criteria is assessed, has the potential to prejudice the P&I insurer. The International Group of P&I Clubs (IG) have made their position quite clear that if an alteration to the standard LOF and SCOPIC terms causes an increase in the amount of remuneration payable by the Club then it may affect cover unless it has first been consulted and approved the change. Other liabilities or remuneration obligations may be inadvertently created which may not be covered under the Club Rules.

This concern raised by the IG has been reflected in an amendment to the standard form SCOPIC Remuneration Salvage Guarantee Form ISU5. A new clause has been inserted which makes the guarantee contingent on the LOF and SCOPIC terms being unamended unless agreed by the Club. The guidance notes of the ISU 5 states that if the LOF has been amended by a side agreement or otherwise „in a manner that has the potential to change the amounts payable by one or more interested party“ the amendment must be disclosed to the Club. Failure to disclosure will result in the security becoming void.

There is also a risk that the side agreement does not bind the cargo interests. Cargo interests are usually bound to an LOF when entered into by a shipowner on their behalf supported by Article 6 of the Salvage Convention 1989. If the agreement is not entered into promptly or the terms of the agreement are unreasonable and prejudice cargo then they may not be bound.

LOF continues to be a popular salvage contract albeit in a challenging climate for salvors. There have been some attempts to develop an alternative LOF option relying on a more commercial tariff based model. This has led to a so called LOF „Light“ proposal to be developed but this concept has not received support from stakeholders in the salvage and property market.

In conclusion, it is recommended that careful consideration is given when entering into amended LOF contracts. A side agreement can create unintended consequences for a shipowner and what was intended to reduce the cost of salvage may affect their insurance cover or ability to recover salvage contributions from other property interests. A shipowner and/or the H&M underwriter are strongly advised to obtain legal advice on these issues and to also engage with the relevant P&I insurer to either submit any draft side agreement for their review or include them in discussions early on before entering into any agreement.

For Shipowners who want to have the liberty to negotiate an alternative commercial contract (e.g. Wreckhire, Towhire, etc.) but do not want to run the financial risk to support the full GA expenditures until the GA Adjustment is finalised, your Georg Duncker Team can offer an insurance product which provides liquidity. Indeed, products such as Cargo Contribution Protect insurance provide cover for the GA proportions of the interests other than the ship (e.g. cargo, bunker) and they ensure immediate reimbursement of these proportions. Your Georg Duncker Broking Team would be happy to assist you in finding and placing a suitable cover.



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