

# **The Supreme Court decision in *The LONGCHAMP*<sup>1</sup> and its potential impact on General Average**

by

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On 29 January 2009 the vessel LONGCHAMP was enroute from Norway to Vietnam loaded with a cargo of chemicals in bulk when it was boarded by pirates. The pirates ordered that the vessel proceed to Somalia where she anchored off the coast on 31 January. Meanwhile, the pirates had demanded a ransom of USD6m, the vessel's owners response to this demand was to establish a crisis management team. This team set a target settlement figure of USD1.5m and made an opening offer of USD373,000 on 2 February which was declined. Negotiations over a period of some seven weeks ultimately led to an agreement on 22 March to pay a ransom of USD1.85m. This amount was paid on 27 March and the vessel continued on her voyage on 28 March.

At the time of this incident the vessel was carrying cargo shipped under a bill of lading which provided "*General Average, if any, shall be settled in accordance with the York-Antwerp Rules 1974*". A general average statement was prepared in London within which certain running expenses of the vessel incurred during the period of ransom negotiation (30 January/22 March – 51 days) were allowed in general average; these expenses amounted to USD160,000. The adjuster's justification for this allowance was that these expenses were incurred in order to reduce, by negotiation, the amount of the ransom from USD6m to USD1.85m. He argued that had the first ransom demand been met, the amount of USD6m would have been allowed in general average under Rule A and that by undertaking the negotiation of the ransom there had been a very significant saving to the parties to the general average. The adjuster reasoned that such expenses were allowable in general average in accordance with the terms of Rule F of the York-Antwerp Rules 1974.

Rule F provides as follows:

*"Any extra expense incurred in place of another expense which would have been allowable as general average shall be deemed to be general average and so allowed without regard to the saving, if any, to other interests, but only up to the amount of the general average expense avoided."*

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<sup>1</sup> Mitsui & Co Ltd and others v Beteiligungsgesellschaft LPG Tankerflotte MBH & Co KG and another [2017] UKSC 68

<sup>2</sup> 4<sup>th</sup> Edition published by *informa law from Routledge* as part of the Lloyd's Shipping Law Library

The cargo interests disputed the allowance made under Rule F and they were supported in this by a report issued by the Advisory Committee of the Association of Average Adjusters who concluded, *inter alia*, that the payment of the initial ransom demand would not have been reasonable and therefore would not be allowable in general average under Rule A which requires expenditure to be reasonably incurred. However, the Committee did accept that at some time during the course of negotiations a particular proposed settlement might be reasonable.

Having already made payments on account of their contribution to the general average, upon publication of the general average adjustment the cargo interests commenced proceedings challenging the adjustment. The Commercial Court found in favour of the adjuster's position but this was overturned by the Court of Appeal. The Supreme Court handed down its' judgment on 25 October 2017 supporting the decision of the Commercial Court and the allowance made by the adjuster.

The principle issue before the Court was whether or not the daily operating expenses of the vessel incurred by the shipowners whilst they were negotiating the payment of a ransom with the pirates should be allowed in general average under Rule F. In this case those daily operating expenses incurred during the period of negotiation amounted to USD160,000.

As noted above, the position of the adjuster was that these expenses saved USD4.15m, that is the difference between the pirates' first demand and the final settlement, which, in the absence of negotiation would have been allowable in general average under Rule A. And, on that basis, the daily operating expenses being less than the saving achieved through negotiation were allowable under Rule F as a substituted expense. The cargo interests argued that the payment of the initial demand of USD6m would not have been reasonable and could therefore not have been allowed under Rule A which requires expenditure to be reasonably incurred.

The Supreme Court is of the opinion, by a majority, that it was not necessary to resolve the issue of whether or not the payment of the initial ransom demand would have been reasonable because it was not critical to an allowance under Rule F. Lord Neuberger said that the assumption that it was necessary to determine whether the payment of the initial demand would have been reasonable would lead to very odd results: *"It would mean that if a ship-owner incurs an expense to avoid paying a reasonable sum, he can in principle recover under Rule F, whereas if he incurs expense to avoid paying an unreasonable sum (i.e. a larger sum), he cannot recover."* This is known as the "Hudson conundrum", named after Geoffrey Hudson who first described it.

In the opinion of the Court the reference in Rule F to *"expense which would have been allowable"* is reference to an expense of a nature which would have been allowable rather than its' quantum. Per Lord Neuberger: *"... the interpretation I favour produces an entirely rational outcome: whenever an expense is incurred to avoid a sum of a type which would be allowable, that expense would be allowable,*

*but only to the extent that it does not exceed the sum avoided.*” Thus the Court found that as the ransom was an allowable expense in principle, the expenses amounting to USD160,000 fell within Rule F, this being subject only to it being demonstrated that the payment of a ransom of approximately USD2.4m (the ransom paid plus USD160,000 plus the costs of negotiation) would have been reasonable.

The judgment also mentioned that even if their analysis was not correct, Rule F would still apply to whatever was decided to be a maximum reasonable ransom. Thus if a reasonable ransom would have been USD4m, Rule F would have applied to USD4m of the USD6m ransom demand.

Interestingly, both of the lower courts concluded that it would have been reasonable for the owners to have accepted and paid the first ransom demand of USD6m. In his dissenting judgment in the Supreme Court, Lord Mance said that he was unable to accept the evaluative judgment of the lower courts in this respect and considered that the owners would have been acting unreasonably in the circumstances had they accepted the pirates’ initial demand.

Lord Mance mentions that no alternative case has been advanced to reflect the possibility that settlement of the ransom at some figure less than USD6m, some time after the initial demand, would have reduced the negotiation expenses recoverable under Rule F. He concludes: *“The owners have established that Rule F is in principle capable of applying to negotiation period expenses, which may well be the principle which this litigation is about. But I do not think that they have established on the facts that they have a claim on the only factual basis on which the case has been put.”*

Other significant issues considered by the Supreme Court were as follows:

Firstly, the cargo interests contended that the vessel operating costs incurred during the period of negotiation were not allowable under Rule F because the payment of the reduced ransom was not an *“alternative course of action”* to the payment of the ransom originally demanded. This argument was rejected by the Court on the basis that the incurring of the vessel operating expenses did represent an alternative course of action to that of paying a higher ransom.

Secondly, the cargo interests contended that the the vessel operating costs must be shown to have been consciously and intentionally incurred by the owners. It was argued that in this instance the owners never made a conscious choice between paying the initial ransom demand and negotiating with the pirates. This contention was rejected by the Court on the basis that it must have been clear that negotiations would be required if the ransom was to be reduced. Thus the expenses incurred during the negotiation were intentionally incurred and resulted in the reduction in the ransom that was achieved.

Thirdly, the cargo interests contended that the claim under Rule F should fail because the costs claimed were indirect losses excluded by Rule C. Although the Court accepted that if the expenses incurred during the period of negotiation had

been in consequence of a general average act they would be excluded by Rule C, the Court was of the opinion that Rule C does not apply to expenses covered by Rule F in mitigation of expenses which would otherwise be allowable in general average: *“By definition sums recoverable under Rule F are not themselves allowable in general average, but are alternatives to sums which would be allowable.”*

In reference to the almost universal practice of average adjusters not to make allowances under Rule F in the circumstances of this case, Lord Neuberger said:

*“... the law cannot be decided by what is understood among writers and practitioners in the relevant field ... . Experience shows that in many areas of practical and professional endeavour generally accepted points of principle and practice, when tested in court, sometimes turn out to be unsustainable. I accept that it may be right for a court to have regard to practices which have developed and principles which have been adopted by practitioners, but they cannot determine the outcome when the issue is ultimately one of law.”*

This is, of course, correct however, it underlies the problem inherent in the application of commercial rules that are intended to be applied in a fair and equitable manner.

This judgment will have a number of consequences.

Having established the principle that vessel operating expenses incurred while a ransom is being negotiated are recoverable under Rule F, the breadth of such expenses may be considered. The claim in this instance was limited to crew wages and maintenance and fuel costs. However, might other operating expenses such as insurance premiums and management costs also be included? It would appear that such expenses may be included provided that they are incurred on a periodic basis; clearly capital costs or depreciation could not be included.

It is understood that a number of adjustments were being delayed in publication awaiting the outcome of this appeal. Presumably these adjustments will now go forward on the basis of the Supreme Court's decision.

In addition, it is quite likely that shipowners will require closed cases to be reopened resulting in additional claims on hull & machinery and cargo underwriters.

It is difficult to see why the principle established in this case might not be applied in cases other than those involving piracy and ransoms. For example, during delays on the voyage whilst salvage rewards are being negotiated.

It should be noted that this case involved the application of the 1974 York-Antwerp Rules. In 1994 a Rule Paramount was added to the Rules which provides: *“In no case shall there be any allowance for sacrifice or expenditure unless reasonably made or incurred”*. This Rule has remained unamended since that time. In 1994 there was a proposal to amend Rule F to read as follows: *“Any*

*expense incurred in place of another expense which would have been reasonably incurred and allowable as general average ...”* (emphasis added) but this was withdrawn when the Rule Paramount was voted on and approved.

The prime objective of the Rule Paramount, which was a reaction to the English case of *The Alpha*<sup>3</sup>, was to apply the concept of reasonableness to all subsidiary Rules (i.e. both the lettered and numbered Rules); in particular to ensure that the concept applied to the numbered rules which were not subject to Rule A by reason of the Rule of Interpretation.

It would appear that the application of this Rule would make no difference to the impact of this judgment as it would only apply to the expenditure which was avoided, a higher ransom, which it has been decided refers to the nature and not the quantum of the expense. To come to this conclusion the Court must have concluded that the nature of the expense would have been reasonably incurred under the reasonability constraints of Rule A. So the issue is whether or not the reasonability requirement in Rule A is different to that of the Rule Paramount. Both Rules use the words “*reasonably ... incurred*” thus it would appear that there should not be any difference between the constraint used in Rule A and that adopted for the Rule Paramount.

In this context it should be remembered that the two lower Courts both concluded that the allowance of the initial ransom would have been reasonable both in principle and quantum.

There would seem little doubt that it was never intended that Rule F should be applied in the way that it has been by the adjuster and endorsed by The Supreme Court. It would therefore seem quite likely that the shareholders in general average the shipowners and the cargo interests, and their respective insurers, may seek to revert to the practice which was generally accepted. This might be achieved by market practice, express language in the contract of carriage or the amendment of the Rules.

There are at least two precedents in this respect.

When the lettered Rules were introduced in 1924 their intended purpose was to supplement the particular provisions of the numbered Rules and to furnish a general framework acceptable to the international maritime community. However, at that time, no provision was made to govern the relationship between the lettered and numbered Rules and this deficiency was exposed in the case of *The MAKIS*<sup>4</sup>. In this case it was held that, as a matter of construction, the lettered Rules constituted the general principles which were to be applied, to which the numbered Rules were subservient. Accordingly the shipowner’s claim

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<sup>3</sup> *Corfu Navigation Co and another v. Mobil Shipping Co Ltd and others* [1991] 2 Lloyd’s Rep. 515.

<sup>4</sup> *Vlassopoulos v. British & Foreign Marine Insurance Co* [1929] 1 K.B. 187; 34 Com. Cas. 65.

for expenses that would otherwise have been met under Rules X and XI was denied on the basis that the prerequisite of peril under Rule A was not present.

The implication of this judgement caused considerable consternation in the shipping and insurance markets as it directly contradicted the intention of the framers of the 1924 Rules. As a result leading British shipowners and underwriters concluded a market agreement, which became known as the Makis agreement, under which it was agreed that: *“Except as provided in the Numbered Rules 1 to 23 inclusive, the Adjustment shall be drawn up in accordance with the Lettered Rules A to G inclusive.”* This agreement formed the basis for the Rule of Interpretation incorporated in the 1950 Rules.

The case of *The ALPHA* has already been mentioned. This case concerned a grounding and consequent refloating operations which were conducted in a particularly unskilful manner such that significant damage was sustained by the vessel’s machinery. It was found that the requirement for reasonableness in Rule A could not be imported into Rule VII (Damage to Machinery and Boilers) under which the refloating damages were claimed. This case led to the introduction of the Rule Paramount in the 1994 Rules.

Having just been through a quite comprehensive revision of the Rules in 2016, it is doubted whether there will be sufficient enthusiasm to seek an amendment to Rule F in the foreseeable future. Any remedy may therefore seem to be limited to either a market agreement or an amendment to the contract of carriage.

Neither of these avenues would seem to be attractive particularly at a time when the numbers of Somali-style seizures by pirates, where the ship, cargo and crew are held hostage, have reduced to a trickle. Recent piracy events appear to have been directed to the taking of some of the crew as hostages or the theft of the cargo, events which do not have the necessary ingredient for any ransom to constitute general average; the necessity of common peril.

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