EYE-SPY – LATENT DEFECTS AND "AS IS, WHERE IS" CLAUSES IN CHARTER PARTIES

In the recent decision of *Delaware North Marine Experience Pty Ltd v The Ship "Eye-Spy"* [2017] FCA 708, the Federal Court of Australia clarified what constitutes a "latent defect" and who is responsible for such defects in chartered vessels where they are accepted in an "as is, where is" condition. The Court held that "as is, where is" clauses do not necessarily exempt shipowners from their obligations of due diligence or from liability for latent defects which are not readily discoverable on inspection.

This decision raises important issues for consideration by shipowners and charterers alike when negotiating and drafting charter parties. It also reinforces the importance of on-hire surveys. In general terms a "latent defect" is a defect which is not readily observable – they generally require something to be substantially pulled apart in order to be discovered, as opposed to a defect that is readily observable. Accordingly, the practicability of discovery on a reasonable inspection is a material factor in determining whether or not a defect is latent.

The case is also notable for the Court's award of damages against the arresting party for seeking excessive security to secure the release of the Vessel from arrest – the security sought was over three-fold the claimant's maximum recoverable claim.

Key points

- "As is, where is" clauses do not per se exonerate shipowners from their due diligence obligations.
- An "as is, where is" clause will not protect a shipowner from responsibility for latent defects where the charter party expressly allocates responsibility for latent defects to shipowners – they will bear that responsibility, despite the existence of the "as is, where is " clause.
- The practicability of discovery of a defect during an on-hire survey is a material factor in determining if the defect is "latent" or patent - a defect will be "latent" if it is not readily discoverable on reasonable inspection.
- A charterer may be relieved of its redelivery obligations where redelivery is illegal or impossible.

THE FACTS

Delaware North Marine Experience Pty Ltd (Delaware) bareboat chartered the passenger ferry "Eye-Spy (Vessel) from its owner, TKL Holdings Pty Ltd, and disponent owner, Moreton Bay Whale Watching Tours Pty Ltd (Owners). The charter was for a minimum of 14 days and on termination of the charter the Vessel was to be redelivered at Redcliffe.

On 7 February 2015, only a few days after delivery, the Vessel's starboard stern tube assembly (SSTA) failed due to inadequate water supply, thereby damaging the Vessel's stern. Due to the condition of the stern seal and a prohibition order which was issued by Maritime Safety Queensland (MSQ) on 10 February 2015 (prohibiting use of the Vessel until repairs were carried out), the Vessel did not undertake any further voyages under the charter party. The Vessel remained moored at Gladstone. On 18 February 2015, Delaware purported to redeliver the Vessel to the Owners at Gladstone.

On 26 November 2015, Delaware lodged a claim *in rem* against the vessel "Eye Spy" seeking damages for the cost of repairing the Vessel and expenses incurred as a consequence of the inability to use the Vessel (e.g. costs of substitute vessels). Delaware caused the Vessel to be arrested pursuant to section 17 of the *Admiralty Act 1988* (Cth) (AA), for a general maritime claim "*arising out of an agreement that relates to the carriage of goods or persons by a ship or to the use or hire of a ship, whether by charter party or otherwise*" (section 4(3)(f) AA). On the Owners' application, the Court ordered the Vessel be released from arrest on the Owners posting security for Delaware's claim plus legal costs. Security was paid into Court the following day, and the Vessel was released.

THE CLAIMS

Delaware claimed (among other things) that:

(a) the SSTA failure and resultant Vessel damage was caused by the Owners' failure to exercise due diligence to make the Vessel seaworthy before and at the time of delivery, in breach of clause 2 of the charter party; and

(b) the Owners were liable to repair the Vessel because the SSTA failure was caused by a "latent defect" – it alleged the SSTA had been deteriorating over time due to water starvation prior to commencement of the charter.

The Owners denied the claim and lodged a counter-claim alleging that:

(a) the Vessel was properly maintained before the charter and the SSTA was inspected during the on-hire survey;

(b) Delaware accepted the Vessel "as is, where is" – i.e. in its current condition including with any latent defects;

(c) the SSTA defects were not "latent defects" but were capable of detection during an "ordinary inspection" of the Vessel.

THE CHARTER TERMS

The relevant charter party included the following terms:

1 Clause 2 which provided that:

   (a) the Shipowners shall "exercise due diligence" to make the Vessel seaworthy before and at the time of delivery;

   (b) delivery of the Vessel constitutes full performance of all of the Shipowner's obligations under clause 2 but "Owners shall be responsible for repairs or renewals occasioned by independently verified latent defects in the Vessel"; and

   (c) on delivery, Delaware accepted the Vessel "as is, where is".

2 Clause 12 which provided that Delaware is not responsible for the costs of repairs to, or replacement of, any major engine failure where such a component is proven (through independent third party consultation) to have had latent defects.

3 Clause 14 which provided for the Vessel to be re-delivered at Redcliffe. It also provided that where repairs had to be carried out to restore the Vessel to its condition prior to departure, Delaware agreed to pay the Owners a penalty of $10,000 (including GST) for each day the Vessel was delayed or underwent repairs.

COURT'S DECISION - LIABILITY FOR VESSEL FAILURE

Justice McKerracher found the Owners were responsible for the Vessel's SSTA problems. The Court found there was evidence of pre-existing problems with the SSTA, consistent with the early stages of a bearing failure. The only way to further examine the SSTA bearing would have been to pull the shaft. The Owners' due diligence obligations required them to slip the Vessel and pull the shafts to enable the SSTA to be properly examined. However, there was no evidence that the Vessel's shaft had been pulled in the past 5 years.

As the Owners failed to exercise due diligence to make the Vessel seaworthy, the Owners breached clause 2 of the charter party. As a consequence, the Vessel could not be operated by the Charterers for the commercial purpose for which she had been chartered, causing Delaware to incur replacement vessel hire and vessel mooring charges.

"AS IS, WHERE IS" CLAUSES

His Honour noted that "as is, where is" clauses do not operate without exception. Specifically, they do not extend to acceptance of a vessel with latent defects i.e. defects that are discoverable only by substantially pulling something apart. The Court found it was impracticable for Delaware to slip the Vessel and pull its shaft on delivery or during the on-hire survey. As such, Delaware could not have realistically ascertained the existence of the latent SSTA defect.

As the defect that caused the SSTA failure was latent, the Owners were responsible for its repair pursuant to clauses 2 and 12 of the charter party - clause 2 expressly allocated responsibility for latent defects to the Owners, and clause 12 excluded Delaware from liability for latent defects.

REDELIVERY OBLIGATION

Delaware's failure to redeliver the Vessel to the designated redelivery location, Redcliffe, was held not to be a breach of its contractual redelivery obligations. Delaware was physically and legally unable to move the Vessel to Redcliffe due to the latent defect caused by the Owners' breach of their due diligence obligation to make the Vessel seaworthy under clause 2 of the charter party and due to the statutory notice issued by MSQ.

The onus was on Delaware to prove that clause 14 was unenforceable because it was a penalty clause and not a genuine pre-estimate of loss (*Multiplex Constructions Pty Ltd v Abgarus Pty Ltd* (1992) 33 NSWLR 504, 527). This involves a question of construction of the clause and the circumstances of each contract at the time of entering into the contract. While clause 14 itself refers to a "penalty", this is not conclusive of its status (*Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79, 86).

The relevant tests include whether the amount is extravagant in comparison with the greatest loss that could conceivably follow from a failure to redeliver the Vessel. See also *Paciocco v Australia and New Zealand Banking Group Limited* [2015] FCAFC 50 and *Andrews v Australia and New Zealand Banking Group Limited* [2012] HCA 30.

His Honour stated the daily sum of $10,000 payable under clause 14 for each day the Vessel remained undelivered was not delivered was not a genuine pre-estimate of the loss the Owners would suffer. The evidence showed the hire rate for the Vessel likely fell between $3,100 and $3,500, and the evidence supporting higher costs for delayed redelivery was found to be unconvincing. As such, His Honour concluded that the penalty aspect of clause 14 was unenforceable, not being a genuine pre-estimate of loss.

EXCESSIVE SECURITY

The Owners also claimed damages against Delaware for excessive security under section 34(1)(a)(i) (the Wrongful Arrest provision) of the AA. Owners alleged that Delaware had unreasonably and without good cause demanded "excessive security" for the release of the Vessel from arrest. Justice McKerracher accepted the Owners' claim in that regard and in a rare instance, ordered that Delaware pay damages for excessive security sought by it to effect the release of the Vessel under section 34 of the AA. This was one of the few instances in which section 34 of the AA was successfully invoked to hold an arresting party to account for seeking excessive security to secure the release of a vessel from arrest.

His Honour considered that the amount claimed by Delaware in its affidavit in support of the application for an arrest warrant was a "bald assertion", which was unsupported by documentary evidence such as invoices or proof of payments. The evidence adduced by Delaware showed its best case was substantially less (being approximately only one third of) of the amount sought as security for release of the Vessel from arrest. His Honour stated that Delaware must have undertaken some forensic analysis of the case before instituting admiralty proceedings, and ought to have realised that the quantum of security it sought was substantially excessive. The Court found the assertions in the supporting affidavit were "unreasonable" and "without good cause" within the terms of section 34 (1)(a)(i) of the AA.

FUTURE CONSIDERATIONS

It is well accepted in the industry that shipowners are required to provide a seaworthy vessel or exercise due diligence to ensure the vessel is seaworthy. Usually charterers have the opportunity to inspect the vessel prior to or at delivery. If the charterer accepts a vessel after an inspection, the shipowner is protected from liability for patent defects. However, if a charterer accepts a vessel after an inspection and a latent defect subsequently causes the vessel to become unseaworthy, the charterer may have a claim in damages.

"As is, where is" clauses apply such that the charterer accepts the vessel subject to all faults and defects. However, this case has demonstrated that "as is, where is" clauses do not necessarily negate shipowners' due diligence obligations under a charter party or liability for latent defects. Where the charter party expressly allocates responsibility for latent defects to shipowners, shipowners will bear responsibility for latent defects despite the existence of the "as is, where is" clause.

This case clarifies that shipowners have an ongoing obligation to keep their vessels seaworthy and cannot escape this obligation through "as is, where is" clauses.

However, note that in this case, the charter party expressly provided that the Owners are responsible for latent defects. A different outcome may have been reached if the charter party did not contain such a clause or is silent on the allocation of responsibility for latent defects. To ensure latent defects fall outside the umbrella of "as is, where is" clauses, charterers should ensure the charter party expressly allocates liability for latent defects to shipowners. Charterers taking vessels "as is, where is" should also undertake sufficient inspection on delivery to uncover "discoverable defects", which are within the scope of "as is, where is" clauses.

Shipowners should be aware that strict compliance with redelivery obligations may be relieved if the shipowner contributes to the charterer's inability to comply with those obligations.

Finally, arresting parties should ensure their claim for security is substantiated by documentary evidence and note that should they seek security over and above their maximum recoverable claim, damages may be awarded against them. Arresting parties should take heed of Justice McKerracher's warning to properly quantify their best possible case and to avoid demanding excessive security to secure the release of a vessel from arrest.

CONTACTS

Pat Saraceni
Director of Litigation
and Dispute Resolution

T +618 9262 5524
E pat.saraceni
@cliffordchance.com

Gervais Green
Partner
Asset Finance

T +65 6410 2252
E gervais.green
@cliffordchance.com

Kate Sherrard
Partner
Asset Finance

T +65 6661 2023
E kate.sherrard
@cliffordchance.com