

## **MORTGAGEES INTEREST INSURANCE (MII)-30/5/1986**

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### I-INTRODUCTION

This type of insurance was devised to answer needs of banks in the shipping finance. The bank advancing funds which is used to enable the borrower to purchase a ship which he was to become a part or full owner. The Bank (or any other institution having insurable interest in the subject matter insured) naturally would seek a security for the amount being loaned. As a traditional way to secure the loan, the Bank would seek a parent company guarantee. In absence of such guarantee the Bank would have a mortgage on the ship or would effect an insurance in his own name and account or would ask assignment of the hull policy from the owner mortgagor. As long as ship is not a total loss and hull policy is operational the said security may provide enough coverage for the Bank. But there may be cases where the shipowner (mortgagor) is not able to provide coverage from the hull policy and eventually the value of the mortgage may be lost through its being subordinated to large prior liens or legal claims. The standart MII insurance was devised to provide a coverage to mortgagee bank for loss arising out of any loss of, damage to or liability of a ship that are normally under the coverage of the hull and P&I Club policies but there is subsequent non-payment. The Bank may take out a MII policy through Lloyds market.

### II- BANKS (MORTGAGEE) POSITION UNDER HULL POLICIES

For the convenience we are to refer to insurance policies of Institute Time Clause Hulls ('ITCH')1995 and to its amended form The International Hull Clauses - 01/11/03(the 'IHC') and Institute Cargo Clauses ('ICC') (A)-(B)-(C). All marine insurance policies cover losses and damages that are result of the proximate cause which are perils of the seas. The loss and damages may effect the ship and cargo. If this effects the ship ITCH or ITVC policy and if cargo is effected the ICC (A),(B) or (C) would come into the picture. The definition of the perils of seas gains great importance. This term has been defined as to refer only to fortuitous accidents or casualties of the seas (first part). It does not include ordinary action of of the winds and waves (second part). So, the perils shall be unique for the sea voyage. In this context scutling, accidents on board (the crain dropping off the board are perils of the seas-those are peris ON the sea) and unseaworthiness of the ship are not perils of the seas (scutling in the limited circumstances it might be a peril of the seas) but collison (regardless the amount of the fault and whether only party is to blame) is a peril of the sea. In order to esatblsh position of the lending Bank we shall well esatblsh under what circumstances the shipowner is entitled to recover its losses and damages from the policies he has.

#### A- MORTGAGEE BANK AS AN ASSIGNEE OR WHERE EFFECTS AN INSURANCE IN HIS OWN NAME AND ACCOUNT

By loosing its security (the ship) banks are not always able to receover its damges under the hull policy assigned to them. Because this policy might be void or voidable or there has been a breach of the policy conditions.

#### 1- FIRE AND SCUTLING

Fire is a peril insured against (ITCH 95, Clause 6.1.2 and IHC, Clause 2.1.2) regardless whethet it has started accidentally or deliberately. As long damage or loss has been proximately caused by fire the assured Bank would be able to recover under the hull policy, provided that –of course- the wilful misconduct can not be attributable the Bank. But if the ship is set on fire by the wilful misconduct of the shipowner the assignee Bank would not be able

to recover. Because deliberate damage or loss is not recoverable. Since the assignee mortgagee Bank steps into the shoes of the owner and every defence that can be alleged against the owner could be alleged against the assignee Bank as well. In other words, the Bank is no better position of the owner and all defences (non-disclosure, unseaworthiness, class requirements, wilful misconduct ..etc) available by the insurance company against the assured owner can be successfully used against the assignee Bank.

But if the ship is lost by scuttling (with knowledge of the owner but without connivance of the Bank) the coverage provided by the hull policy is a bit complicated. If the Bank is an assignee of the hull policy and the ship is scuttled the Bank can not recover. The Bank may try to argue that they are innocent mortgagees and wilful misconduct of the owner shall not effect them. This argument would not be valid because, as we said above, the assignee shall not be in a better position than the assignor. The problem arises then, what if the ship is scuttled with connivance of the owner and the Bank has its own hull insurance policy? It is a tricky question. The Bank has nothing to do with the owner they have their own hull policy but suddenly of all the ship is lost due to misconduct of the owner. Can ITCH cover for this lost? Initial answer shall be 'no, the Bank can not recover because scuttling is not a peril insured against'. Well, this policy condition is right but does this is in balance with the other policies. For comparison we shall take a look to the cargo owners in the scuttling position. The cargo owners if they have ICC (A) all risk policy they would recover, because scuttling is a RISK but not peril of the seas; the cargo owner would not recover under ICC (B). Clause 1.2.3 covers damages to/loss of cargo by 'entry of sea lake or river water into vessel ..' BUT Clause 4.7 says: *this insurance does not cover deliberate damage to (scuttling) ... of the subject matter insured (cargo) ... by wrongful act of ANY person (the shipowner, crew etc).* So damage or loss of cargo is covered under 1.2.3 but then it is EXCLUDED by virtue of Clause 4.7 and cargo can not recover. Under ICC(C) cargo can not recover because Clause 1 does not cover this position. This analyse helps us to understand true position of the Bank with its own hull policy in the situation of scuttling of the ship. We may therefore conclude that, in the scuttling regardless whether the Bank takes out its own hull policy insurance (this insurance is different from the policy that they have assigned from the owner) the Bank can not recover because the scuttling is a RISK of the seas but not perils of the seas. This type of interpretation may lead us to unsatisfactory results. Where the mortgagee Bank independently insures his own interest separately and where the owner scuttles its ship, the bank would have no protection under hull policy (but would be protected under the MII policy Clause 6.1.2). It might be a severe outcome for the Bank. In order to minimise this negative effect and protect the innocent mortgagee Bank new interpretation can be developed. For this purpose we shall take into account the interest of mortgagor (the owner) and mortgagee (the Bank) are distinct interests, the mortgagee does not claim his interest through mortgagor. If the mortgagor is done something that the sea water enters into ship then this shall be act of the stranger. Then by insurance law that would be a loss by perils of the sea, the proximate cause of the loss being such a peril. Therefore, in that case only, the mortgagee Bank would not be affected by the wrongful act of the owner, who would be stranger to him; and the Bank would recover for a loss by perils of the sea.

## 2- BARRATRY

The barratry has been defined in the rules for construction of policy. Rule 11 says that *'the term 'barratry' includes every wrongful act wilfully committed by the Masters, Officers or Crew to the prejudice of the owner, or, as case may be, the charterer'*. Clause 6.2.4 of the ITCH (95) and Clause 2.2.5 of the IHC defines the barratry as the perils insured against. If the barratrous act is also committed in connivance of the owner this policy would not cover the owner nor the assignee Bank. If the hull policy has been taken out by the Bank, any connivance of the owner of barratrous act would not prevent the Bank from recovering.

## 3- LOSS OR DAMAGE CAUSED BY THE PERILS OF THE SEAS

If the loss or damage has been caused solely by the peril of the seas loss would be recoverable. But if the loss or damage has been caused deliberately or there is an element of fraud the Bank, whether assignee or on its own hull policy, can not recover. Perils of the seas requires ingredient of 'fortuity' any involvement of element of certainty such as wilfulness or fraud shall prevent coverage under the hull policy.

All situations stated above explain how vulnerable could be position of the Banks in reliance on the hull policy for the funds they advanced in financing the purchase of the ship. We stress the fact that difficulties for the Bank are not limited only to those stated above. Issues of misrepresentation, non-disclosure of material facts, breach of warranties (class maintenance seaworthiness, time limits for the representation of the claim, additional premium..etc) can have negative impact on the Banks claim against insurance companies.

#### B-COVERAGE UNDER THE MII POLICY

The Bank is not entitled to claim under the MII policy automatically. Clause 4 of the MII sets out warranties that to be complied before a mortgagee Bank to take advantage of the the policy. Those are:

- (1) *Hull and machinery policies on terms **equivalent** to ITCH or American Institute Hull Clauses*
- (2) *War risks policies equivalent to Institute War and Strikes Clauses-Time; and*
- (3) *full Protection and Indemnity Risks collectively referred to as 'the Owners Policies and Club Entries'.*

It has further been stated *'that these policies shall be taken out and maintained throughout the currency of this contract'*. First of all, of we shall indicate that MII is also applicable with the The International Hull Clauses (01/11/03) that are amended form of the ITCH (85).

In this section the word 'warranties' need to be elaborated in the light of the English law. Under English law 'warranty' is used in contract law and shipping law and they have different interpretation (see s. 33/3 Marine Insurance Act 1906 –MIA- *'a warranty ... is a condition..'*). In the shipping law breach of warranty gives right to repudiate the contract and claim damages, whereas the breach of condition gives right to claim damages only. Some features of the warranty are: Warranty can be express or implied . So you do not have to have warranty being with the word *'warranty'*, intention of the parties shall take the priority (but *'warranted free from capture and seizure'* is an exception clause and is subject to link of causation). In the shipping world the word a-warranty is an obligation that shall be exactly complied with (subject to *deminimis rule*), b- no need to be material to the risk (absence of the link of causation), c- there is no remedy for breach (the breach can not be cured even if it is cured before the loss-because the warranty was not exactly complied with) and d- there is no defence for the breach. If any bank comes to insurance company and asks payment under the MII policy the insurance company shall examine existence of the all warranties described in the Clause 4. If any defect has been noticed then the insurance company is entitled not to meet the claim. In practice, most of the problems regarding owners P&I and hull policies is non-payment of the premiums, maintenance of the class etc. This is a burden on the Banks. So they have to closely monitor payment of the insurance premiums and maintenance of class requirements by the shipping companies. In practical terms the Banks shall monitor payment of insurance premiums and if there is a gap they shall pay the premiums and add onto the mortgage debt. On the other hand insurance companies, as a commercial gesture, may waive this breach and meet the Banks claim under the MII policy. This can be made by signing a memorandum of agreement (or any other form of agreement) where issues preventing application of the MII policies are stated to be valid or to be in place. This type of agreements are based on commercial gesture or are *measures taken by the Assured (the Bank) or the Underwriter (the MII insurer) with the of averting or minimising a loss which would be recoverable under this contract (Clause 10.4)*. Agreements with regard a loss which would be recoverable under the MII policy shall not be considered as a waiver or acceptance of a claim or otherwise prejudice the rights of either party. MII policy by virtue of Clause 10.4 encourages a settlement between parties which would prevent deterioration in the ship and increase of damage in the ship. Parties usually

are reluctant to enter into negotioton and sign contract to prevent deterroration of the ship which later could be used against them as an evidence of waiver or acceptance. The Clause 10.4 prevents this situation.. Any agreement between the parties is with intention is to avert or minimise damage to the ship not to make a statement of acceptance or waiver.

Once the insurance company finishes with the examination of the obliagtion regarding warranties then they shall examine whether the nature of loss-damage-liability meet requirements of the Clause 6. In order loss-damage-liability to be covered (*'indemnified'*), a- the loss damage or liability shall be prima facie covered by Owners policies and Club entries, but b- full payment is refused (*'subsequent non-payment'*) or just partial payment is made only due to circumsatnces in Clause 6.1.1 and 6.1.2. Caluse 6.1 states that if partial payment or non-payment is : *'by reason any act or omission of any one or more of the Owners, Operators, Charterers or Managers of the vessel or their servants or agents including breach or alleged breach of warranty or condition whether express or implied or non-disclosure or alleged non-disclosure of any fact or circumstances of any kind whatsoever'* . Clause 6.2 states that if partial payment or non-payment is *'by virtue of any alleged deliberate, negligent or accidental act or omission or any knowledge or privity of any one or more of the Owners, Operators, Charterers or Managers of the vessel or their servants or agents, including the deliberate or negligent casting away or damaging of the vessel or the vessel being unseaworthy'*. This wording is extremely complicated and zipped. It requires further analises for clarification of meaning and careful examination of results of its applications.

*'Prima facie covered'- 'subsequent non-payment'*": This terms shall be referring to a situation where the owner, in the first sight, appears to have all documents enabling him to recover from the insurer. But, expected the coverage is by *'subsequently'* discovery of some facts (within the limits of the Clauses 6.1.1 and 6.1.2) that gives to the insurar to reject the claim. For example in a collision cases where the ship is a total loss and the owner claims under the hull policy. Insurance company, in order to meet the claim they require some documents from the owner. Those are to be, *inter alia*, valid updated class certificate, valid insurance policy, seaworthy certificate, prove that the loss/damage was caused by the perils insured against etc. This documents might be produced by the owner and all this documents in first examination may seems to be correct. But if further examination reveals that there are some breaches, for example, the class certificate (breach of warranty under ITCH Clause 4.1 and IHC Clause 13.1.3, 13.2.2, 14.4.2, 36 by reason of MII Clause 6.1.1) is not updated, scuttling (if we accept that the scuttling is not peril of the seas the Bank would recover on MII Clause 6.1.1), barratry (the Bank to recover under MII Clause 6.1.2). Of course, those findings are not necessary to be correct in fact. They can be only *alleged* defficiencies (*'breaches'*). The hull underwriter, if it feel right, may choose not the cover the loss under the policy alleging some deficiencies. By doing this invokes possibility that the owner (or the assignee Bank) to initiate a legal action for the coverage and interest. The MII policy addresses to this position under Clauses 6.1 and 6.1.2. Reading them together we understand that the MII insurer covers damages of the Bank where the hull underwriter refuses payment under the hull policy ALLEGING some deficiencies in the hull policy. What if MII underwriter and hull underwrire are the same? It appears that if reason(s) rejection of payment under the hull policy is/are falling into definition in the Clause 6.1.2, then underwriter has no 'escape'. They are either to pay under the hull policy to the owner (or assignee Bank) or under the MII policy only to the Bank.

The MII is not all risk policy, its coverage is limited to cases stated in the Clause 6. But not all cases in the Clause 6 are covered, Clause 7 sets exclusions where the loss-damage-liability would not be covered.

Clause 8 of the MII defines what deem to be non-payment by the insurer of the owners policies and/or Club entries. If there is a court decision in favour insurance company not to pay to the shipowner under the hull policy

(Clause 8.1.1) or where the Mortgagee Bank is able to demonstrate to the satisfaction of the MII insurance company that there is no reasonable prospect of the Owners and/or Assured succeeding in the claim against the insurance companies of the hull policy and/or the owners P&I Club (Clause 8.1.2). How the Bank going to demonstrate that if there is not a court decision? What if the MII insurer and the hull policy insurer are the same (mostly are)? What if the owner is already sues the insurer under the hull policy for non-payment but on the other hand the Bank invokes acceleration of the loan clause under the mortgage agreement for failure to pay mortgage instalments to the Bank (if the ship is lost or damaged that prevents the ship from sailing the owner can not earn money and would default on its loan to the Bank)? If the hull underwriter does not pay to the owner, the owner can not pay back the loan to the Bank. So the owner would in all his effort would sue the underwriter and the guilty party (they are both liable for the same loss or damage) causing damage (for example the colliding vessel) for damages (that are tend to increase to the total loss) and loss of profit. The owner would sue the guilty party on the ground of tort, and the insurer on the ground of the hull policy. This is a not a win-win position for the underwriter . Because if the owner wins the case they will end up paying much more then in the begining. If they win they it would mean that they pay nothing to the owner and the ship is to be lost (either CTL or bunker supplier to sell it for scrap). But that time the underwriter may end up paying to the Bank,by virtue of the MII, full value of the ship. For the insurer probably the best way is to pay to the owner because this amount would be less then the total value of the ship and initiate a recourse action against the guilty party (ie colliding ship). The Bank would be the less worrying party. They have a secure position; if they could not get from the owner they would get from the insurer. What would worry them is that: their claim may not be falling under Clause 6.1.1 or 6.1.2, warranties in Clause 4 are not fulfilled or Clause 10 to be invoked. In a situation where the ship is under arrest of the bunker supplier (bunker suppliers claim has a priority over a mortgage) in the one hand and deteriorating unrepaired ship (with potential to become a constructive total loss) on the other, the Bank, the insurer and the owner would be extremely constructive in their approach to make the ship working. All parties fearing potential dangers they would be very willing to agree to resolve the problem among them.Their willingness is supported by the fact that regardless for the amount they agreed among themselves they have right to sue the guilty party for the residual amount (insurer is to sue the guilty party for amount they imburse to the owner or to the Bank; the owner is to sue the guilty party for the residual amount –full loss less the amount received from the insurer- ). This agreement would not release the guilty party from its full liability as no one shall be entitled to escape unpunished from the problem he causes.

Caluse 10 is referred as sue and labour clause. It says that *'It is a condition of this insurance that the Assured (=the Bank) shall give notice in writing to the Underwriters of any circumstances which may give rise to a claim under the contract and shall there after keep the Underwriter fully informed of all developments'*. In order for banks to comply with the requirements of Clause 10.1 they must monitor and watch closely the shipping companies they lended the money. The obligation of banks are extremely high. In order to give notice to the underwriter **any** circumstance which **may** give rise to a claim refers to very extended monitoring obligations on part of banks. It is also woth noting that Clause 10 is a *'condition'* upon banks (please note that Clause 4 says *'warranted'* but not *'condition upon'*), so underwriter is not entitled to cancel the policy by argument of non-compliance with the Clause 10. All they can do is to deduct from the amount they are to pay. This is a natural outcome arising out of difference of warranty and condition.

### III- CONCLUSION

The MII policy is subject to a continue duty of utmost good faith of the all parties concern. This requires exercise of care and diligence in all business transctions. Proper application and conduct of MII policies would give a protection to insurance companies and banks and make contribution to the Turkish shipping.