“An Inspector Calls”

Charles Baker

“Final & binding” quality/quantity determination clauses—are they really final?

A Disputatious Dialogue

between

Charles BAKER[1] and Paul DAVID QC[2]

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Dramatis personæ

Charles — Claims manager, ***Hi-Spec Fuels, S.A.*** of Lausanne

Paul — Post-fixture manager, ***Dalmatia Fruit d.d.*** of Dubrovnik

THE FACTS

In early September Hi-Spec Fuels, S.A. sold 700 mt. of 380 cSt. fuel oil to Dalmatia Fruit ("Dalmatia") under a spot sale contract. Delivery took place at Copenhagen last week to the m/v *"BANANA SPLIT"* (one of the reefer vessels in Dalmatia's pool of time chartered ships). The vessel is a modern "unifuel" ship, which uses the same fuel in both main engine and her three generators.

The supply contract was subject to English law, and contained the following clauses:

> "The fuel oil to meet the specifications for RMG 380 grade set out in ISO 8217: 2005"
>
> "The quantity and quality of the product delivered…..to be determined by an independent surveyor whose determination shall be final and binding"

Dalmatia's agents have standing instructions to arrange for samples of newly purchased bunkers to be taken and tested within 48 hours of delivery by an independent surveyor, on this occasion by SGS. Hi-Spec Fuels also appointed a surveyor, from SurvisMar, another inspection company, to certify the delivered quantity and take samples. The report issued by SGS was slightly delayed due to lack of laboratory staff caused by sickness.

4 days after the *"BANANA SPLIT"* sailed, her owners informed Dalmatia that the Master of the vessel reported that the ship had problems with 'choking' of fuel oil filters and injectors and that plungers in the fuel pumps in main engine and generators were 'sticking'. Owners suspect the bunkers taken at Copenhagen are defective and have put Dalmatia on notice of a likely claim under the time charter. The same day, Dalmatia received SGS's report. This indicated that the fuel oil was off-spec. SurvisMar's report, on the other hand, was silent about any quality problem, but stated that the quantity delivered was less than that ordered.

Charles and Paul are under pressure from their respective senior managements to sort out the problems arising out of this bunker supply. They have agreed to meet for lunch – at the Geranium – to identify the factual and legal issues involved and try to sort out the dispute.

There follows a transcript of a recording made by Charles' mobile phone, which accidentally switched itself on and recorded their two lunch-time meetings. At certain times, the words in the recording become rather unclear. At such times we shall have to ask you, the audience, to speculate what you think they *should* have said, had they had the benefit of your advice.

TRANSCRIPT OF TAPE

CHARLES: *How nice to see you, Paul! Sit down – have a drink.*

PAUL: Thanks. I think a Bloody Mary will do.

CHARLES: *Well, let's get this business out of the way so we can both enjoy lunch – no point spoiling a business lunch with too much business! Now, what's the problem you say you have with our fuel?*

PAUL: As you know, the *"BANANA SPLIT",* which we operate under time charter, took on 700 mt. fuel oil from Hi-Spec Fuels last Friday, right here in Copenhagen …….

CHARLES: *I think I know what your concern is. SurvisMar, whom we appointed to oversee this delivery as part of our new quality control procedures, has reported that we undersupplied you by about 40 mt. Here, have a copy of their report. Of course, this was no doubt the result of careless ullaging. No worries Paul, we will credit you for the difference immediately.*

PAUL: Thank you, but I'm afraid that is the least of the problems which Hi-Spec Fuels are going to have to sort out. The vessel has been immobilised, while filters and fuel pumps are replaced and fuel injectors repaired.

Firstly, the bunkers are obviously off-spec. Fuel oil suction was switched only 2 days ago to No.2 Port tank (containing the bunkers supplied at Copenhagen). What's more, SGS inform us that their analysis of the continuous-drip sample taken at the vessel's manifold reveals the following:

i) potentially abrasive catalytic fines, as reflected by the combined aluminium and silicon content of 75 ppm. (compared with the maximum permitted limit of 60 ppm.)

ii) levels of calcium, zinc and magnesium which suggest that high levels of waste lube oil was mixed into the fuel oil, and

iii) a high acid number causing problems with the fuel injectors.

CHARLES: *Wait a minute Paul. If you look at clause 4 of our contract, you will see that the opinion of the independent surveyor is to be final and binding.*

You will see on page 2 of their report that SurvisMar also checked for quality -- and they found the fuel oil within spec.

Are you saying SurvisMar are not independent?

PAUL: I'm not saying that, Charles. No doubt SurvisMar are independent, otherwise they would not report that you undersupplied us by 40 tonnes.

By the same token, you will agree with me that SGS are well-reputed and independent, and that **their** opinion that the cargo is off-spec is final and should also bind us both!

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To audience

So who is right? Whose survey report are the parties to rely on? Is **either** report “final and binding”?

Just how final are determinations made by independent inspectors pursuant to clauses in supply contracts (not to mention certain charterparties), which provide that an inspector's findings shall be "conclusive" or "final and binding"?

Clauses of this nature are typically found in two different situations:

- In charterparties, where the usual question to be addressed by the inspector is whether the condition of the vessel's tanks is acceptable; and

- In sale agreements, where the focus is on the product’s conformity with the contractual specifications or description.

The starting point is the inspection clause in the contract. Does the clause in fact provide that the inspector's findings shall be conclusive? Such clauses come in a variety of forms. The precise words used in the clause need to be examined to discover what parameters are subject to conclusive determination and what other - possibly important -

matters fall outside the scope of the clause[3].

An important point to remember – particularly for any bunker supplier – is this. Conclusive determination clauses are regarded in law as exception clauses. Any ambiguity in the language used in such clauses will therefore be interpreted by courts or arbitrators *against* the party seeking to rely on them. And even when not ambiguous, they will generally be given a restrictive interpretation.

The justification for this restrictive approach was explained by an English judge[4] as follows:

> "('Final and binding' clauses) involve a very substantial modification of the rights of the parties and in particular of the buyers' rights, since they may be called upon to accept and pay the full price for goods which are substantially sub-standard. In such circumstances common sense and the law both dictate that the parties must use clear language if they intend this result…."

In our case, it is clear that quantity and all aspects of quality within the relevant ISO 8217 spec. were to be subject to analysis and conclusive determination. But is this enough to answer the objection raised by Paul? Here we have not one, but two "independent inspectors".

The answer was given in a judgment in the Commercial Court in London in 1997[5]. It involved a claim relating to excessive residues of an oil cargo remaining on board after discharge.

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[3] This principle is illustrated vividly by Commercial Banking Co of Sydney Ltd v. Jalsard Pty. Ltd [1973]A.C. 279 in which the Judicial Committee of the Privy Council held, allowing an appeal from the Supreme Court of Australia, that where the contract called for a "certificate of inspection", this did not mean a document certifying the condition and quality of the goods inspected (which could not have been determined by mere visual inspection). All that the document had to certify was that the goods had been inspected.

[4] Mr Justice Donaldson in Rolimpex –v- Dossa & Sons [1971] 1 Lloyd's Rep. 380

[5] The "Protank Orinoco" [1997] 2 Lloyd's Rep. 42

The *"Protank Orinoco"* was chartered to Total to carry two parcels of vacuum gasoil to two terminals in Houston. The vessel discharged one parcel of the cargo at Chevron's terminal and the balance of the cargo at Exxon's terminal. At both terminals, a significant quantity of oil remained in the ship's tanks after completion of discharge. The ROB at each terminal was measured by SGS, who were appointed by both the receivers. Owners also appointed surveyors at each discharge terminal and the charterers, Total, appointed a surveyor from General Maritime Corporation ("GMC").

At both terminals all the surveyors were in agreement as to the quantity of oil remaining on board after each discharge operation. The receivers' and charterers' surveyors considered that the ROB was, (as SGS put it) *"liquid … (commonly referred to as "pumpable" by the industry)"*. However, owners' surveyor described it as *"unpumpable".* The difference in opinion was important, since the charterparty had a "freight retention" clause, that entitled the charterer to deduct from freight the value of *"liquid and pumpable"* cargo remaining on board:-

> "…. as determined by an "independent surveyor", whose estimate shall be final and binding."

Total (relying on the SGS survey) deducted US$80,000 from freight. Owners claimed this was wrong.

Mr Justice Thomas examined the claim from two angles: (i) was SGS an 'independent surveyor' within the meaning of the freight retention clause? And (ii) if the answer was 'yes', was a determination or "estimate" in fact made?

Issue 1: Was the inspector "independent"?

It was not disputed that SGS employ inspectors who have the highest reputation. But it was clear that they were appointed by the receivers alone and not jointly by receivers, charterers and owners. The judge held that, if the meaning of the word "independent" could be satisfied simply by showing that the inspector in question was from a firm that operated independently of the parties, then there was always the likelihood that at any port of discharge there would be more than one inspector involved who was "independent". If each reached a different conclusion, it would be impossible to say that each determination was "final and binding". The freight retention clause therefore implicitly envisaged that the inspector *"whose estimate shall be final and binding"* should be appointed jointly on behalf of the parties and not solely by one of them.

Issue 2: Did the SGS inspector in fact make any determination or "estimate"?

The court also gave its view on the second issue, namely whether a determination or estimate had in fact been made. The clause required the inspector to estimate the volume of ROB which was 1) liquid, 2) pumpable **and** 3) reachable by the vessel's pumps. The SGS certificates contained no statement whatsoever on the third point. That omission was a further reason why Total could not rely on the SGS surveyor's certificate.

The result was that owners recovered the deducted freight. SGS were not appointed in the manner required by the "freight retention" clause; and in any event, their certificates did not make the factual determinations asked for by the clause.

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PAUL: *(calmly)*: So you see, Charles, your Clause 4 doesn't help Hi-Spec Fuels.

CHARLES: *OK, Paul, I can see that I can't rely on the Survismar report in this particular case, but the fact remains that our contract did assume that an independent inspector should have the final word. So that we don't spoil this pleasant and expensive lunch, why don't we agree to give a set of loadport samples to a mutually agreed independent inspector, such as Malmö Fuels and ask them to report?*

PAUL: That's not a bad idea. We've used them before and they're reliable.

CHARLES: *So that's agreed. Let's meet here for another lunch once we have the results.*

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2 days later

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CHARLES: *Hello, Paul, for someone just about to enjoy a good lunch you're looking rather unhappy!*

PAUL: *(tensely)* Dalmatia don't have much to smile about right now. Last I heard, the *"BANANA SPLIT's"* main engine had been inoperative for most of the last 3 days while successive cylinders and injectors have shut down and required lengthy repairs. The Chief Engineer has had to use his limited supply of MDO for the

generators and owners have had to call in tugs to tow the vessel to Malta. It looks as if we'll miss deadlines with our commercial customers and face a huge claim from owners under our charterparty for damage to the main engine and generators, for detention and towage costs.

CHARLES: *Even if the fuel is somehow off-spec – and that's not yet proved – surely the ship is at fault for starting to use the Copenhagen bunkers so quickly before having them tested? I assume the vessel is registered with one of the Fuel Quality Testing programmes? At the very least they should have waited until SGS reported their results.*

PAUL: That's something we may have to look at later. Now what about this analysis carried out, as we both agreed, by Malmö Fuels. The results are unequivocal. Too many catalytic fines (75 ppm) and, just as we suspected, excess acid in the fuel (Acid Number[6] 3.2, as opposed to a maximum of 2.5 mg KOH/g). What is more, there are clear indications of organic substances, probably waste cooking oil.

CHARLES: *This all sounds very unlikely. But, tell me, did Malmö Fuels really do all this testing? I mean, did they attend themselves to perform – what's this? Gas Chromatography - Mass Spectrophotometry*

[6] *The mass of potassium hydroxide (KOH) in milligrams that is required to neutralize one gram of chemical substance.*

analyses? I had no idea they had this sort of equipment.

PAUL: Well, in fact they don't, Charles, but it seems they delegated that part of the tests to your SurvisMar friends here in Copenhagen….

Charles? You cannot possibly be implying that SurvisMar are not independent. You were emphasising their independence when this problem first arose!

CHARLES: *But we agreed 2 days ago that the tests – and that means all, not just some of them – were to be performed by Malmö Fuels!*
There is also one further point. The contract refers to the older, 2005 version of the ISO 8217 marine fuel specification instead of the subsequent ISO 8217:2012 (or recently introduced 2017) specification. The 2012 specification reduced the maximum permissible level of cat fines from 80 ppm to 60 ppm. So the level found here, 75 ppm, was within the contractual specification. Your claim concerning the cat fines is therefore no good.

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To audience:

What is Charles getting at? Several issues arise here.

1.) The question whether the surveyor doing the inspection was the "right" person required by the contract arose in a sale of goods case,

Kollerich Cie S.A. –v- State Trading Corp. of India[7]. The contract provided for a pre-shipment inspection of bagged cement to be carried out by either one of two named firms of inspectors, to be appointed by sellers. Sellers appointed one of the firms, GESCO, to issue inspection reports at the two loading ports in India. The contract provided that the inspection certificates were to be

> "sufficient proof of … good packing …and loading of only sound bags … and the same would fully absolve the seller of any responsibility for shortage or bursting of bags."

On arrival at the discharge port the stitching on numerous bags was found to be defective. On the findings of the arbitrator, sellers would clearly be liable unless they were saved by the pre-shipment inspection clause.

GESCO had certified that they had attended the loading of the cargo and that the bags were securely stitched in sound condition. It turned out that they had in fact delegated the inspection to another firm, a fact that was apparent from the GESCO certificates. The Court of Appeal in London agreed with the Commercial Court's judgment that the certificates were uncontractual.

2.) As for Charles's second point, regarding the level of cat fines, he is right that the level was within the agreed specification. However, the fuel also contained excess acids. This could mean that there are two *competing* concurrent causes of the damage to the main engine: (1) a breach by Hi-Spec Fuels in providing fuel with excess acid and (2) an excess of catalytic fines, which is not a breach at all.

[7] *[1980] 2 Lloyd's Rep. 32*

The position under English law is that if a breach of contract is one of two causes of damage, both being effective or 'proximate' causes, the party in breach is liable for all the damage, unless he can prove that a distinct, identifiable part of the damage or type of damage was caused solely by the 'innocent' cause. In the latter case, he is liable only for the damage attributable to his breach, but the burden of proving which cause occasioned what damage rests on him[8].

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PAUL: Taking your first point, even if Malmö Fuels did delegate their duties—what's the difference?

You cannot rely on the <u>*Kollerich*</u> case, since the certificates issued by Malmö Fuels, on their face, fulfil the requirements of our agreement. We agreed at lunch 2 days ago that the results have to be <u>*reported*</u> by Malmö Fuels, not necessarily *ascertained* by them.

CHARLES: *This situation is essentially no different from the facts of the <u>Kollerich</u> case. There, as here, the inspectors who issued the reports did not even perform the required inspection. The certificates in that case showed that someone else had done the inspection, whereas <u>this</u> report does not spell out what we know happened. Surely that can't make a difference?*

PAUL: We'll see about that in a minute. Let me just deal with your argument that the cat fines level was within the specification. It's true that the 2005

[8] *See 'The Panaghia Tinnou' [1986] 2 Lloyds Rep. 586*

> version of ISO 8217, which your standard contract still uses, permits levels up to 80 ppm. But the delays to the vessel were very largely caused by the breakdowns to the fuel injectors, and I'm sure it will not be too difficult to separate out the shorter delays caused by the cat fines.

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To audience:

Well, what do we think about Charles's reliance on the *Kollerich* case?

The Malmö Fuels report itself does not reveal that SurvisMar in fact did part of the work.

A similar situation faced the English Court of Appeal in ***Coastal (Bermuda) Ltd –v- Esso Petroleum Co. Ltd***[9]***.*** A sale contract, negotiated after the cargo of 50,000 mt. fuel oil had been shipped, contained a detailed specification that included an upper limit for asphaltines. The inspection clause provided as follows:

> "For quality and quantity, as determined at loadport and confirmed by (Caleb Brett) with findings to be binding on both sides".

On outturn, the percentage of asphaltines was much higher than the permitted maximum. Coastal's claim against Esso for the price of the fuel supplied succeeded at first instance. Esso appealed, after its own investigations showed the following:-

- Caleb Brett had analysed the cargo at the loadport, but not for asphaltines;

[9] *[1984] 1 Lloyd's Rep. 11*

- Coastal later asked Caleb Brett to confirm that the cargo conformed with the contract specification (the cargo having in the meantime been on-sold to Esso “afloat”, i.e. after the vessel left the loadport);
- Caleb Brett sent a telex that repeated the contents of their original analysis, but added an analysis for the asphaltines percentage, which was *within* the contractual limit.
- Subsequently, it was discovered that Caleb Brett had not themselves determined the asphaltines content, but had apparently merely asked the terminal for their figure.

Could Coastal resist Esso's appeal by relying on the inspection clause? Esso argued that the reasoning in the *Kollerich* case was directly applicable.

Lord Justice Donaldson, referring to the new facts discovered by Esso, identified the issue in the case as follows:

> "On that fresh evidence, it is argued that there has to be a full investigation to see what the reality was. What this appeal really comes down to in the last resort is, does it matter what the reality was if, on a fair construction of the (Caleb Brett) telex, Caleb Brett were confirming the analysis of the sample in accordance with the inspection clause?"

The Court of Appeal held that Esso could not go behind Caleb Brett’s confirmation and that their appeal therefore failed[10]. But Lord Justice Donaldson also sounded a warning for inspectors when he added:

[10] *A similar conclusion was reached by the Court of Appeal in Toepfer v. Continental Grain Co. [1974] 1 Lloyd’s Rep. 11 where the main issue was whether buyers were bound by a certificate when the person issuing it had been found negligent.*

> "What rights (Esso) will have against Caleb Brett, or against the ship, or against both, it is obviously not for me to say".

The distinction between this and *Kollerich* is that the Caleb Brett telex was, on its face, in all respects as required by the contract; whereas the *Kollerich* certificate revealed that the wrong party had inspected the cargo.

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PAUL: If you remember our agreement carefully, Charles, you will see that we did not specifically provide for Malmö Fuels to do all the analyses themselves—a report from them would suffice.

CHARLES: *I wouldn't go so far as that. If two people agree to be bound by a report made by Company X, it must be implied that Company X will do all the work. The only thing that allows you to rely on the report is the fact that it doesn't show who did the GC-MS analysis. But I'm not finished yet. Who actually carried out the analysis?*

PAUL: As I said, it was someone from SurvisMar.

CHARLES: *Yes Paul, but was that surveyor properly qualified to make an accurate determination? We did some checking and discovered it was some new guy working there during his college vacation.*

PAUL: I've no idea. But I hardly think that matters. Malmö Fuels' report is clear, and – as we saw in the ***Coastal –v – Esso*** case – the reality behind the report is

irrelevant, as there is no apparent error or misrepresentation on the face of the report.

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To audience:

The *"MAROF"*[11]

A striking example of arbitrators going behind an apparently "final and binding" certificate occurred in a New York arbitration concerning a deduction of US$812,000 from freight made by charterers under an Amoco freight retention clause. The ROB consisted of Gulf of Suez Mix crude, which is a notoriously 'sticky' blend that, at the time, was frequently shipped under 'no heat' charters and gave rise to large ROB claims, particularly before crude oil washing was universally introduced.

As to whether the ROB was "pumpable", the Saybolt inspector had simply noted in his report "*bob slow going through material".* After the vessel sailed, Saybolt's office manager signed a certificate stating that the ROB was "pumpable".

The arbitrators held that the Saybolt office manager patently lacked any proper qualifications to make such a determination. They found that he had: -

- majored in psychology at college;
- worked as a manager of a McDonald's;
- managed a cinema, and

[11] 1984 AMC 769

- had one year's general training with Saybolt, mainly on office procedures.

The arbitrators concluded that the certificate was uncontractual. Not only was the office manager not qualified, but it was also clear from the inspector's report that there had been no examination of the ship (especially her pumps). They questioned the 'independence' of Saybolt, who had been appointed solely by Charterers and Receivers.

We believe that an English court or arbitrators, faced with similar facts, might possibly have agreed with the New York arbitrators' first ground; namely, that the inspector's report revealed that he had not examined the ship's pumps and had not himself certified that the ROB was "pumpable". The answer might well depend on whether the inspector's report was attached to the certificate. But, given what was said in the ***Coastal –v – Esso*** case, we do not think that London arbitrators would have gone behind the Saybolt certificate to examine the manager's technical qualifications.

SOME PRACTICAL LESSONS

Parties should ensure, if they insert a conclusive determination clause in their contracts, that the parameters to be covered by the inspector's certificate are clearly and exhaustively set out. They are also advised to avoid words that have no accepted scientific meaning (such as "pumpable") or parameters that are incapable of objective measurement.

The identity of the surveying organisation should be specified only after a check has been made that it has people properly qualified for the specific task in hand, with laboratory facilities or other necessary equipment at the place where the inspection or analysis has to take place (assuming the contract stipulates this).

If a buyer on-sells goods to a sub-buyer (or a charterer sub-charters the vessel), it makes obvious sense to try to make the sub-contract on "back-to-back" terms with the head contract. This is particularly important when it comes to agreeing inspection clauses. For if the sub-sale contract or sub-charter imposes quality parameters or cleaning obligations, which differ from those in the head contract, the buyer or charterer may find it impossible to comply with his obligations to the sub-buyer or sub-charterer.

If the success of the transaction depends in large part on the buyer getting the goods he wants or the charterer having a ship suited to carry the intended cargo, particular care should be taken to see that any conclusive determination clause states clearly the precise method of appointment of the inspector, what quality parameters are to be ascertained and by what internationally recognised testing methods.

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PAUL: Well Charles, we've managed to establish that these problems — or most of them — and the cost of these two lunches – are for Hi-Spec Fuels' account.

Now, I've carried out an inspection of their excellent Wine List. I think their 1952 cognac is something we should definitely sample.

CHARLES: Samples are not something I wish to discuss!