LETTERS OF UNDERTAKING AND GETTING IT RIGHT

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Introduction

A letter of undertaking ("LOU") is a contract where in return for a promise to release from arrest or not to arrest or re-arrest marine property[1] in relation to a described cause of action, the issuer, which may be a P+I Club or an insurer or some other acceptable solvent entity, offers to undertake to pay up to a certain amount upon final judgment against the owner of the marine property. The composition of the "letter of undertaking" falls outside of the Federal Courts rules in Canada, but the identity of the issuer and its solvency may be determinative in any discretionary decision of the court to accept this as security and order the release from arrest[2]. The contract is governed by general principles of law including the freedom to contract to whatever the parties might agree subject to public policy and is construed as a commercial contract having regard to its commercial purpose[3]. Unlike bail, discussed below, there is no limit in law as to the amount the issuer may undertake to pay, and, in fact, the issuer may agree to unlimited liability or up to the market value of the marine property at the time the cause of action arose, under the undertaking if it should so wish.

A letter of undertaking is not bail[4] nor does it have the effect of releasing the ship from an "in rem" action and standing in substitute thereof, although the beneficiary is obliged to cause the release from arrest of the marine property. Nor is it a contract of surety subject to special rules of interpretation because it is not premised on the surety's secondary liability. These LOU contracts are treated as being commercial contracts governed by the civil law and by the civil courts of the place in which they are is accepted.[5]

To constitute bail, a defendant must offer either a surety bond or bank guarantee or cash – which may take considerable time and expense to arrange. The amount of security offered by LOU or bail is equivalent to the capital amount of the claim, three years of interest and an estimated amount of legal costs.[6] Disputes as to the proper amount of bail or form of security must be resolved by the court.[7] The limit to the amount of bail that can be required is the market value of the property at the time of or immediately prior to the time the cause of action arose.[8] The posting of bail has the effect of discharging the claimant's "in rem" rights against the vessel.[9]

When formal bail is posted, there is controversy as to whether the Court has the power to revive those "in rem" rights in the event that there is a mistake in the market value or the claim has been unsecured, for example, when the surety becomes insolvent, or when security is clearly insufficient.[10]

The Letter of Undertaking

It has been observed that the formal procedure of "bail", the offering of a surety to submit to the Court and pledge its assets to honour any judgment that might be rendered in the claimant's favour, has fallen into disuse. Bonding companies require counter-security, usually in cash or a secured undertaking from an acceptable correspondent. Banks which are increasingly under pressure from "know your customer" regulations, have a long list of questions about where the funds used for counter-security for the issuance of a bank guarantee have come from, ie the nature of the financial operations and the provenance of its revenues of the new, "one-time" customer, which ship owners are reluctant to divulge.

Throughout this paper, when reference is made a "P&I Club" as the issuer of the letter of undertaking, it is intended to include any issuer which would meet the tests of solvency, trust, and public confidence that the traditional P&I Clubs within the International Group enjoy. P&I Club letters of undertaking have been widely accepted not only in litigation, both civil and penal, but also for many other purposes.[11] And they have received judicial acknowledgement:

> The advantages for all parties of the time honoured practice of club undertakings are obvious; included are speedy security in a negotiated amount, no need for actual payment of money or provision of a bank guarantee, a negotiated choice of jurisdiction, avoidance of the delay, cost and inconvenience which an arrest inevitably causes, and continuing security for the claimant without risk. One of the primary purposes is to avoid the machinery of the Court being invoked until the time comes (which in a number of cases it never does) that it is necessary for the cargo-claimants to issue proceedings because the claim has not been settled. Further, it is inherent in the claimant's agreement not to invoke the process of the Court that the security should place the claimants in no less favourable a position than if they had begun their action in rem and arrested the ship. Objectively, this was part of the commercial purpose.[12]

Normally, as a requirement to post bail, it is incumbent on the proposer to show that the surety offered has a commercial reputation in the industry, has unquestionable solvency and has a history of quickly responding and honoring its obligations undertaken.

It goes without saying that the purpose of this paper is to explore concepts and litigation strategy; in each jurisdiction, the vocabulary used in describing process will be different depending on whether the law of the jurisdiction follows common or civil law traditions. Care must also be exercised over vocabulary used when describing the legal processes of another jurisdiction, for example, is there an "in rem" procedure, can and how is service voluntarily accepted, if it can be, what does it mean to "appear", when is a judgment ever "final" and the like.

General Issues

Who are the beneficiaries of the Letter of Undertaking?[13] How are they identified?[14]

Who are the "principals" whose liability the issuer is undertaking to pay upon the occurrence of a specific condition?[15] If reference is being made to "owners" of a ship, should not it be specified that a "demise owner" is intended, not just the registered owner against whom there may not even be a cause of action? [16]

What liability or cause of action is intended to be covered? [17]

What is the specific condition that will trigger the obligation for the issuer to pay?[18]

Whether and what time limitation should be imposed for commencement of legal proceedings?[19] For the issuer to appoint a legal representative?[20]

What terms and conditions under an LOU are considered acceptable at law, and which in particular would be unacceptable? Is there a mechanism whereby the amount of the LOU can be decreased or increased? Before what court should any issue about whether the amount should be decreased or increased be adjudicated? Should it be before the court the issuer chooses as the court to adjudicate on issues that arise under the LOU?[21]

Can claimants force the Club to agree that it will instruct local counsel to accept service on behalf of its member and appear in the legal proceedings?[22] Inversely, should not the issuer of the LOU impose a duty on the beneficiary to keep the issuer informed about the commencement and service of legal proceedings?[23]

Conversely, can the Club force the claimant to agree to litigate (or arbitrate) the dispute in a specific forum and under a specific law?[24]

Can claimants force the Club to issue an LOU without providing any adequate basis for the calculation of the amount of security demanded?[25]

What are the consequences if the beneficiary of an LOU breaches its undertaking "not to arrest"? Does the security lapse, or is the remedy limited to provable damages arising from the breach? Or is an "anti-suit injunction" possible?[26] Secondly, when security under the LOU becomes insufficient at a later date, what are the consequences if the beneficiary seizes or arrests property of the debtor who refuses to increase the security held? Thirdly, suppose the issuer of the letter of undertaking becomes insolvent, is the beneficiary discharged from its obligation not to arrest, re-arrest, etc? Fourthly, suppose the beneficiary obtains final judgment for an amount higher than that provided in the LOU, is it precluded from executing on other assets?

How to establish the "factual matrix" to show the intention that the issuer's liability under the LOU is engaged, even though the defendant no longer exists juridically?[27]

What happens if a claimant at a later date discovers that the security it holds is insufficient? For example, repairs to a damaged fixed object have been unforeseeably more expensive.

The foregoing only sets the context for a problem that arises frequently – what are the rights of a beneficiary and the issuer when there is a need to increase the amount of security under an LOU?

The Decision "FSL NEW YORK"[28]

Damage had been caused to a chemical tanker during loading operations in Indonesia which resulted in claims being made by Owners and Charterers. To contain the situation becoming a catastrophe, P+I interests for each side agreed to exchange LOUs. In the LOU given to the Owners on Charterer's behalf, it was stipulated:

> It is agreed that both Charterers and Owners shall have liberty to apply if and to the extent the Security Sum is reasonably deemed to be excessive or insufficient to adequately secure Owners' reasonable Claims. (underlining ours)

During the arbitration, the Owners realized that they were significantly under-secured and Charterers acknowledged that fact, all the while denying their liability could be for the amount of the increased claim and declining to increase the security. Presumably, Charterers had no available assets for Owners to seize or arrest to enforce their demand for additional security, and as a last resort, Owners applied to the Court for enforcement of the above contractual provision against the issuer, the Club.

The Court's Reasons

The dispute between the Owners and the Charterers about whether the Owners' security was insufficient was not a dispute arising under the letter of undertaking and subject to the jurisdiction of the chosen forum (U.K.), but was rather a dispute to be decided in the forum where the cause of action arose, that is, in Indonesia.[29]

The "Liberty to Apply" phrase is more commonly used in Court interlocutory orders allowing parties to return to the Court for further directives on a subject matter that is already the subject of an Order; it is not appropriate in a commercial contract, but the Court must ascertain the intention of the parties to the LOU. The Charterers in this case are not parties to the LOU addressed to the Owners and signed by the issuer Club. The Court found that the phase qualified the prohibition against further arrest or re-arrest of the charterers' assets if security proved inadequate.

The reference to the court of a dispute between Owners and Charterers does not imply that the issuer Club has undertaken to increase the security, should Charterers fail to do so. Express language of such undertaking and the related cap on liability, is required.

There is nothing in the language used to show that the beneficiary had the right to apply and require the issuer Club to increase the security.

Note:

The Court did **not** decide that it is legally impossible to draft a contract of undertaking whereby an issuer agrees that, at some time in the future, the amount secured under the undertaking can be increased upon the occurrence of a certain event.

Proposal

Letters of undertaking issued in Canada usually provide for reduction in security in the following terms:

> (e) It is expressly agreed that the amount of this Letter of Undertaking be subject to reduction by agreement of the beneficiaries of this undertaking and those at interest with the MV "WRETCHED SHIP" (the "parties") and if the parties cannot agree to the reduced amount of this letter, that those at interest with the M/V "WRETCHED SHIP" may approach the Federal Court in Canada to set the amount of security. In the event the amount of this letter is reduced, either by agreement or otherwise, the beneficiaries, ABC Inc. and their Underwriters, agree to surrender it for replacement by a new Letter of Undertaking in the same wording except for the amount and save for this paragraph, for a lesser amount as agreed between ourselves and the beneficiaries of this Letter of Undertaking, or as ordered by the Court.

A suggestion for discussion as to a clause whereby security may be increased:

> (f) It is expressly agreed that the amount of this Letter of Undertaking may be increased by agreement of the beneficiaries of this undertaking and those at interest with the MV "WRETCHED SHIP" (the "parties") and if the parties cannot agree to the increased amount of this letter, then the beneficiaries of this undertaking may approach the Federal Court in Canada to set the amount of the increase of security, without prejudice to their rights to the security hereunder. In the event that the said Court declares that the amount of security should be increased, then the beneficiaries of this undertaking may request the undersigned Association to replace this Letter of Undertaking with a new Letter of Undertaking in the same wording, except for the increased amount. In the event that the Association refuses to replace this Letter of Undertaking, then the beneficiaries are at liberty to arrest or seize any assets of those at interest of the MV "WRETCHED SHIP" in accordance with law, but without prejudice to their rights under the present letter of undertaking.

Or, if the issuer is agreeable to committing itself in advance:

(f) .....in the event that said Court declares that the amount of security shall be increased, the undersigned Association agrees to replace this Letter of Undertaking with a new Letter of Undertaking in the same wording, except for the increased amount, but in no event shall the undersigned Association be bound to any amount that exceeds the value of the MV WRETCHED SHIP at the time the above stated cause of action arose.

July 14, 2017

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The text of a typical letter of undertaking that is issued in Canada follows for discussion purposes.

TEXT OF A TYPICAL LETTER OF UNDERTAKING
ISSUED IN CANADA

Date: September 26, 2017

To: Beneficiary: ABC INC. and their Underwriters
c/o Pettifoggers and Associates

Dear Sirs:

RE: M/V "WRETCHED SHIP"
At Any Old Place, Canada, September 26, 2017
Bill of lading no. 6, dated August 15, 2017 at Nowhere
Alleged damage & pilferage to a shipment of widgets

In consideration of your agreeing to refrain from seizing, arresting or otherwise detaining the ship, "WRETCHED SHIP" or any other assets in the same or associated ownership or management, whether beneficial or otherwise, in this or any other jurisdiction, and refraining from commencing legal proceedings otherwise than as described below against said ship, her owners, Master, their managers, operators, servants or agents, in connection with any claim you may assert in relation to the above captioned incident (your said agreement being deemed evidenced by your acceptance of this Letter of Undertaking) the undersigned Association, personally and for and on behalf of the owners of the said vessel, whether or not the said vessel be lost or disposed of, agrees:

(a) on demand to submit to the jurisdiction of the Federal Court in Canada and to instruct attorneys to accept service on their behalf of any proceedings you may cause to be taken therein against the said vessel or her owners in respect of your said claim, within ten (10) days of your demand, and to instruct such attorneys to issue an originating document in defence;

(b) on demand to pay any sum not exceeding XXXXXXXXXXXXXX DOLLARS ($xxxxxxxx) (inclusive of interest and costs) which may be adjudged due to you by final judgement against the vessel and her owners, operators, arising from such proceedings or agreed to be due to you under any compromise of your said claim provided always that such compromise has our prior written approval;

(c) on demand or at our option to cause to be filed in the said proceedings to secure your said claim, security in form, sufficiency and amount satisfactory to the Court (but not to exceed the sum abovementioned). In the event such security be filed, all liability under Paragraph (b) hereof shall automatically lapse;

(d) that subject to clause (c) above, this letter of undertaking shall remain in full force and effect during the course of any trial or appeal in the said proceedings, and in the event of any appeal or appeals, the words "final judgement" in Clause (b) above shall refer to the time when any amount due to you in this matter is determined in the last appeal taken. Furthermore, this undertaking shall remain in full force and effect until any amounts due by way of final judgement or settlement have been paid in full, and whether or not the vessel shall have been damaged, lost or sold or until alternative security has been filed as hereinbefore provided.

(e) It is expressly agreed that the amount of this Letter of Undertaking be subject to reduction by agreement of the parties and if the parties cannot agree to the reduced amount of this letter, that those at interest with the M/V "WRETCHED SHIP" may approach the Federal Court in Canada to set the amount of security. In the event the amount of this letter is reduced, either by agreement or otherwise, the beneficiaries, ABC INC. and their Underwriters, agree to surrender it for replacement by a new Letter of Undertaking in the same wording except for the amount and save for this paragraph, for a lesser amount as agreed between ourselves and the beneficiaries of this Letter of Undertaking, or as ordered by the Court.

If no action be filed in the said Court within the applicable limitation period and served or forwarded for acceptance of service in accordance with the Federal Courts Rules (Canada), the present Letter of Undertaking shall automatically lapse. In the event this Letter of Undertaking lapses or upon satisfaction of any judgement or settlement herein this Letter of Undertaking shall be returned to the undersigned for cancellation.

This Letter of Undertaking is not to be deemed an admission of liability and is given without prejudice to all rights and defenses available to the vessel, her owners, operators, charterers, managers, servants or agents, including but not limited to, proceedings in limitation of liability and the right to have the dispute referred to arbitration, if any.

This Letter of Undertaking is not to be construed as binding personally upon [name of agent signatory], except as to their warranty of authority to issue this letter as agents, but is to be binding only upon the undersigned Association.

Yours very truly,

XYZ P+I ASSOCIATION

Per: (authorized agent's name)

Duly authorized as we so declare

[1] *Whether it is a ship, cargo, freight, bunkers, even ship equipment*

[2] *Under the Federal Courts Rules, at Rule 486, bail can only be in the form of cash, bank guarantee or a bond by a Canadian licensed bonding company. Under Rule 488, the Federal Court has the power to release marine property under arrest without bail and has the residual discretion to accept LOUs as adequate security for the claimant. For example, in North Sask. Riverboat v 573475 Alta Ltd. (1995) 96 F.T.R.166, the court ordered that hull insurance be posted on the vessel naming the claimant as a co-insured before the vessel could be released.*

[3] *The "Elpis" [1999] 1 Lloyd's Rep.606 at 610.*

[4] *Bail is an undertaking to the Court to pay a sum of money, whereas an LOU is a private contract with a beneficiary.*

[5] *For example, in Canada, the Federal Court has jurisdiction over causes of action that arise from maritime matters. Whether an LOU given as security for a claim involving a maritime matter can be construed as a maritime matter itself is the subject of dispute, which has never been resolved.*

[6] *The rule of thumb calculation is to take the capital amount and multiply by 150% to cover pre-judgment and post-judgment interest and costs.*

[7] *Rule 485*

[8] *The "Staffordshire" (1872) 1 Asp.M.L.C.365; Scindia Steam Navigation Co., The "Jala Godavari" v Canada [1985] F.C.J. no.1130*

[9] *The "Kalamazoo "(1851)15 Jur.885; The "Pointe Breeze" [1928] 30 Ll.L.Rep.229*

[10] *Thomas, D.R. Maritime Liens, Stevens & Son London 1980 paras.513-514*

[11] *Reference is made to P&I Clubs, Law and Practice, by Steven J. Hazelwood, third edition, LLP, 2000 which contains a chapter on "Club Letters of Security" from which much of this paper has drawn inspiration. A fourth edition prepared by David Semark has been published by Informa in 2010.*

[12] *The "Oakwell" [1999] 1 Lloyd's Rep.249 at 253*

[13] *The "Laemthong Glory" [2005] 1 Lloyd's Rep.688 – a ship owner cannot claim the benefit of an LOU given by a receiver of cargo to a charterer to obtain delivery without surrender of Owner's bills of lading.*

[14] *The "Elpis" [1999] 1 Lloyd's Rep 607 – dispute over who is included in the description "Owners of Cargo laden on Ship Elpis".*

[15] *The "Oakville" [1999] 1 Lloyd's Rep.249 –if issuer has undertaken to appoint solicitors and file a defense, it does not matter if the principal has ceased carrying on business or sold the ship in the meantime.*

[16] *The "Spirit of Independence" [1999] 1 Lloyd's Rep. 43 - claim by ship repairer for repairs ordered by a demise charterer for which the registered owner was not responsible. Similar issues arise when claims are pursued under Master's bills of lading for cargo damage for which the registered owner who did not hire the Master is not responsible.*

[17] *The "Rays" [2005] 2 Lloyd's Rep.479 – three arbitrations heard concurrently to determine claims of cargo owner, voyage charterer, time charterer and ship owner.*

[18] *The "Maersk Neuchatel" [2014] 2 Lloyd's Rep.377 – dispute over whether LOU is payable when general average adjustment was issued, or upon determination of what was legally owed.*

[19] *A typical clause which appears in LOUs - If no action be filed in the said Court within the applicable limitation period and served or forwarded for acceptance of service in accordance with the Federal Courts Rules (Canada), the present Letter of Undertaking shall automatically lapse.*

[20] *The "Juntha Rajarueck"[2003] 2 Lloyd's Rep.103 is illustrative of the dangers in using the phrase "a competent court" – competent over the defendant? Over the subject matter of the dispute? A "forum conveniens"? a forum where the LOU can be enforced? Can the issuer refuse to appoint solicitors and instruct them to accept service, if the issuer contests the competency of the court?*

[21] *One of the debates in The FSL New York, where it was held that this issue was to adjudicated before the court where the vessel was arrested or was to be arrested but for the LOU; it was not a matter under the terms of the LOU.*

[22] *Usually a claimant welcomes the undertaking of the issuer to instruct a solicitor to accept service, rather than having to pay fees and associated expenses to effect the arrest of the ship and/or service of legal proceedings, especially in connection with service on foreign defendants pursuant the Hague Convention (Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters),.*

[23] *However, issuers should be cautious that if legal proceedings are issued, that the issuer be informed about them before steps are taken to obtain judgment! See The "Tutova" [2007]1 Lloyd's Rep.104 – Court ordered the P+I Club to pay under the LOU, even though its counsel had not been informed about the legal proceedings wherein claimant obtained a default judgment after serving the ship owner's local agent and waited until all delays for appeal expired before presenting a demand for payment. I don't believe the usual working "on demand to submit to the jurisdiction of the Federal Court in Canada and to instruct attorneys to accept service on their behalf of any proceedings..." meets the problem created by this decision.*

[24] *The issuer can stipulate the forum for adjudication, if it is agreed to by the beneficiary – see The "Quest" [2014] 2 Lloyd's Rep.600 but caveat – whether the stipulation in the LOU that proceedings must be commenced in a specific forum may act as an amendment to a chosen forum or arbitration clause in a bill of lading or other contract which is the subject of the dispute?*

[25] *The test is claimant's "reasonably arguable best case" "The Moschanthy" [1971]1Lloyd's Rep.34 followed in Canada in Canadian Sub Sea Hydraulics Ltd. v The Ship "Cormorant" 2006 FC1051 The answer to the question is that there is nothing, other than the refusal to issue the LOU, where a claimant can be forced to reveal the basis of its calculation of its reasonably arguable best case. Once the LOU is issued, then the principal should apply to the Court for reduction of the amount of the security forcing the claimant to reveal its calculations.*

[26] *By the defendant, but the Club does not have standing – see The "Flag Evi" [2017] 1 Lloyd's Rep.467; a possible solution might be for the issuer to stipulate that in the event of any breach by the beneficiary of its undertaking under the LOU, eg not to arrest the vessel, the sanction will be the automatic lapsing and cancellation of the issuer's obligations under the LOU.*

[27] *The "Rio Assu (No.2)" [1999] 1 Lloyd's Rep.115 at page 125 where the Court of Appeal that the intentions of both parties was to provide security in any circumstances where the claimant was ultimately held or agreed to have a valid claim.*

[28] *FSL-9 Pte. Limited and Nordic Tankers Trading A/S v Norwegian Hull Club [2016] EWHC1091 (Comm.)*

[29] *Query – in the LOU that was issued, it stipulated that "....any dispute arising hereunder shall be subject to the exclusive jurisdiction of the High Court of Justice in London"; to avoid going back to Indonesia, should not the clause have read "....any dispute arising hereunder and in connection with this undertaking shall be subject ...."*

Biography

David Colford, admitted to the Barreau du Quebec in 1980, practices maritime and commercial law in Montreal, Canada, with Brisset Bishop, where he has been a partner since 1985. He is the Past President of the Canadian Maritime Law Association (2015-2017), a lecturer on International Carriage of Goods by Sea at the McGill Law Faculty and gives presentations to ship agent, chartering brokerage, and freight forwarder groups in the marine industry. He specializes in multi-modal transport issues, contractual disputes and litigation controversies before the admiralty and civil courts. He has appeared in the Supreme Court of Canada on several occasions.