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Is Unseaworthiness a Viable Defense for Underwriters in the 21st Century?

Treatment of Warranty of Seaworthiness in Courts of the United States

INTERNATIONAL MARINE CLAIMS CONFERENCE DUBLIN

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I. INTRODUCTION & BACKGROUND

American and English law both address warranties of seaworthiness, allowing hull underwriters a defense in the event of breach. Where English law is found in case law and the Marine Insurance Act of 1906, the United States has no similar national statutory regime addressing marine insurance law. Instead, federal marine insurance law of the United States has developed through case law which constitutes part of general maritime law. (Note that relevant state law will apply, however, as to specific questions as to which there is no established federal rule of decision and there is no need for one to be created in the interest of uniformity.) This memorandum briefly surveys decisions by federal courts in the United States in respect of the implied warranty of seaworthiness in time hull policies.*

American marine insurance jurisprudence has been strongly influenced by and often parallels English law.[i] For example, English law recognizes an implied warranty in voyage policies that "at the commencement of the voyage[,] the ship shall be seaworthy for the purposes of the particular adventure insured."[ii] If the voyage is insured for multiple stages, there is an implied warranty of seaworthiness at the commencement of each stage.[iii] Similarly, American law recognizes an implied warranty of seaworthiness in voyage policies.[iv] The warranty, heavily favorable to insurers, is "absolute in nature . . . ."[v] In accord with English law, the implied warranty of seaworthiness in the United States applies to every voyage policy.[vi]

English law does not recognize an implied warranty of seaworthiness in time hull insurance policies.[vii] A time policy often takes effect in the middle of a voyage. The legal tradition, codified in the Marine Insurance Act, recognizes an owner's inability to control the vessel's seaworthiness after it has already set sail.[viii] English law does allow a defense to coverage when the assured allows the vessel to set sail knowing it is unseaworthy.[ix] In such a case, the insurer has no obligation to pay any loss proximately caused by the unseaworthy conditions.[x]

Many courts in the United States have recognized an implied warranty of seaworthiness in time hull policies, however, marking a definite split from English law. In what has become known as the first part of the "American Rule", a warranty of

seaworthiness is implied at the time the policy commences.[xi] Courts have reasoned that the same rationale that creates an implied warranty of seaworthiness at the inception of voyage policies ought to provide a similar warranty in time policies.[xii]

After commencement, the second part of the American Rule applies. In what has sometimes been called a "negative, modified warranty", the vessel's owner must exercise due diligence so the vessel will not "break ground in an unseaworthy condition."[xiii] Violation of this warranty does not normally void the policy because it is not treated the same as a breach of the implied warranty which applies at inception.[xiv] Instead, the insurer is relieved from any duty to pay a loss "caused proximately by such unseaworthiness."[xv]

The "American Rule" has not been uniformly recognized or applied in federal courts of the United States. Some have followed the "English Rule,"[xvi] and others have embraced the "American Rule."[xvii] In the Second Circuit, both the American Rule and the English Rule have been followed.[xviii] A number of federal circuit courts have had no occasion to decide the issue.

In the midst of such confusion, calls for uniformity between English and American law have arisen.[xix] Although some have said that the Supreme Court already announced at least the second part of the American Rule in Union Ins. Co. v. Smith,[xx] others claim the court's reference to the rule is merely "the hasty reading of a few words dropped in passing."[xxi] A circuit by circuit examination of federal case law indicates that the courts in the United States have tended to favor the American Rule over the English Rule, but the decisions are far from uniform.

II. SURVEY OF DECISIONS WITHIN THE FEDERAL CIRCUITS

A. First Circuit

A district court within the First Circuit recognized that both an express and implied warranty of seaworthiness applied to a time policy. In Certain Underwriters at Lloyd's v. Johnston, the policy contained an express warranty that the

vessel was "seaworthy at the inception of coverage."[xxii] The Court held that the warranty of seaworthiness, whether express or implied, will "void coverage" when the vessel is unseaworthy at inception of the policy.[xxiii] The Court cited Fifth Circuit authority and voided coverage without regard to whether the owner had knowledge of or was at fault for having failed to discover the unseaworthy condition.[xxiv] The court furthermore applied policy language reflecting a "negative implied warranty" (that it said reflected the "American Rule") to exercise due diligence to maintain the vessel in a seaworthy state, finding the owners were in breach because they had to have known of the unseaworthy conditions which allowed seawater to flood the vessel.[xxv]

B. Second Circuit

The case of New York, New Haven & Hartford R.R. Co. v. Gray mainly addressed whether the loss was caused by a peril of the sea as opposed to gross negligence or willful misconduct of the assured.[xxvi] The Court also noted that the insurers had "correctly disclaimed defense of an implied warranty of seaworthiness, since these are time policies," clearly a nod to English law.[xxvii] The Court dismissed as obiter dicta references to the "so-called American rule" in earlier cases that an assured should not recover for any loss caused by the want of due diligence in making repairs.[xxviii]

Several months later a slightly different panel of judges of the very same court (Judge Lumbard having sat on both cases) reached a different conclusion. Citing to the very same American authorities that were brushed aside in Gray, the court in McAllister Lighterage Line, Inc. v. Insurance Company of North America declared that, "With a term policy of insurance the warranty of seaworthiness arises at the time when the insurance becomes effective."[xxix]

More recent district court cases from New York such as Royal Indemnity Co. v. Deep Sea International and Continental Ins. Co. v. Lone Eagle Shipping Ltd. note that the Second Circuit has never resolved the conflict between Gray and McAllister. The district court judges in these cases concluded that the Second Circuit

would resolve the conflict in favor of recognizing an "absolute" implied warranty of seaworthiness in time hull policies where the vessel was in port at the time the insurance attached.[xxx] Thus, the judges in both cases observed that the absolute warranty would not apply if the vessel was at sea when the policy commenced.[xxxi]

C. Fifth Circuit

Definitive elucidation of the two warranties variously referred to as the American Rule may be traced to the Fifth Circuit's decision in Saskatchewan Government Ins. Office v. Spot Pack, Inc..[xxxii] In Spot Pack (authored by noted maritime law jurist Judge John R. Brown), the Fifth Circuit said that the American Rule implied in time policies both a warranty of seaworthiness at the time insurance attached and a "negative, modified warranty" that the owner will not knowingly allow the vessel to break ground in an unseaworthy condition. Breach of the former warranty voids the policy while breach of the latter relieves the insurer from any obligation to pay for loss caused by the unseaworthy condition.[xxxiii] Judge Brown traced the American Rule to the Supreme Court's opinion in Union Insurance Co. of Philadelphia v. Smith.[xxxiv] Spot Pack observed that the American Rule was "a rare departure from a determined course of parallel uniformity" with English law.[xxxv]

More than a quarter of a century later, the Fifth Circuit reaffirmed Spot Pack in Employers Ins. of Wausau v. Occidental Petroleum Corp. and applied the implied warranty of seaworthiness where a vessel had been delivered in an unseaworthy state, and was therefore unseaworthy at the inception of the time policy.[xxxvi] The vessel sank solely due to its unseaworthy condition. The Court held that the breach of the implied warranty does not require knowledge or fault, as it may discourage vessel owners from taking steps to ensure the vessel is seaworthy.[xxxvii] Although the court reaffirmed Spot Pack, the insurers did not escape paying for the loss because the implied warranty was waived or displaced by the policy's liner negligence clause.[xxxviii]

In D.J. McDuffie, Inc. v. Old Reliable Fire Ins. Co., the Fifth Circuit recognized again and applied the "federal maritime rule extending an implied warranty of seaworthiness to a maritime hull insurance policy."[xxxix] The Court affirmed the district court's decision that the owner "had breached their implied warranty of seaworthiness at the outset of the policy period."[xl]

Gulfstream Cargo, Ltd. v. Reliance Ins. Co. was another decision written by Judge Brown. Although the case primarily focused upon avoidance of the policy because owners had concealed the vessel's unseaworthiness, the Court noted that owners also could find no comfort under the distinctive "two-pronged" American Rule pronounced in his Spot Pack decision because breach of the implied warranty meant that the policy was voided.[xli]

D. Eighth Circuit

In L & L Marine Service, Inc. v. Ins. Co. of North America, a time hull policy contained a provision which excluded from coverage any loss arising out of the assured's failure to exercise due diligence to maintain the vessel in a seaworthy condition after inception of the policy. Citing to case law from the Second and Fifth Circuits, the Court first recognized both warranties of the American Rule, just as they were expressed in Spot Pack.[xlii] It then proceeded to interpret the policy's exclusion "in light of the historical development of the implied warranty of seaworthiness" to determine whether the exclusion was triggered by mere failure to exercise due diligence or required proof that the assured knowingly permitted the vessel to break ground in an unseaworthy state.[xliii]

After observing that the cases were not entirely consistent in their pronunciation of appropriate standard applicable to the warranty the Court concluded that the lower due diligence standard was appropriate for the exclusion before it. Thus, it upheld the district court's use of a jury instruction which triggered the exclusion upon a finding of lack of due diligence without regard to actual knowledge that the vessel was unseaworthy.[xliv]

It merits note that Spot Pack itself went the other way when addressing the "negative modified warranty" free of any policy exclusion, ruling in the end that the insurer had to pay the loss in question for lack of evidence that owners knew of the unseaworthy condition. The Eighth Circuit therefore did not heed the ultimate decision in Spot Pack. It instead took instruction from the Supreme Court's dictum in Union Insurance to the effect that lack of diligence on the part of the owners or his agents discharged the insurer from liability for those losses caused by that lack of diligence.[xlv]

E. Ninth Circuit

In the interest of uniformity between English and American law of marine insurance, a district court in Alaska followed the English Rule and held in Gregoire v. Underwriters at Lloyd's that "there is no implied warranty that a vessel will not break ground in an unseaworthy condition" in a time hull policy.[xlvi] (It must be pointed out that the Court expressly did not have to consider or decide whether there existed an absolute implied warranty of seaworthiness at the inception of the policy because the insurer conceded that the vessel was seaworthy when the policy attached.[xlvii]) In accordance with § 39(5) of the Marine Insurance Act, however, the Court also said that if the owner sent the vessel to sea knowing it to be unseaworthy, then the insurer would not be liable for any loss caused by the unseaworthy condition.[xlviii]

F. Eleventh Circuit

In Kilpatrick Marine Piling v. Fireman's Fund Ins. Co., a hull insurer appealed a jury verdict requiring it to pay for a vessel that sank. Although it did not challenge the seaworthiness of the vessel at the time of the sinking, it argued that the vessel was unseaworthy at the policy's inception, thereby voiding the policy under the implied warranty recognized in Spot Pack and other cases. The Eleventh Circuit noted the argument and authorities supporting the insured's argument without actually declaring whether it acknowledged the existence of such a warranty. It did not have to

take that step because it found there was sufficient evidence to support the jury's finding that the vessel was seaworthy at the inception of the policy.[xlix]

A federal district court in Florida had occasion to give limited consideration of the warranties of the American Rule in Lloyd's U.S. Corp. v. Smallwood. The time hull policy at issue contained express warranties reflecting the American Rule as laid out in Spot Pack.[l] Independent of the express warranties, the Court acknowledged the existence of both an absolute implied warranty of seaworthiness at inception of the policy and the negative, modified warranty that the vessel not thereafter be permitted to break ground in an unseaworthy condition by virtue of bad faith or neglect.[li] Neither the express nor the implied warranties at play in the case spared the insurer from having to pay for the vessel's loss because the Court found that the vessel was seaworthy at inception and the insurer failed to prove that an unseaworthy condition caused the vessel's loss.[lii] The Court found that the loss resulted from negligence of the captain and crew covered under the policy's Inchmaree clause.[liii]

III. CONCLUSION

The American Rule as recognized in Spot Pack has generally been acknowledged in many federal courts in the United States, but, as can be seen from the above survey of cases, it is not uniformly followed. Decisions like Gregoire demonstrate that courts are not always willing to break from the English Rule. Cases like L & L Marine Service, Inc. v. Ins. Co. of North America show that even policy provisions intended to mirror the American Rule as expressed in Spot Pack do not guarantee strict adherence to that case. Thus, predictable outcomes which are always sought by insurance claims handlers (and their counsel) remain elusive.

* I am very grateful to Keesal, Young & Logan law clerk Bryan A. Gless for his assistance with the preparation of this survey of court decisions.

[i] See Robert Bocko, et al., Marine Insurance Survey: A comparison of United States Law to the Marine Insurance of 1906, 20 TUL. MAR. L.J. 5 (1995); Graydon S. Staring, A Warranty of Seaworthiness in Time Hull Policies? Disuniform Unrealism, 5 Benedict's Maritime Bulletin 166 (2007).

[ii] Marine Insurance Act § 39(1).

[iii] Id. at § 39(3).

[iv] Eagle Star & British Dominions Ins. Co., 9 F.2d 296 (9th Cir. 1925); Compania Transatlantica Centro-Americana, S.A. v. Alliance Assur. Co., 50 F. Supp. 986 (S.D.N.Y. 1943); Staring, supra note 1, at 166 (citing M'Lanahan v. The Universal Ins. Co., 26 U.S. 170, 183 (1828)).

[v] See Nicolas R. Foster, The Seaworthiness Trilogy: Carriage of Goods, Insurance, and Personal Injury, 40 Santa Clara L. Rev. 473, 491–92 (2000) (stating that the seaworthiness policy is "independent of any knowledge or fault on the part of the insured. It is also not dependent on whether the subsequent loss is directly attributable to the lack of seaworthiness.").

[vi] Id. at 491 (quoting R.J. Lambeth, Templeman on Marine Insurance: Its Principles and Practice, 37 (1981)).

[vii] Marine Insurance Act § 39(5).

[viii] Foster, supra note 5, at 494.

[ix] Marine Insurance Act § 39(5).

[x] Id.; Foster, supra note 5, at 494–95.

[xi] See Lloyd's U.S. Corp. v. Smallwood, 719 F. Supp. 1540 (M.D. Fla. 1989), aff'd, 903 F.2d 828 (11th Cir. 1990); Gulfstream Cargo, Ltd. v. Reliance Ins. Co., 409 F.2d 974 (5th Cir. 1969); Bocko, supra note 1, at 46 (citing Jones v. Ins. Co., 13 F. Cas. 982 (C.C.E.D. Pa. 1852)).

[xii] Employers Ins. of Wausau v. Occidental Petroleum Corp., 978 F.2d 1422, 1436 (5th Cir. 1993).

[xiii] Saskatchewan Government Insurance Office v. Spot Pack, Inc., 242 F. 2d 385, 388 (5th Cir. 1957).

[xiv] See Id. at 388.

[xv] Id. at 388.

[xvi] See Gregoire v. Underwriters at Lloyds, 559 F. Supp. 596 (D. Alaska 1982).

[xvii] See Gulfstream Cargo, 409 F.2d 974.

[xviii] Compare McAllister Lighterage Line, Inc. v. Ins. Co. of N. America, 244 F.2d 867 (2nd Cir. 1957), with New York, New Haven & Hartford R.R. Co. v Gray, 240 F.2d 460 (2nd Cir. 1957).

[xix] Gregoire, 559 F. Supp. at 600-01; Foster, supra note 5, at 501.

[xx] Union Ins. Co. of Philadelphia v. Smith, 124 U.S. 405, 427 (1888); Foster, supra note 5, at 496–97.

[xxi] Staring, supra note 1 at 169, 171 (suggesting the reference to an American Rule in Union Ins. is either dictum or a misreading).

[xxii] Certain Underwriters at Lloyd's v. Johnston, 124 F. Supp. 2d 763, 771 (D.P.R. 1999) (express warranty stating "It is a condition of this policy that the vessel is seaworthy at the inception of the policy. Violation of this condition will void this policy from its inception.")

[xxiii] Id. at 771.

[xxiv] Id. at 771 (quoting Employers Ins. of Wausau, 978 F.2d 1422 (5th Cir. 1993) ("The insurer need not demonstrate that the insured had knowledge of the unseaworthy condition nor that the insured was somehow at fault in not discovering the unseaworthy condition. It is enough to discharge the insurer . . . if the vessel is in fact not seaworthy at the inception of the policy.")).

[xxv] Id. at 772.

[xxvi] New York, New Haven & Hartford R.R. Co. v. Gray, 240 F.2d 460 (2d Cir. 1957).

[xxvii] Id. at 466.

[xxviii] McAllister Lighterage Line, Inc. v. Ins. Co. of North America, 244 F.2d 867, 871 (2nd Cir. 1957).

[xxix] Id. n.10.

[xxx] Royal Indemnity Co. v. Deep Sea International, 2007 AMC 1872 (S.D.N.Y. 2007); Continental Ins. Co. v. Lone Eagle Shipping Ltd., 952 F. Supp. 1046, 1067 (S.D.N.Y. 1997).

[xxxi] Id.

[xxxii] See Staring, supra note 1 at 169.

[xxxiii] Saskatchewan Gov't Ins. Office v. Spot Pack, Inc., 242 F.2d 385, 388 (5th Cir. 1957) (American Rule implying for a time policy, "a warranty of seaworthiness as of the very moment of attachment of the insurance . . . [and that] the Owner, from bad faith or neglect, will not knowingly permit the vessel to break ground in an unseaworthy condition.").

[xxxiv] Id. at 388–89 (citing Union Insurance Co. of Philadelphia v. Smith, 124 U.S. 405, 427 (1888) ("In the insurance of a vessel by a time policy, the warranty of seaworthiness is complied with if the vessel be seaworthy at the commencement of the risk; and the fact that she subsequently sustains damage, and is not properly refitted at an intermediate port, does not discharge the insurer from subsequent risk of loss, provided such loss be not the consequence of the omission.")

[xxxv] Id. at 388.

[xxxvi] Employers Ins. of Wausau v. Occidental Petroleum Corp., 978 F.2d 1422, 1436–37 (5th Cir. 1993).

[xxxvii] Id. at 1435–37 (noting that both McDuffie and Gulfstream do not answer whether the knowledge of a vessel's unseaworthiness is a pre-requisite for a breach of the implied warranty of seaworthiness).

[xxxviii] Id. at 1437-40.

[xxxix] D.J. McDuffie, Inc. v. Old Reliable Fire Ins. Co., 608 F.2d 145, 147 n.1 (5th Cir. 1979).

[xl] Id.

[xli] Gulfstream, 409 F.2d 974, 982-83 (5th Cir. 1969) (recognizing that breach of the implied warranty of seaworthiness in a time policy at the time the insurance attaches voids the policy).

[xlii] L & L Marine Service, Inc. v. Ins. Co. of N. America, 796 F.2d 1032, 1035–36 (8th Cir. 1986); id. at 1036 n.6 where the Court observed that "the American rule appears to have become relatively well embedded in federal maritime law."

[xliii] Id. at 1035-36.

[xliv] Id.

[xlv] Id. at 1036.

[xlvi] Gregoire, 559 F. Supp. at 601.

[xlvii] Id. at 599.

[xlviii] Id. at 601.

[xlix] Kilpatrick Marine Piling v. Fireman's Fund Ins. Co., 795 F.2d 940, 945 (11th Cir. 1986).

[l] Lloyd's U.S. Corp. v. Smallwood, 719 F. Supp. 1540, 1543 (M.D. Fla. 1989).

[li] Id. at 1549.

[lii] Id.

[liii] Id. at 1549–50.