CLEAN BILLS, DIRTY BILLS AND LOI'S – BE VERY CAREFUL!

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INTRODUCTION

This Risk Bulletin provides a reminder and a guide to shipowner/carriers on the risks related to a wrongful description of cargo in a Bill of Lading (B/L) as being in "Apparent Good Order and Condition" (i.e. 'Clean on Board') when in fact – like the steel coils shown in the above photo – it is not. Cargo claims from the consignee will likely follow and the outcome can be very expensive.

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BACKGROUND

In the break bulk and bulk cargo trades it is not uncommon for cargo shippers and/or charterers to request that the master sign 'Clean' B/Ls at the load port in circumstances where the cargo appears to be damaged. The shipper/charterer will usually offer a Letter of Indemnity (LOI) to the master and shipowner so as to provide cover against any possible claim from the cargo consignee at the discharge port. This situation is not unusual. However, it can be considered in law to be a fraud on the cargo consignee and his bank. Why? Because the consignee will usually know nothing about the damage. Further, they will often be purchasing the goods based on the 'as shipped' B/L description and by use of the Letter of Credit (LOC) process.

Readers may quickly say, "Well, this happens every day, all around the world". Yes, it does, but this does not make it legal. Nor does it provide any justification or defence to a shipowner, even if the governing Charterparty contains a specific requirement that the master must sign Clean B/Ls against the shipper's/charterer's LOI. So what are the impacts of the legal and insurance issues? And what should a shipowner do?

FUNCTIONS OF A BILL OF LADING

A Bill of Lading is a critically important shipping document. It is issued by the carrier after the goods are 'shipped on board'. B/L's (apart from Seawaybills) are generally considered to have three principal functions as:

1. **Receipt for the Goods** – which normally states "*Received on board in apparent good order and condition*" (i.e. a '*Clean*' B/L) unless remarks to the contrary are made on the face of the B/L which would then make it a '*Dirty*' B/L).

2. **Evidence of the Transport Contract** – in that the terms of carriage by sea (and sometimes 'door to door') are printed on the front and back of the B/L.

3. **Document of Title** – in that the B/L is both a negotiable document and the 'key to the warehouse' such that an authorised holder is entitled to cargo delivery upon production of the B/L to the carrier.

Function 3., 'Document of Title', allows the goods to be sold by the shipper during the course of the voyage. It also comprises an integral element of the associated sale contract and secured payment terms for the goods are often facilitated by a bank issued LOC. All good so far. Regrettably, this is also where the '*Clean*' and '*Dirty*' B/L problem originates from.

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LETTERS OF CREDIT AND THE NECESSITY FOR A 'CLEAN' B/L

The LOC process requires that the seller's/shipper's bank be provided with an agreed range of documentation before it is entitled to release payment to the shipper. The most important of these document will be an original copy of the relevant B/L which proves the goods have been 'shipped on board'. The B/L must also be *'Clean'* in that it must not contain any remarks that indicate the goods are not in the condition they were described as when sold. If any such remarks are made on the front of the B/L, it will then be classified as a *'Dirty'* B/L. As such, it is virtual certainty that the buyer will reject the goods and, based on this presumption, the seller's bank will not be permitted to release payment.

Not surprisingly, the aforementioned non-payment scenario is one which a seller/shipper wants to avoid. Thus, in circumstances where the cargo being loaded on board a ship is observed to be damaged (e.g. steel coils noted on the Mate's Receipts to be 'rusty and dented'), the shipper will invariably approach the Master to request that he not make any similar remarks on the B/Ls i.e. that he should issue and sign them as 'Clean on Board'. In exchange, the shipper will offer an Letter of Indemnity (LOI) against any claim for damage or loss made by the cargo consignee at the discharge port.

ARE LOI'S RELIABLE AND ENFORCEABLE?

On the face of it, the shipper's offer of an LOI appears to provide a simple and risk free solution. It does not. The principal reasons for this are the '3-U's' as follows:

1. **Unenforceable** – In that if the cargo is damaged but the B/Ls issued and signed contain no remarks as to the nature of this damage (i.e. they are issued '*Clean*') then the buyer/consignee of the goods and their bank will have no knowledge of the damage until the goods arrive. The master and shipowner could then be seen to have colluded with the seller/shipper to intentionally misrepresent the cargo condition to the ultimate buyer/cargo consignee. As such, they will have effectively committed a fraud. The associated LOI will then be considered an illegal contract and unenforceable in law. Result? The LOI is worthless if the seller/shipper later refuses to settle the buyer/consignee's cargo claims against the carrier/shipowner.

2. **Unsecured** – In that the seller/shipper may have no money to pay the claims even if he is willing to do so. The only fall back then would be if the seller/shipper also provided a back to back bank guarantee from a reputable bank. However, what reputable bank would provide a guarantee against the perpetration of a prospective fraud and the virtual certainty of a claim?

3. **Uninsured** – In that all P&I Clubs exclude any claims for losses arising out of a member's intentional involvement in an illegal contract, inclusive of unenforceable LOIs. As such, there will be no liability cover for their member against cargo consignee claims if a shipper/charterer does not honour his LOI. The attention of MM members is also brought to the Managers' discretionary exclusion of cover under the Club Rules, Class I, Rule 4 (19) (ix) (e).

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B/L'S AND CHARTERPARTY OBLIGATIONS

An associated B/L issue is that seller/shippers are often also the charterers of the vessel (e.g. when goods are sold and shipped on CIF terms). Most C/P terms will include a requirement that the Master of the vessel is to *"…sign B/Ls as presented"* by the shipper/charterer. This requirement will be backed by a C/P indemnity provision that engages if the B/L terms and obligations are more onerous than the C/P term liabilities of the shipowner.

Do C/P indemnity terms obligate the Master to sign any and all B/L's as presented if they are issued as '*Clean*' in circumstances where the cargo appears to be damaged? No, they do not as it is established law that a Master is not obligated to sign B/L's which are manifestly inconsistent with the observed condition of the cargo as loaded. If the Master does so, then the shipowner will be bound and will likely have no defence to subsequent cargo claims (*The Nogar Marin* [1988] CA 1 LR 412).

WHAT ARE THE SHIPOWNER'S OPTIONS?

There appear to be five options. The first two are both reliable and recommended. The third appears to be both technically and legally feasible but could, if the cargo suffers further damage during the voyage, lead to a counterclaim by charterers. The fourth can provide a solution but is subject to the accuracy of independent cargo surveyor assessments. The fifth is potentially high risk, high cost and legally unenforceable.

1. **Decline to load** on board any damaged cargo and require it be replaced with sound cargo. If possible, this condition should be pre-agreed under C/P terms.
2. **Decline to sign the B/Ls** or decline to authorise their subsequent signature by ship's agents unless they are claused in accordance with any damage noted in the 'Mate's Receipts'.
3. **Insist shipper/charterer signs the B/L as the named contractual carrier** and is clearly identified as such, inclusive of the deletion of any 'Demise clause' or 'Identity of the [shipowner as the] carrier clause' on the reverse of the B/L. Cargo claims would then be required to be brought in the first instance against the charterer, as the contractual carrier, and not the against the shipowner.
4. **Dispute the cargo condition** and accept a 'Dispute LOI' from the shipper/charterer which specifically notes the precise nature of the dispute and refers to all related specifications, analysis and survey reports. (Court dicta supports this option as an enforceable LOI against the dispute outcome).
5. **Agree to sign an arguably fraudulent B/L** if a shipowner – after conferring with their P&I Club –believes they have no other choice. If so, then they must be very sure of the integrity and asset base of the party providing the LOI. This is because a legally unenforceable LOI will become their only protection in circumstances where their P&I cover will not attach.

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CONCLUSION AND TAKEAWAY

The problem of shippers/charterers pressing the Master for the issue and signature of 'Clean' B/Ls, despite observed damage to cargo, has existed for decades. It seems likely this practice will continue as long as shipowners do not fully understand the dangers and are then subjected to commercial pressures to effectively falsify B/Ls. This Risk Bulletin is intended to help curtail and control such situations.

MM members are asked to ensure that their Operations Departments and their Masters are made fully aware of the serious risks and exposures to liability that the B/L signature and LOI scenarios described above can generate. If Members are faced with such legally complex and commercially problematic situations, they should notify the Club immediately. MM will then be pleased to provide urgent assistance inclusive of requisite legal advice (this may vary dependent upon applicable jurisdiction and law), surveyor attendance and expert opinion on cargo condition.

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