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## Managing moral hazard in English marine insurance law – The implied warranty of seaworthiness

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### Abstract

Theories of moral hazard hold that once a policyholder has obtained insurance his incentive to take care in order to avoid a particular loss diminishes. Moreover, he may even cause losses on purpose in order to receive insurance payment. In general, moral hazard on the part of the policyholder represents a big problem for underwriters of all insurance types and marine insurance is not an exception. This begs the question of how insurers deal with the issue of moral hazard in the marine insurance bargain. One of the methods that insurers and law makers use to deal with the possible moral hazard problem is by conditioning payment under the marine insurance policy with particular risk delimiting terms, such as warranties. In the context of marine insurance, it is presumed that the most effective warranty used against the possible effects of moral hazard is the warranty of seaworthiness which is set in Section 39 of the Marine Insurance Act (MIA) 1906. Therefore, in this paper the author will explain why section 39 of the MIA 1906 represents an appropriate protective technique in relation to the management of moral hazard on the part of the policyholder in marine insurance contract law.

*Key Words:* Marine Insurance, Moral Hazard, Warranty of Seaworthiness

### 1. INTRODUCTION – THE PROBLEM OF MORAL HAZARD IN GENERAL

Many legal and economic theorists have exemplified focus on the fact that despite being a positive risk

controlling method, insurance, can also have bad consequences on people. The existence of the insurance institution to prevent individuals and therefore society as a whole from risk is a rational action. However, this rational action on individual basis is self-oriented and concentrated on self-benefit. According to Baker, helping people has harmful consequences. ‘Social responsibility is a euphemism for individual irresponsibility.’<sup>1</sup> This causes increased concern about how people react when they are protected from risk.

It is believed that a person is rarely motivated to protect the property of someone else as to protect his own belongings. When an insurer agrees to cover the costs of certain insured risks, in a sense the property belongs to him. Consequently, it is expected that the policyholder will be less concerned about avoiding accidents once an insurance contract is signed. In other words, the policyholder’s incentives to take care change. This is the problem of moral hazard in insurance.

The existence of moral hazard is a proof that insurance can have bad consequences on the individuals. Insurance can lead people to particular temptations that they would not have if the risk was in their hands. The moral hazard argument holds that insurance creates individual incentives to make people careless about avoiding harms or maybe even cause them on purpose. It describes individual behaviour as immoral when there is insurance cover available. It views insurance as a method which wakes up the evil in people through their careless behaviour with no intentions to prevent from loss and sometimes even willingness to cause loss intentionally.

In general, moral hazard behaviour represents a serious problem for insurers. That is because when the behaviour of the policyholder shifts as a result of the

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<sup>1</sup> Baker, Tom. (1996) ‘On the Geology of Moral Hazard’, *Texas Law Review*, vol. 75, p. 237, 240.

insurance bargain, the likelihood of loss also changes. As a result, the underwriter will not be able to anticipate the level of the damage and to set the premiums accordingly. There is no doubt that moral hazard behaviour is induced by the insurance arrangement itself, but the question is what really makes it up? In this article we will explain how the concept of moral hazard has changed over time. Moreover, which form of moral hazard is relevant for the study of marine insurance contact law and therefore, how marine insurance underwriters manage it through the requirement of the warranty of seaworthiness.

## 2. THE SHIFTING NATURE OF MORAL HAZARD

Historically, moral hazard was limited to the idea of bad character, and the assumption that bad people did bad things. It was believed that people behave within the boundaries of moral hazard once they obtain insurance because of their bad character traits.<sup>2</sup> However, the development of the economic rational choice theory extended the conceptual framework of moral hazard. Consequently, moral hazard became known as a result of the incentives created by the availability of particular benefits; in this case the availability of insurance. Thus, moral hazard behaviour was considered as a rational decision making in response to economic incentives.<sup>3</sup> However, even economists, themselves did not agree on to a single theory of moral hazard in terms of law and economics. For example, on one side there was the rigid economic approach,<sup>4</sup> which described moral hazard as a pure reflection of rational choice decision making. On the contrary, there was the softer economic theory acknowledged by Arrow,<sup>5</sup> according to whom moral hazard reflected both rational economic decisions as well as moral perfidy.

Furthermore, Heimer described moral hazard as a reflection of both; character traits and rational

<sup>2</sup> Ibid.

<sup>3</sup> Heimer, A. Carol. (1985) *Reactive Risk and Rational Action: Managing Moral Hazard in Insurance Contracts*, University of California Press, Berkeley, p. 35.

<sup>4</sup> Pauly, Mark. (1968) 'The Economics of Moral Hazard: Comment', *The American Economic Review*, vol. 58, p. 531; Posner, Richard. (1977) *Economic Analysis of Law*, 2<sup>nd</sup> edition, Boston.

<sup>5</sup> Arrow, Kenneth. (1963) 'Uncertainty and the Welfare Economics of Medical Care', *The American Economic Review*, vol. 53, p. 941.

economic decision making.<sup>6</sup> According to her, bad character and economic rationality did not occur independently. Thus, people of bad character probably responded differently to economic incentives than more moral people.

In addition, the concept of moral hazard was also adopted in the so called behavioural science theory. That model of human conduct was largely developed as a criticism to the approach of economic rationality. In general, it holds that human beings may well have other motivations besides the wish to pursue their self interest. As a result, the developers of the behavioural science theory are of the opinion that psychology and sociology should also be taken into account when analyzing individual's conduct in terms of incentives because pure economic analysis does not cover every aspect of human decision making.

Furthermore, the behavioural science theory does presume that people are selfish, self-interested actors very often. However, 'as social beings, individuals are also motivated to comply with community standards, even if the content of those standards is at variance with their selfish desires.'<sup>7</sup> This suggests that when community norms are contrary to the individual's selfish interest, his behaviour will oppose his self interest due to the attraction of norm compliance. Therefore, social norms<sup>8</sup> are believed to have a great impact of how people behave. According to Lisa Bernstein,<sup>9</sup> social norms are powerful motivators of behaviour, and they, as well as, other relational factors, are well incorporated into existing legal and academic approaches to gap filling.

The central point that we tried to emphasize in this section is that the notion of moral hazard represented and still represents different things to different people of various scholar backgrounds. If we want to analyze how moral hazard is managed in marine insurance law in the context of all of these theories independently we would have to write a whole book. Furthermore, the author does not agree that either one of the theoretical

<sup>6</sup> It resembles to the Arrow's presumption of moral hazard. The only difference is that he uses the word morality and she uses character as additional factors to the rational economic decision making process.

<sup>7</sup> Korobkin, Russell. (2000) 'Behavioural Analysis and Legal Form: Rules vs. Standards Revisited', *Orlando Law Review*, vol. 79, p. 23, 54.

<sup>8</sup> Social norms are rules that a group uses for appropriate and inappropriate values, beliefs, attitudes and behaviours. They are behavioural expectations and cues within a society or a group. They indicate the established and approved ways of doing things.

<sup>9</sup> Bernstein, Lisa (1992) 'Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry', *Journal of Legal Studies*, vol. 21, p. 115.

approaches to insurance moral hazard is applicable individually. Instead we are of the opinion that people's decision making is based on a combination of rationality and morality aspects. Therefore, for the purpose of this article we will assume that our policyholder is a rational economic actor who makes rational decisions, but also takes into account particular moral constraints. Furthermore, he or she takes into consideration the social norms that are customized over time in regards to the relations developed through the marine insurance contractual dealing. For clarity we will label this model of behaviour the Arrow-Bernstein-Relational Contract Theory.<sup>10</sup>

### 3. THE ARROW-BERNSTEIN-RELATIONAL CONTRACT THEORY MODEL

The human decision making model that we will use for the purposes of this article is the Arrow-Bernstein-Relational Contract Theory hypothesis. Therefore, our base will be the soft economic approach of the well respected economist Professor Arrow.<sup>11</sup> In order to provide a better explanation of his theory, we will demonstrate its correlation with the important role that social norms play in the process of decision making.<sup>12</sup> That will lead us into the literature of the relational contract theory.

In general, Arrow as an economist is strongly in favour of the rational economic approach. However, unlike traditional neoclassical economics theorists, he also takes into account the moral element as an important factor in decision making. He holds that people do make economically rational decisions that pursue their self-interest, but only if no further constraints are contained. Furthermore, he continues that 'it does not follow that no constraints ought to be imposed or indeed that in certain context individuals should not impose constraints on themselves.'<sup>13</sup> The restraints that he refers to are social norms imposed by the commercial nature of the insurance contractual framework. In a long passage in relation to medical insurance Arrow explained: "The underlying point is

<sup>10</sup> The Arrow-Bernstein-Relational Theory Model is developed by Milica Josifovska herself for the purpose of her PhD thesis; Josifovska, Milica. (2010) *The Coverage of Human Related Risks in Marine Insurance Contract Law and the Effects of Moral Hazard*, Cardiff Law School, Cardiff.

<sup>11</sup> Arrow, Kenneth. (1968) 'The Economics of Moral Hazard: Further Comment', *The American Economic Review*, vol. 58, p. 537.

<sup>12</sup> Bernstein (n9).

<sup>13</sup> Arrow (n11) 538.

that, if individuals are free to spend as they will with assurance that the insurance company will pay, the resulting resource allocation will certainly not be socially optimal. This makes perfectly reasonable the idea that an insurance company can improve the allocation of resources to all concerned by a policy which rations the amount of medical services in several different ways: (1) there might be a detailed examination by the insurance company of individual cost items allowing those that are regarded "normal" and disallowing others, where normality means roughly what would have been bought in the absence of insurance; (2) they may rely on the professional ethics of physicians not to prescribe frivolously expensive cost of treatment, at least where the gain is primarily in comfort and luxury rather than in health improvement proper; (3) they may even, and this is not as absurd as Mr. Pauly seems to think, rely on the willingness of the individual to behave in accordance with some commonly accepted norms."<sup>14</sup>

In addition, Arrow holds that because of insurance moral hazard, complete reliance on economic incentives does not lead to an optimal allocation of resources. In most societies, alternative relationships are built up, which to some extent serve to permit cooperation and risk sharing. In order to justify this, Professor Arrow uses as an example the principle of the agency relationship. Accordingly, he states that: "One of the characteristics of a successful economic system is that the relations of trust and confidence between principal and agent are sufficiently strong so that the agent will not cheat even though it may be rational economic behaviour...nonmarket controls, whether internalized as moral principles or externally imposed, are to some extent essential for efficiency."<sup>15</sup>

It is the last restraint; the one of commonly accepted norms to which Arrow refers that leads us into the studies of Professor Bernstein who has largely dealt with social norms in the commercial framework. Subsequently, the relational nature of trust and morality in a contractual relationship, associates Arrow's assumptions with aspects of the relational contract theory.<sup>16</sup> On the whole, the social norm approach and the scope of the relational contract theory represent justifications for our preference to consider Arrow's presumptions regarding individual's decision making as a model of moral hazard in marine insurance contract law.

<sup>14</sup> Ibid.

<sup>15</sup> Ibid.

<sup>16</sup> Macneil, Ian. (1999-2000) 'Relational Contract Theory: Challenges and Queries', *Northwestern University Law Review*, p. 877.

The author takes this approach because immanent business norms are vital for an appropriate understanding of the relationship between the contracting parties.<sup>17</sup> Consequently, Bernstein holds that social norms and other aspects of the contracting context are of fundamental significance to people's conduct within a contractual enterprise.<sup>18</sup> They (social norms), are powerful motivators of behaviour. That is, as she argues, because 'social norms and other aspects of the contracting context are of central importance to relational contract theory.'<sup>19</sup> According to the relational contract theory:

In many transactional settings, promises are kept for reasons wholly unrelated to the existence of a legally enforceable contract. Parties may be induced to perform under the contract because of social custom or a concern for relationships, trust, honour and decency.<sup>20</sup>

In general, the relational contract theory holds that parties do not agree only on what is written in the contract. On the contrary, there are additional norms depending on the commercial nature of the relationship upon which the contract is based. Relational contracts represent agreements of cooperation aiming to achieve long-term mutually desired goals. They are 'more like marriages than one-night stands.'<sup>21</sup>

From the brief analysis above, regarding the relation contract theory we can agree to three distinguishing characters of relational contracts. Primarily, the exchanged relationship extends over time. Therefore, it is a long-term contractual scope, 'not a "spot" market deal.'<sup>22</sup> Secondly, because of the long-term contractual nature some parts of the exchange cannot be defined at the time of contracting. Lastly, 'in a relational contract the interdependence of the parties to the exchange extends at any given moment beyond the single discrete transaction to a range of social interrelationships.'<sup>23</sup> Subsequently, this begs the following question: What is it that links the relational contract theory to the marine

insurance contractual framework? In addition, why is it significant for the present analysis of moral hazard?

Firstly, the contractual relationship between an underwriter and a policyholder indeed is a relational agreement. It is a relational contract 'par excellence.'<sup>24</sup> The contractual relation between the parties extends over time, and enhancing long-term cooperation is important. The policy is unique, because performance might not be required if the insured risk does not take place. In addition, the relation is part of the insurance social system in which reputation is important both in terms to commercial norms (the shipping industry as a whole) and in relation to contractual norms (relation between the insurer and the insured). Thus, it is highly possible that honourable reputation will lead a ship-owner to more gain in the long run and preferable insurance premiums.

Having defined the concept of moral hazard for the purpose of this article we will now merge it with the requirement of Section 39 of the Marine Insurance Act 1906 and analyze how it represents a reasonable solution to the management of moral hazard in marine insurance contract law.

#### 4. SECTION 39 OF THE MARINE INSURANCE ACT 1906 – THE IMPLIED WARRANTY OF SEAWORTHINESS

One of the various techniques that marine insurers apply in order to keep their policyholders from altering their behaviour and therefore increasing the likelihood of loss is the use of certain risk delimiting terms or conditions of coverage, such as warranties. The implied warranty of seaworthiness is probably the most significant risk delimiting condition in marine insurance which is used in order to manage potential moral hazard behaviour on the part of the policyholder.

Moral hazard largely relates to the control of the insured over a loss. Therefore, since it is the owner that most often sends his ship to sea, particularly in voyage policies,<sup>25</sup> it is him that has control over its condition. Consequently, the warranty of seaworthiness represents a significant management in the control of the insured regarding his level of care in making the vessel sound when sent to sea. In general, section 39 of the Marine Insurance Act 1906 imposes the following:

<sup>17</sup> Bernstein (n9).

<sup>18</sup> Bernstein, Lisa. (1993-1994) 'Social Norms and Default Rules of Analysis', *Southern California Interdisciplinary Law Journal*, vol. 3, p. 59.

<sup>19</sup> Ibid.

<sup>20</sup> Feinman, M. Jay. (1993) 'Relational Contract and Default Rules', *Southern California Interdisciplinary Law Journal*, vol. 3, p. 43.

<sup>21</sup> Gordon, Robert. (1985) 'Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law', *Wisconsin Law Review*, p. 565, 569.

<sup>22</sup> Speidel, Richard. (1999-2000) 'The Characteristics and Challenges of Relational Contracts', *Northwestern University Law Review*, vol. 94, p. 823.

<sup>23</sup> Ibid 824.

<sup>24</sup> Feinman, M. Jay. (2009) 'The Insurance Relationship as Relational Contract and the "Fairly Debatable" Rule for First-Party Bad Faith', *San Diego Law Review*, vol. 46, p. 553, 556.

<sup>25</sup> Voyage policy is a policy that covers a particular voyage of a specified ship.

“(1) In a voyage policy there is implied warranty that at the commencement of the voyage the ship shall be seaworthy for the purpose of the particular adventure insured...”

However, it continues that,

“... ”

(5) In a time policy there is no implied warranty that the ship shall be seaworthy at any stage of the adventure, but where with the privity of the assured, the ship is sent to sea in an unseaworthy state, the insurer is not liable for any loss attributable to unseaworthiness.”

The law illustrates that there is a difference regarding the seaworthiness requirement between time and voyage policies. In the following section we will explain the role of both in relation to the management of moral hazard in marine insurance law.

#### 4.1. The Implied Warranty of Seaworthiness, Section 39 (1) of the MIA 1906

The implied warranty of seaworthiness plays an important role in the law of marine insurance. Practice illustrates, that it is one of the most effective defence methods used by insurers.<sup>26</sup> That is because of its firm nature in relation to limitation of coverage. For instance, strict compliance with the warranty is a condition precedent to the underwriter's liability for loss.<sup>27</sup> When an insured breaches the implied warranty of seaworthiness, automatic discharge of liability on the part of the insurer follows.<sup>28</sup> It is not material whether the unseaworthiness is a result of fault of the insured or whether it is the direct cause of the loss. As long as the ship is not seaworthy at the commencement of the insured voyage, and at that time only, under a voyage policy the underwriter is discharged from liability.

In general, the automatic discharge as a consequence of a warranty breach is based on the fact that non compliance with the warranty constitutes alteration of the risk otherwise agreed, and the insurer has not agreed to cover such change.<sup>29</sup> Thus, there is no doubt that section 39(1) represents a significant risk limiting device in marine insurance contracts.

The standard of seaworthiness extends from the structure of the vessel itself, to the fit state in response

to repairs, equipment, and crew, as well as in all other respects to encounter the ordinary perils of the sea.<sup>30</sup> Accordingly, the seaworthiness requirement at the commencement of the voyage and only at that time in a voyage policy can be defined as a normative level of precaution on the part of the insurer when assessing the risk before the policy is signed.

Risk is a decisive factor in insurance cover. As a result, an underwriter must possess sufficient information to rate the risk that the vessel will suffer loss by perils of the sea.<sup>31</sup> However, the time of contracting and the time of the insured coming to risk are different, so the insurer cannot predict whether the ship-owner will make the vessel seaworthy before every voyage. In addition, with the vessel being in control of the insured and the possibility of him not taking relevant care as a result of having insurance is greater. Thus, the risk is higher. In order to assess the risk, the underwriter must have the right to assume a certain standard of suitability of the vessel.<sup>32</sup> Subsequently, it could be said that the imposition of the warranty of seaworthiness in voyage policies helps the insurer to rate the risk properly and therefore, calculate the premium accordingly.

Furthermore, in relation to the problem of moral hazard, the implied warranty of seaworthiness in marine insurance for voyage policies represents a rule of a disciplinary nature.<sup>33</sup> It is presumed that an insured ship-owner could grow careless regarding the condition of the vessel and the safety of the master and crew once he obtains an insurance cover. As, a result the imposition of such a warranty exists in order to protect the interest of innocent freighters. Moreover, it serves to safeguard the crew against the consequences of the owner's irresponsibility of sending the ship to sea in a condition that can endanger the interests of all.<sup>34</sup> The rule could be defined as a societal norm to protect the interest of people outside the immediate contract transaction. Within this context, in *Douglas v Scougall*<sup>35</sup> Lord Eldon observed that: “... there is nothing in matters of insurance of more importance that the implied warranty that a ship is seaworthy when she sails on the voyage insured; and I have endeavoured, both with a view to the benefit of commerce and the

<sup>30</sup> *Dixon v Sadler* (1839) 5 M&W 405, 414 (Parke B).

<sup>31</sup> *Ibid.*

<sup>32</sup> Schoenbaum, Thomas. (1999) *Key Divergences between English and American Law of Marine Insurance: A Comparative Study*, Cornell Maritime Press, Centreville, p. 160.

<sup>33</sup> It creates a standard of care that needs to be undertaken by the insured before he sends his ship to sea.

<sup>34</sup> Mustill, J. Michael (1998) ‘Fault and Marine Losses,’ *Lloyd's Maritime Commercial Law Quarterly*, p. 310 i 345.

<sup>35</sup> (1816) 4 Dow 269.

<sup>26</sup> Soyer, Baris. (2002) ‘Defences Available to a Marine Insurer,’ *Lloyd's Maritime and Commercial Law Quarterly*, p. 199.

<sup>27</sup> *De Hahn v Hartley* (1786) 1 TR 343.

<sup>28</sup> *Bank of Nova Scotia v Hellenic Mutual War Risk Association (Bermuda) Ltd (The Good Luck)* [1992] 1 AC 233 (HL).

<sup>29</sup> Bennett Howard (1991) ‘Good Luck with Warranties,’ *Journal of Business Law*, p. 592, 596.

preservation of human life, to enforce that doctrine as far as, in the exercise of sound discretion, I have been enabled to do so.<sup>36</sup>

Therefore, section 39(1) of the MIA 1906 provides disciplinary standards to the ship-owner's level of care, and consequently, protects the interests of those indirectly involved in the insurance bargain.

Overall, the disciplinary nature of the warranty of seaworthiness serves to motivate policyholders to be responsible for the conditions of their ships. It induces ship-owners to make their ships seaworthy, especially when they have to pay the consequences if a loss occurs due to unseaworthiness. Such seaworthiness sets responsibilities on the part of the insured, which oblige him to exercise further care once insurance cover is obtained. This statement of incentives in terms of care leads us to consider the relationship of moral hazard; specifically within the context of the Arrow-Bernstein-Relational Contract Theory model, and the warranty of seaworthiness. Thus, we will hereby provide explanation that we consider relevant in relation to the effects of the warranty of seaworthiness on the behaviour of our presumed ship-owner.

As already stated, in a marine insurance context, for the purpose of this article, moral hazard is appropriately explained within the scope of the theory set by Professor Arrow. Arrow holds that, in general, people make rational economic decisions, however they also consider the aspects of morality. Subsequently, in most cases, people's decision making arises from the notion of economic rationality, but further constraints are also imposed, or individuals impose constraints on themselves.<sup>37</sup> Therefore, on the whole, Arrow is of the opinion that economic rationality and morality function mutually. Morality of this kind, relates to the willingness of individuals to behave in accordance with some commonly accepted norms. This assertion directs us into the writings that specifically recognize the centrality of social norms in many transactional settings.<sup>38</sup> In addition, business norms are of significant importance to relational contract theory.

In general, relational contract theory holds that people are individuals, but function in a social matrix. Furthermore, it explains that a contractual scope is not purely based on the plain wording used in the agreement. On the contrary, the relations between the contracting parties, as well, are of a vital importance. In the marine contractual context, that means, that a marine insurance contract is not a purely discrete

agreement based solely on the explicit contractual language setting. Instead, contracts of marine insurance are relational agreements between the insured and the insurer which are developed over time. Therefore, for an economically rational individual, that behaves in the context of norms and custom of the specified commercial 'relationship' that he is part of, it is important that the contractual relation is not limited only to the literal wording at the time of signing.

On the whole, our assumed ship-owner is an economically rational individual, whose decision making process also considers the social norms of the marine insurance enterprise in order to enhance relational ties with the insurers. Consequently, such individual makes economically rational decisions that maximize his interest and wealth, but in the long run. This means, that relations of the contractual nature in terms of norms and customs in the marine insurance scope are important for reaching that goal.

Having said all of this, one might ask, whether our presumed insured with a long-term interest in his insurance relation, requires an explicit obligation of seaworthiness in order to minimize loss and therefore, manage his behaviour. If the warranty of seaworthiness is part of a disciplinary contract analysis, the answer might be positive. That is because the requirement of seaworthiness sets minimum standards of a ship's condition and a moral, as well as, an economic rational actor will fulfil this requirement in order not to gamble on his insurance coverage. However, within the context of the relational contract theory, under the circumstances, our assumed ship-owner might even apply greater efforts to make his ship safe, not just seaworthy in order to fulfil the minimum standard. Consequently, it is questionable why would someone make his ship safe (greater standards of seaworthiness) when his obligation under the insurance contract is fulfilled by meeting the seaworthiness requirement.

In general, we believe that there are few reasons because of which our presumed individual who is looking to enhance his long-term insurance relation will make such a decision. Firstly, an effort of this kind will bring him respectable reputation in the market. In addition, it will result in long-term investment returns, because the excellent reputation, most likely will convince more cargo owners to want to ship their goods with a ship-owner of this kind. In addition, it is highly probable that making his ship safe, rather than just seaworthy, will also open opportunities for more favourable insurance premiums during the renewal of the marine contract. On the whole, a decision to make the ship safe, rather than just seaworthy almost certainly will enhance the ship-owner's position on the market

<sup>36</sup> Ibid, p. 276.

<sup>37</sup> Arrow (n11), p. 538.

<sup>38</sup> Bernstein (n9).

and the relations with his underwriters. Subsequently, these are vital motivating factors for an economically rational individual who also considers the importance of morality and commercial social norms in his decision making process. Therefore, we can conclude that the warranty of seaworthiness represents a well balanced anti-moral hazard device for our assumed ship-owner, both from a disciplinary and a relational contract perspective.

#### 4.2. Section 39 (5) of the Marine Insurance Act 1906

The Marine Insurance Act 1906 implies a warranty of seaworthiness strictly in voyage policies; however, the rule is softer regarding time policies.<sup>39</sup> In particular, the courts in the nineteenth century recognized a more limited defence requiring proof of three elements when the question of seaworthiness occurs in the context of time policies.<sup>40</sup> First, the vessel must be unseaworthy; that means not reasonably fit to encounter the ordinary perils of the insured adventure,<sup>41</sup> when sent to sea. Secondly, the insured must be privy to that unseaworthiness. This implies that the insured must subjectively know of the circumstances rendering the vessel unseaworthy and consciously recognize that such circumstances do make the vessel unseaworthy.<sup>42</sup> Moreover, privity also includes blind-eye knowledge. A person with blind-eye knowledge has a clear and conscious suspicion of the existence of the relevant circumstances and deliberately avoids confirmation that the suspicion is true;<sup>43</sup> mere negligence is not enough. Thirdly, the succeeding loss upon which the assured claims must be attributable to that unseaworthiness. Once these three elements are fulfilled, underwriters are relieved from liability in respect of any loss caused by unseaworthiness but remain liable in relation to other losses.<sup>44</sup> This questions why the requirement of seaworthiness varies between voyage and time policies in marine insurance law?

<sup>39</sup> A time policy insures a particular ship for a specified period of time, usually for one year.

<sup>40</sup> *Gibson v Small* (1853) 4 HLC 353; *Michael v Tredwin* (1856) 17 CB 551; *Thompson v Hopper* (1856) 6 EL & BL 172; Marine Insurance Act 1906 (UK) s 39(5).

<sup>41</sup> *Ibid.*, cl. 39(4).

<sup>42</sup> *Compania Maritima San Basilio SA v Oceanus Mutual Underwriting Association (Bermuda) Ltd (The Eurysthenes)* [1977] QB 49 (CA).

<sup>43</sup> *Manifest Shipping Co Ltd v Uni-Polaris Insurance Co Ltd (The Star Sea)* [2001] 1 Lloyd's Rep 389 (HL).

<sup>44</sup> *Thomas v Tyne & Wear Steamship Freight Insurance Association* [1917] 1 KB 938 (KBD).

The rationale behind the diverse seaworthiness requirements between time and voyage policies can be found in the case of *Gibson v Small*.<sup>45</sup> In that case the judges, primarily discussed that the identification of the moment at which the warranty of seaworthiness could be implied in a time policy can be problematic. It was questionable whether that moment 'should be at the time when the contract is made; or at a time fixed for the inception of the risk; or at the moment when the ship breaks ground on the first voyage after the inception of the risk?'<sup>46</sup> Or, then again, should the warranty relate to the moment when the ship commenced the intended enterprise? Whichever of these moments is chosen, some consequences that might not be consistent with the main principles of insurance law could arise.<sup>47</sup> For example, if the warranty is implied at the time of the contract formation, or a fixed time at the inception of the risk, a difficulty may appear especially if the insured vessel is at sea at that period.<sup>48</sup> That is so, because it is supposed that when the vessel is at the high seas the insured has difficulties in making certain the condition of the vessel at the time she comes to risk. However, it must be indicated that the case of *Gibson v Small* was decided in the year of 1853. At that time, the ship-owner had difficulty in ascertaining the condition of the vessel while in the high seas, but nowadays with the technological and communicational improvements, that is not the case. In modern times the ship-owner is presumed and expected to have control of his vessel most of the time, despite the physical distance.

Furthermore, the different approaches to time and voyage policies in relation to seaworthiness according to the discussion in *Gibson v Small*, takes upon the fact that whereas under a voyage policy, the standard of seaworthiness could be inclined by reference to the intended voyage, it could not work where the cover includes only the latter part of the voyage which is already in progress, or that part plus one or more different voyages, with or without the addition of the first part of another voyage. The enquired standard in all of these voyages could be different and unpredictable at the moment of inception. That is because the exact criterion of the requirement of seaworthiness varies according to the voyage to be undertaken.<sup>49</sup> The extent of the seaworthiness obligation may also be different for

<sup>45</sup> (1853) 4 HLC 353.

<sup>46</sup> *Ibid.*

<sup>47</sup> Soyer, Baris. (2006) *Warranties in Marine Insurance*, 2<sup>nd</sup> edition, London, p. 81.

<sup>48</sup> *Ibid.*

<sup>49</sup> For example, a ship seaworthy for inland navigation or coastal voyages might be unseaworthy for an ocean voyage.

the same voyage at different seasons.<sup>50</sup> However, Lord Mustill noted that this problem has become quite weak due to the increased homogeneity of the sea transport.<sup>51</sup> This means that, in modern times ships are made similar, and undergo certain procedures that make them seaworthy for almost all types of voyages.

The third reason upon which the majority in *Gibson v Small* differentiated between time and voyage policies was based on the disciplinary nature of the rule of seaworthiness. It was acknowledged that, while the warranty may be of a disciplinary character in voyage policies, it would be unfair to impose a similar burden on the assured in time policies. This unfairness, once again was based on the fact that the assured in a time policy may have no opportunity to inspect the condition of his vessel on inception. However, we already stated above and justified such statements why such position is not true today. That is mainly because in modern times the ship-owner can have control over and can be informed about the ship and its journeys most of the time.

In general, the reasons for the divergences of the seaworthiness requirement in time and voyage policies are quite limited and not very much persuading. It could be assumed that if the same questions arose today, the courts will not distinguish so much between the imposition of the seaworthiness warranty in time and voyage policies, unless there is a clear market reason to do so. However, the existence of the implied warranty in voyage policies, and its softer requirement in time policies, are preserved in the Marine Insurance Act 1906 and there is no reason to believe that the position will be changed. Notwithstanding, in reality the only differences between the two types of policies, relates to the manner in which the duration is ascertained, the one being measured 'by the motion of the ship and the other by the motion of the earth'<sup>52</sup> and that is not a solid ground for a different seaworthiness obligation.

In summary, the requirement of seaworthiness is softer in time policies. In other words there is no implied warranty that the ship shall be seaworthy at any stage of the adventure, but where with the privity of the assured, the ship is sent to sea in an unseaworthy state, the insurer is not liable for any loss attributable to unseaworthiness. Although, section 39(5) of the MIA 1906 is more flexible, (it requires proof of fact, mental element, and causation) nevertheless, it motivates

the insured to exercise due diligence in regard to the condition of his/her ship and therefore, to regulate possible moral hazard behaviour. It creates incentives for the policyholders to take reasonable care of the vessel's state, before they allow it to be sent to sea. Thus, within the context of the Arrow-Bernstain-Relational Contract Theory model of moral hazard the economically rational individual, with a long-term moral interest in the maritime enterprise would clearly be motivated to follow all of the relevant standards of due diligence in order to be covered by his insurer. In addition, for a better place in the market, and therefore, financial gains in the long run within the scope of the relational nature of the contract, our presumed ship-owner might even consider higher levels of due diligence. Accordingly, it can be presumed that as a disciplinary standard, section 39(5) of the MIA 1906 provides incentives to take care and encourages decision makers to use due diligence regarding the condition of their vessels in order to keep their insurance cover. Moreover, as a relational standard, section 39(5) enhances the long-term interest of our assumed ship-owner, under which he might even exercise a higher standard of due diligence for the purpose of the relational exchange in the marine insurance contract. That is because behaviour of this kind, almost certainly will bring him respectable reputation, excellent standing in the shipping market and will subsequently, lead to long-term financial gains. All of these resemble a rational economic decision, combined with the aspects of morality. This is based on the fact that if a ship-owner is found privy to an unseaworthiness, which caused damage or loss to the ship, the underwriter will not be liable. In addition, all of the above factors in terms of reputation, and financial gain on the long-run will be lost in such a situation. Therefore, there is no doubt that despite being softer in nature, section 39(5) of the MIA 1906, as well, represents a solid mechanism which manages moral hazard in marine insurance contract law.

## 5. CONCLUSION

In conclusion, the comprehensive review of the seaworthiness rule in marine insurance law illustrated that section 39 of the MIA 1906 imposes a regulatory framework, which protects the insurer when assessing the possible risks by making the insured to fulfil the minimum standard requirements in regard to the condition of his vessel. It certainly, manages the control of the insured in relation to the standard of care that is required by the law as a condition of coverage. Consequently, it deters moral hazard behaviour, as

<sup>50</sup> For example a ship may be seaworthy for a summer voyage, but unseaworthy for the same voyage in winter because she might not be reasonably fit to encounter the perils of the sea for a winter voyage, such as ice.

<sup>51</sup> Mustill (n34), p. 348.

<sup>52</sup> *Gibson v Small* (1853) 4 HLC 353, 384-385.

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it would be neither rational, nor moral to send a ship at sea in an unseaworthy state, knowing that there is a possibility for losing insurance cover. Therefore, it appears that marine insurance law has created a relatively efficient framework for protection in relation to potential moral hazard occurrence<sup>53</sup> in relation to the standards of care that an insured ship-owner must follow as a condition of coverage.

#### *SUMMARY*

The problem of moral hazard is present in all insurance types. Marine insurers are not an exception from the threat of the moral hazard syndrome; rather,

they are maybe even more affected by it in comparison to other types of insurance.<sup>54</sup> However, the concept of moral hazard, itself has evolved over time and it is interpreted differently by various scholar disciplines. For the purpose of this article we assumed that our insured ship-owner is a rational economic actor for whom the aspects of morality are also important. In addition, it is the long-term relational interest that he takes into consideration when making decisions. Therefore, for such an individual the implementation of Section 39 of the Marine Insurance Act (The imposition of the warranty of seaworthiness) represents an efficient risk controlling mechanism in relation to moral hazard within the Arrow-Bernstein-Relational Contract Theory model of behaviour in marine insurance law.

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<sup>53</sup> Relative but not absolute protection because profiles of short-term interested ship-owners may decide otherwise.

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<sup>54</sup> Heimer (n3), p. 93.