

CHARTER PARTY FRAUD

The international trading community has been beset in recent years by a large number of failures in chartering contracts. Typically these occur whenever the market moves rapidly in either direction.

When shipowners and charterers operate on very fine profit margins in a difficult market, any factor which alters original cost estimates puts the profitability of the voyage into jeopardy. If either defaults on their contractual obligations to make payment or to complete the voyage, the other party and the cargo owners are left with the problem and financial burden of ensuring cargoes are delivered to their destinations, often at substantial additional cost.

Charterers who have taken a vessel on long term charter in the belief that over a period of say 6-12 months freight rates will remain firm, may find themselves in the unenviable position of having to pay high time rates which cannot be sustained in a low freight market if the market plunges.

Where freight rates barely cover operating costs and shipowners face bank loan repayments on mortgages taken out in a boom period on inflated ship values, a break-even voyage can quickly turn into one of financial disaster.

The problems are not just financial. There is also the difficulty of reaching an agreement on how costs are to be apportioned, the logistical problems of trying (on a typical liner voyage for example), to get over two hundred bill of lading holders in the destination country to agree to pay their share of the contributions and sign the necessary releases for the voyage to be resumed, and to organise any joint action to be taken against the defaulting shipowner/charterer for recovery.

Whether it is the charterer or the shipowner who defaults, the one party who invariably gets hurt is the cargo owner. Typically, having paid for the goods soon after the issue of the bill of lading, he faces, at the very least, long delays before receiving the cargo. During this period he continues to pay bank interest charges which could wipe out profit margins. Furthermore, he may be liable for penalties for late delivery to his customers.

Along with the cargo owner, the shipowner suffers in cases where the charterer defaults. His vessel has on board a shipload of cargo bound for a distant port and no funds to carry out the voyage. Where bills of lading have been issued on a 'liner out basis' the shipowner faces, in addition, the costs of discharge at two or more discharge ports - an expense he can ill-afford and which could bring many small to medium sized shipping companies to the verge of bankruptcy.

A charterer, who is not the cargo owner, has the least to lose. This is particularly true where the charterer is registered in a country of convenience and the beneficial ownership of the company may be impossible to trace. The only asset that one can attach is the bank accounts. Given the ease with which monies can be transferred around the world into different bank accounts, and the lack of knowledge of the beneficial owners, it is in practice, difficult to achieve any real recovery, unless one acts quickly and is lucky.

Since none of the charterers' assets are on the line, there is a strong tendency on the part of the unscrupulous charterer to discontinue his involvement in a chartering contract that is turning sour, rather than risk any further funds in seeing it through.

Trends

There has always been a rise in chartering failures in a depressed market and vessels of all types and of all ages can be involved.

There was a marked increase in chartering failures during the period 1976 to 1979 and there has been a rising trend from 1982 onwards.

In the liner trades chartering failures were predominant on the Europe/West Africa route during the late seventies. A significant factor contributing to this was the congestion in West African ports due to mis-planned cement imports. This gave rise to unusually large demurrage bills which charterers could not meet. The emphasis has shifted recently to the liner trades operating from Western Europe to the Indian subcontinent and the Middle East.

In terms of shipping, it can generally be said that whilst owners of newer and more expensive tonnage may find themselves involved with charterers who default, these owners are more capable of extricating themselves from the problems before they grow to unmanageable proportions. This is usually the result of competent management and its financial capacity to withstand short term losses without affecting their overall fleet performance.

It follows that the vessels involved in serious chartering failures tend to be older tonnage and small to medium sized companies with limited financial resources.

A brief examination of the liner companies who have failed on the Europe/Middle East/Indian subcontinent indicates a number of similar characteristics.

They tended to have a life of eighteen months or less of regular frequent sailing before going under. Their marketing was aggressive and they tended to substantially undercut the existing freight rates. Companies which last as long as eighteen months generally have reputable agents who can canvass cargoes effectively. The decision makers do not generally come from liner trade background, but from other sections of the industry. They do not

have any great expertise in the areas they intend to service. The venture may be heavily loan financed.

Chartering failures have been an aspect of the market place for so long that they have become a constant fear in the minds of chartering brokers when concluding a fixture. A chartering failure no longer elicits the condemnation from the market place that it used to. Brokers in the market place may not condone it, but it is becoming more accepted as one of the dangers of working in the ship chartering business.

Causes

A study of defaulting charterers has shown that they are severely under-capitalised for the kind of business they are in. Typically, these are companies who have grown too fast, too quickly. The first few voyages would have been relatively trouble free. But instead of consolidating finances they tend to enter into far too many chartering commitments, stretching their resources. In so far as there are no problems on the voyage cash flows can be maintained in the black.

Difficulties arise when one of the many ships on charter faces delay, congestion, or an unexpectedly excessive war risk premium. All of a sudden a large injection of cash is required if the voyage is to be completed. There is no ready cash as they are already fully stretched financially.

Charterers then either divert funds from other vessels' voyage accounts or else suspend payments to the owners of the vessel in trouble.

Doing the former gives rise to a subsequent cash shortfall on that vessel, which cannot be met. As they keep transferring monies from the voyage accounts of one vessel to another in order to keep the vessels moving, inefficiencies in operation cause the cash shortfall to grow. Like a bubble, the cash shortfall rapidly reaches a size where it cannot be supported by the total freight income trickling in and the whole enterprise collapses. By this time there could be a fleet of ships abandoned by their charterers in various stages of their voyage with no funds to complete them.

Having suspended payments to the owners whilst they look for other sources of funds, again the delay to the vessel and the operating inefficiencies from there on will increase the costs on that voyage to such an extent that the charterers would be forced into liquidation.

Voyage cost estimates made by both charterers and shipowners are often more optimistic than realistic. Adequate allowances are not made for contingencies, possible congestion at the ports of call, Customs fines and local regulations.

In many countries export cargoes incur a local freight tax. This could be as much as eight to nine per cent of the gross freight and is usually deductible at source or, at least, by the load port agent before passing on the freights to the owner/charterer. If this is not allowed for in the voyage estimate calculations, it could cause a serious cash flow problem. On many return cargoes from the Middle East/Indian subcontinent this represents a significant portion of the profit and the shipowner/charterer knows he is in trouble from the time he sails from the load port.

In some countries customs fines for shortlanded cargoes can be quite severe and the local agent is, in the first instance, liable to the Customs for the fine. It is often the case that the Customs fines are levied against the agents some considerable time after the vessel has discharged and left the port. Where vessels are chartered in by a liner operator these fines may not become a factor in the liner company's voyage estimates until after the first five or six sailings. By then already it may have become a debt he cannot service from the freight incomes of the new vessels on charter. A dispute develops between the local agent and the liner company, and an innocent vessel coming into that port under charter to the liner operator is arrested by the agent. Depending upon which country it is, the arrest on the vessel may or may not be released without the posting of a guarantee for the full claim.

Customs fines which have accumulated in the manner described above have been responsible, in part at least, to the failure of a liner company operating from Europe to the Indian subcontinent and thought to have been fairly reputable until it failed, leaving four vessels fully laden lying in intermediate ports on the way.

There is another case of a liner operator who took his first vessel on time charter without adequate cargoes to pay for the hire. When the six months expired the vessel had still not completed the voyage, had only loaded part of her full capacity and the charterers stated they did not have the funds to pay for the final two discharge port calls. At that time, they had already chartered in another three ships - one was arrested in the load port and had to discharge its cargo, most of which was damaged in the attempt. The other two vessels were abandoned, one fully loaded, the other partly loaded with cargo. The freight had been collected in large part by the charterers who went into liquidation. All vessels eventually completed their voyage many months later at considerable cost to both the cargo owners and the shipowners.

In the Europe/Middle East/Indian subcontinent trades a primary cause has been the great number of liner operators on the route. There has been fierce competition. New entrants, lacking proper expertise, have offered cargo owners uneconomic freight rates. Inevitably, the inefficient operators stuck with the low rates have disappeared or ceased trading leaving many debts and in some unfortunate cases, laden vessels with no funds to complete their voyage.

The Black Sea ports of Ukraine, Russia and Rumania have their own unique problems. These countries, emerging from centrally controlled economies, are only just coming to grips with the freedom and responsibilities of the free market. Without the right contacts, booked cargoes may easily be cancelled after the vessel's arrival, and berths and allocation of port labour favours those operators who have the experience and influence in these ports. The chances of successfully litigating and recovering a judgement debt from a local company for breach of contract is minimal. Many charterers have found that a chartering business plan on paper can be totally different from reality.

Fraud

There are cases where the charterer intends to defraud from the outset i.e. he intends to collect the freight and disappear leaving the shipowner and the cargo owner to sort out the mess.

The environment described earlier is not conducive to healthy commercial activity. As the market becomes more accustomed to failing charterers, and the lack of effective sanctions against the defaulter, the environment becomes increasingly attractive to the fraudster. Like other genuine failures his alibi is that it was a series of bad business decisions which caused the failure. It is often very difficult to distinguish between genuine commercial failure and failure as a result of an intent to defraud.

In recent years the huge fleets of the former Soviet Union and some countries of the old Eastern Bloc have experienced severe financial problems as a result of the change from centrally planned to market economies. Many of these fleets used to be considered reliable carriers, with well maintained ships operated by contented and competent crews. With central government no longer providing the financial guarantees to operate these vessels, creditors have moved in to arrest the vessels and recover their debts. Cash flow difficulties prevent the shipowners from quickly releasing the vessels for continued trading. The result has been a choking of operating income, whilst running costs continue to mount, plunging the shipowners into deeper debt. The knock-on effect for cargo owners and disponent owners is that the vessels are stranded at intermediate ports with discontented crews whose wages have not been paid. There have been numerous cases of voyages which should have taken sixty days dragging on for more than nine months.

In this process, disponent owners taking advantage of the disorganisation of the shipowners have been involved in the disappearance of part or all of the freight monies. This exacerbates an already bad situation, making the successful completion of the voyage even less likely.

The ICC-International Maritime Bureau has been investigating a group of individuals who, it would appear, have set up a string of companies purporting to be charterers. When asked for trading references these companies provide references for each other which look good on paper. In the heat of fixture negotiations owners and brokers have failed to check out the references before the vessel is fixed. The charter parties inevitably run into difficulties, at which stage the charterers disappear, often with large amounts of freight monies unaccounted for. The owners are left with the option of taking their disputes to arbitration knowing that when the award is published the charterer is unlikely to be around to meet his obligations.

Ancillary Causes

There are a number of market factors which may not directly cause a chartering failure but provide the circumstances which make such failures more likely. It is important to appreciate these factors because they may provide the early warning symptoms of impending disaster.

a) Unusually low freight rates: If the shipowner/charterer is unable to make a profit he may try any excuse to avoid his liabilities.

b) An unexpected change of circumstances after the commencement of the voyage i.e. the breakout of war, sudden congestion, increase in bunker prices/cancel dues etc. This drastically alters the profit estimate and perhaps the willingness to see the contract through.

c) Capital repayments: In a low freight market, the companies best equipped to survive are the ones with no capital repayment obligations. A great many bank loans were advanced when ship values and freight incomes were much higher. Now although freight incomes have plummeted, the repayments on the bank loans may have remained the same, thus putting an unacceptable burden on the shipowner.

In the context of chartering failures, this may manifest itself in two ways:

i) The shipowner is less able to cope with a cash flow crisis and may, therefore, decide to default

ii) As soon as a problem arises, the shipowner may take the view that as the mortgage on the vessel far exceeds its value it suits him to walk away from the problem leaving the bank, the cargo owners and the charterers to resolve it at their cost.

Effects of Delay

Shipowners are not usually responsible for damage to or loss of cargo due to delay in the prosecution of the voyage. So long as the delay is not unreasonable they would not be liable.

The consequences of delay in the delivery of the cargo falls on the cargo owner without recourse to compensation.

When a chartering failure occurs, the shipowner can take his time examining the options, safe in the knowledge that, within reason, he is free from liability and arrest of his vessel on the grounds of delay by the cargo owner. Often, the shipowner declares the vessel has suffered engine damage and this gives him additional time. In some ports in the Mediterranean and the Red Sea, ships have waited for over twelve months whilst negotiations continued between the cargo owners and the shipowner for additional funds to be paid for the voyage.

Such behaviour by shipowners is little short of extortion, but in the absence of suitable legal remedies cargo owners are often helpless.

In the circumstances stated above, where a vessel pulls into an intermediate port and declares 'general average' or 'engine damage' and does not move for months, cargo owners should inform their underwriters and request that the cargo be kept insured. It is likely that the underwriters may ask for an additional premium to be paid.

If prompt notice is not given the underwriters have the option under Clause 9 of the Institute Cargo clauses to consider the voyage and hence the policy as being terminated.

This puts the cargo owners in the inevitable position of finding their cargo in a distant port under the control of shipowners who demand an exorbitant sum for delivery and, in addition, taking on the entire risk of loss or damage to the cargo.

Insurance - The Financial Default Exception

Exclusion 4.6. of the Institute Cargo Clauses states inter alia that any damage, loss or expense arising from the financial default of the owners, managers, charterers, or operators of the vessel is not an insured peril.

In the event of a chartering failure the underwriters would be entitled to write themselves out of any liability to the cargo owners. This aspect is not known to have been tested in court.

Questions arise as to the underwriters liability if the cargo were subsequently lost as a result of a fire or collision, for example. The proximate cause of the loss would not be financial default but an insured peril and, in the absence of a termination of the policy by the underwriters, they may find themselves liable from an insured peril.

If, however, the policy was terminated, the cargo owners may find it impossible to obtain recovery or hold their goods insured until the chartering failure had been resolved.

The pressure is thus on the cargo owners to reach a commercial settlement with the owners without delay.

The financial default exclusion has now been amended. The amended clause JC90 limits the operation of the original clause 4.6. only to the circumstances where the cargo owners cannot show that they have taken due care at the commencement of the voyage to ensure that the charterer, owner, manager and operator are financially sound.

There is, therefore, a burden upon the cargo owners to show that they have taken steps to verify the financial viability of the owners and charterers at the commencement of the voyage. Credit checks with organisations such as the ICC-International Maritime Bureau would help in this regard.

Bills of Lading - Identity of the Carrier

The carrier is responsible to the cargo owner for the contract of carriage. The identity of the carrier can be determined from the bill of lading. Most bills of lading are owners' bills, they are signed by or on behalf of the Master. Page 1 of certain bill of lading forms contain an 'identity of carrier' clause.

In the liner trades the most commonly used form is the Conline Bill. Clause 17 of the standard Conline Bill clearly identifies the shipowner(s) as the carrier.

Certain liner operators issue bills under their own name and assume all responsibilities of the carrier.

In the event of a chartering failure, a cargo owner is best protected by an owners bill. At least he then has a valid contract with the person on whose ship the cargo is. There have been cases under a charterers' bill of lading where the cargo owners are put to considerable difficulty in getting the cargo released from the vessel or suing the shipowner for failure to prosecute the voyage.

Resolution of Chartering Failures

Chartering failures can be best resolved by both the injured parties - usually the shipowners and the cargo owners - reaching an early agreement to contribute towards the cost of completing the voyage.

Whatever the legal merits of each position, to pursue the dispute on a confrontational basis will only add to the delay and thus the costs of any eventual settlement.

This approach depends upon both parties accepting that they are victims of a mutual misfortune and negotiating with a view to cutting their losses rather than attempting to profit out of the others' misfortune. The actions of shipowners who make exorbitant demands upon cargo owners are not condoned. There are ways of dealing with such a situation. It involves the cargo owners incurring some additional expense to bring the shipowners to the negotiating table.

Whenever there has been a satisfactory resolution it has generally come as a result of prompt and productive negotiations. There are a great many cases on record where the unreasonable attitude of, or delay by, one of the parties involved has resulted in the cargoes remaining stranded in an intermediate port for years until the value of the cargo has depreciated to such an extent as to make any real prospect of recovery uneconomic.

Conclusion

Chartering failures are an inescapable part of maritime commerce. They are a serious impediment to the smooth operation of international trade. The cargo owners are invariably put to heavy financial expense. This burden can bring many cargo owners to bankruptcy.

Chartering failures tend to occur when there has been a significant movement in freight rates. They are least likely to occur in a stable market.

Some fleets from the former Soviet Union and Eastern Bloc have been faced with severe cash flow difficulties which have led to chartering failures. Some of the disponent owners, taking advantage of the shipowners disorganisation, have been involved in the disappearance of freight monies, thus making an already bad situation worse.

Where a charterer defaults mid voyage, shipowners can be put to tremendous expense and effort to deliver the cargo at the contractual destinations. In today's market a large number of shipowners are unable to meet these costs from their own resources.

Satisfactory resolutions to charter party failures can only be brought about by prompt, positive action by the cargo owners and the shipowners who enter into negotiations with a view to reaching a settlement which best limits losses on both sides. Any desire to take advantage of the other side will only result in delays and further costs before the matter is resolved, if at all.

Cargo owners may not easily be able to rely on their underwriters to compensate them for the losses which they may be forced to incur as a result of a chartering failure.

There are clauses in the bills of lading which give lesser or greater protection to the cargo owners. They should be aware of these and insist on the favourable clauses being a condition of the bill of lading being presented under documentary credits.

Timely and accurate information is the key to the prevention of chartering failures. Organisations such as the ICC-International Maritime Bureau have specialist data banks which monitor the performance of companies in international chartering. Cargo owners and ship operators would be well advised to obtain as much reliable information as is practicable about a potential charterer before entering into a contract of carriage.