

The Association of Average Adjusters of the United States

VIEWPOINTS 2007

READ THE FINE PRINT: POINTS FOR RISK AND CONTRACT EVALUATION

TALES FROM THE CUTTING EDGE

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When I was first contacted by Mr. Carney, the organizer for this program, he suggested that I respond to the sentence "But it looked so good on paper".

As an engineer my instinctive response would be to assume he meant: "It looked so good in blue print format", which, in turn, would suggest that I would make a presentation on some of the more spectacular design disasters in our industry. This would result in a presentation with lots of pictures and even videos of crash and burns, and cool salty dog stories. What I was thinking of was a presentation that would heavily depend on the various Discovery Channel programs such as: The Deadliest Catch and Mythbusters.

When I started collecting such pictures and tales I came to realize that while it would be fun, it probably would not be terribly helpful to the people assembled here. There are a number of reasons for the limited usefulness, but most of all I suspect that many in this audience would readily recognize the photos and stories and really would not learn anything particularly new.

Moreover, during subsequent discussions on the shape of this Forum I became aware that the discussion will be more related to contracts than to blue prints.

I have always been told that the point of a presentation like this is related to providing to some new insight or at least an alternative point of view and therefore some pictures of a towboat being pushed underneath a bridge, or a bulkcarrier interacting with a bridge will not be the centerpiece of this presentation.

But I do want to draw your attention to the following examples of costly unpredicted issues in our industry:

1. The spate of fatigue related structural failures of large tankers in the 1970's
2. Failures of treatment and use of heavy fuels in diesel engines in the 1970's
3. Medium Speed engine failures in the 1980's
4. The realization that single skin tankers are not sufficiently effective and the implementation of OPA90
5. Bulk Carrier heavy weather losses in the 1990's
6. Large Yacht damages in the middle 1990's
7. Podded propulsor failures in the late 1990's

8. Parametric roll on containers ships in the late 1990's
9. Oily Water Separator failures in the early 2000's
10. Ballast water exchange failures in the middle 2000's

These failures will not be the subject of this presentation.

They will merely serve as examples that our industry is forever changing and that each era in our industry has, and will, continue to encounter failures that were unexpected despite the best efforts by all parties involved. And the best efforts mean: the best contracts, the best management, the best design, the best planning and the best construction. Even with our best efforts, failure is inherent in the human interaction with technology. This failure both gives us pause for thought, advances the state of the art, and allows us to keep track of where the failure edge lies. One of the few undisputable truths in engineering is that only with knowledge of the edge of failure can the most efficient engineering take place.

There are many more failures that you and I have enjoyed, but I picked these failures because they have something in common; all of the above failures can be described as "failure classes". What I mean is that these were not stand-alone failures, but rather they were failures that were related to an advance in the state of the art and that had industry wide implications.

Generally, these failures are unexpected when the applicable new regulations or technologies are implemented, but then suddenly become apparent, first as a single failure and then as class when more failures of the same type start to show up. At that stage the industry, as a whole, comes to the realization that they will suffer more losses of this type and that there will be unexpected negative financial consequences.

Please note that for the sake of this presentation I am not talking about finding fault or the technical resolution, I am simply talking about how our industry, as a community resolves these issues. In the end there always is a technical solution, but that is not really the problem. The real problem is that there are always costs associated with a technical resolution, repair or remediation and the people that are assembled here are in the business of sending the bill to the correct address.

The address could be the Owners, the operators, the designers, the builders, the regulators, or the underwriters.

Some types of failures have fairly well established forwarding addresses, and the search engines for those addresses are our own holy texts. These texts are the contracts, whether they are construction specifications, charter parties, laws, regulations or insurance policies.

I and my colleagues, as surveyors and engineers, get to participate in the search for the right address, and our involvement is best summarized by the field survey catch phrase of: Establishing the Cause, Nature, Extent and Recommended Repairs.

The problem is that from a cold technical point of view the "cause, nature, extent and recommended repairs" are not always clear, and from an industry wide point of view they might be hopelessly muddled, especially when we are playing at the cutting edge.

What I would like to discuss is the common thread that runs through the resolution of these failures and explain to you that there are two approaches to the resolution of these failures.

One of those approaches is well known and consists of the examination and interpretation of the contracts.

These are the contracts that were developed to take care of all eventualities and they function well on those occasions when the potential of a specific failure class was known and when the risk could be estimated.

But then, when a new failure class rears its ugly head, the picture very quickly becomes muddled and there are then as many interpretations of the contract as there are parties to the contract.

At that stage there is a dispute. This dispute is actually artificial, and is really nothing more than Monday morning quarterbacking, but since often large sums of money are involved and sometimes the survival of commercial ventures is involved, they *look* like real disputes about real contracts.

The resolution of these disputes is often very public and often becomes law by precedent or actual enactment even though the final decisions were not arrived at by consensus, but rather by non-armed combat.

It is a case where to the victor belong the spoils, and often the victorious solution is technically incorrect and rarely has a proper sense of fairness.

So what is the other approach?

We all know the other approach, and we have all participated in it at various levels. The only difference is that it rarely gets recorded in specific process terms.

Ironically the theory has been recorded and has been repeated in thousands of places and we have all read it many times. Some of you might have seen it in Sunday school.

It is not the ten commandments, which is a contract.

It is this:

"Treat others as you would like to be treated."

It comes in different wordings, but is generally referred to as the Golden Rule. The Golden Rule is not a contract; it is a process. The reason it is a process is because it takes work to figure out what is right and this relates to fairness and then requires the evaluation of many factors.

There are many factors, but here are some factors to consider:

- 1. Things are always changing (change is constant)**
- 2. First do no irreversible harm**
- 3. Consider the cost of action through the entire chain**
- 4. Look for efficiencies**
- 5. Moderation**
- 6. Communicate**
- 7. Look for fairness from both points of view**
- 8. Cooperate**
- 9. Allow individual freedoms to an extreme if they do not harm others**
- 10. You are personally responsible for your actions on public knowledge**

The Golden Rule itself is hidden in step 7, but in reality it cannot be effected without considering the other steps. These 10 steps are only a generic example. It shows that it isn't necessarily easy, but that there is a real path to success if all parties are interested in success.

The interesting thing is that when things get difficult and confusing the latter process is much more useful than referring to the contract. I will not provide you with detailed examples, but will note that abortion, slavery, racism, OPA 90, podded propulsors, OWS and many other bumps in the road of life were not included in the 10 commandments contract or any addenda such as the Inch Maree or Institute clauses. On the other hand, the second approach, if willingly applied, stands at least a chance of coming up with a decent solution to all the problems noted above.

While there have been many attempts at looking at contracts and regulations when the proverbial seaweed hits the podded propulsor, our firm's and my personal experience have left me with the distinct impression that the best solutions to the difficult problems in the maritime world have been arrived at more often by the application of the Golden Rule than by interpretation of contracts.

At this stage you might feel you have been transported to a Seamen's Church Institute lecture, but nothing is further from the truth. There is not enough time to provide you with the thousands of examples we have seen over the years of some good Golden Rule thinking by the parties in maritime adventures.

But let me provide you with a few:

- A shipbuilder has horrible and unusual production problems and really not a very good chance of recovering under his builder's risk policy. Still he presents his case to the underwriter and the underwriter responds. Why? There is really no coverage for the particular type of failure. On the other hand the underwriter has accepted millions and millions of premiums over the years without any prior claims, and the chance of recurrence is low. No contract language there.
- A shipowner develops fracturing problems from operation in heavy weather. Is it really heavy weather? What is a fair compromise? Let's count heavy weather incidents between inspections and add deductibles such that the damages are fairly spread. No contract language there.
- A damage can fairly be estimated at one million or two million dollars. The two surveyors both have good cases. It will never be repaired. They look each other in the eye and agree to settle on one and a half million dollars. No contract language there.
- The United States Coast Guard is tasked with developing OPA90 tankers. There are thousands of solutions and the USCG has to pick one. When all is said and done the regulation works because it treats all participants in the tanker trade equally. No contract language there.

These solutions did not come out of thin air, but there were no contracts that provided any type of guidance about the resolution. So why did those problems arrive at a resolution without specific contract language?

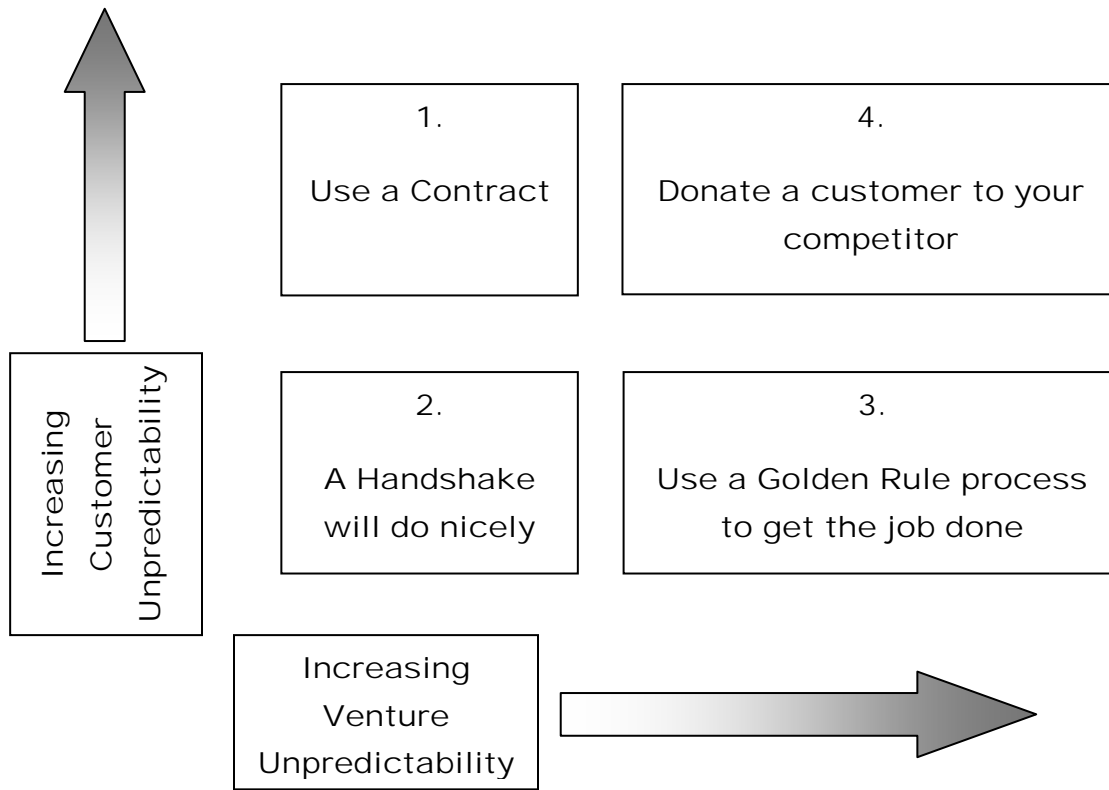
Allow me to add another peculiar reality in the marine industry. While we all see and talk about contracts all the time the most amazing thing in the marine industry is that there are so many instances where there are no contracts. Our firm has no contract with over 90% of our clients, but still our invoices get paid as neatly by our uncontracted clients as by our contracted clients.

So what good are contracts?

There are actually four situations to consider:

1. Contracts are good when players are unpredictable (will they use the golden rule or not?) and when the outcomes are predictable (will the adventure fail or not). Ironically this includes most standard H&M contracts since we all have a reasonable grasp of the risks, but we rarely know the players personally.
2. Contracts are expensive and not very useful when players are predictable (they will use the golden rule) and when outcomes are predictable. This is where a handshake will do.
3. Contracts are of little use when players are predictable and when outcomes are unpredictable. In this situation it is impossible to write a contract that covers all the eventualities and therefore when the chickens come home to roost the document itself does not cover the type and number of chickens that came home. But since the reaction of the players is predictable, a solution can be developed using golden rule principles. Therefore, if everything turns out well no contract work or golden rule work is necessary and when things do not work out as expected golden rule work is needed, but stands a high chance of success.
4. Contracts are of no use when the players are not predictable and when the outcomes are unpredictable. At that stage writing contracts is a waste of time, since the contract cannot cover all eventualities and there is probably no real will by either one or more parties to respond to the contract anyway. A business school professor told me once that this is when you refer a potential customer to your competitors.

The four situations can actually be pretty neatly diagrammed as follows:



Now, to take a quote from a movie, "Greed is Good" and that means that occasionally we are tempted to swim with the sharks and venture into situation 4. But as a risk consultant I tend to advise my clients to either hand a situation 4 to the competition, or to make an investment into changing unpredictable players into predictable players.

How do I make players more predictable? Don't let them bet their entire kitty on one contract (in other words take small steps and build confidence) but most of all refer back to steps 1 through 10 above and work the process a little.

Increasing the predictability of the players would put you in situation 3, which, incidentally, is where most of our client relationships reside, hence no contracts.

Now for those of you who paid attention, you might notice that one can also get from situation 4 to situation 1, but as far as making the future more predictable is concerned, I hope I have provided you with some examples that this is difficult to do, and the only thing that can be readily stated about the future is:

Change is constant and constant change makes things unpredictable.

While knowledgeable consultants and deep thought might decrease unpredictability, it will never go away and therefore some of us will always get to play on the cutting edge.