

International risk team



To repair or not to repair

A universal truth for businesses in the grip of the current global pandemic is that “Cash is King”.

When property gets damaged, it is normally repaired on a “like for like” basis, and the indemnity payable under an insurance policy is the cost of that repair. However, repairs and insurance claims, particularly in the energy sector, can take years to resolve and the values at stake can be millions or billions of dollars.

The Coronavirus pandemic will only exacerbate matters; supply chain issues and labour restrictions will prolong repairs and make them more expensive. Businesses may be unwilling or unable to wait whilst repairs are carried out before they receive the financial injection an indemnity provides. Moreover, in circumstances where the price of Brent Crude has already dropped from US\$69 p/b on 3 January 2020 to US\$28 p/b

on 1 April 2020, businesses may well decide that certain assets are not worth repairing at all and instead look to “cash in” immediately in order to ride out the storm.

Where a repair is not actually carried out, an insured may well have a claim for “unrepaired damage”. In such cases, calculating the indemnity is far from straightforward. Unless a “like for like” repair actually takes place, it is quite hard to know what the cost would have been, and so what the indemnity should be.

Unrepaired damage claims are not a product of the Coronavirus pandemic; it has long been recognised that there are situations where an insured may (for a variety of reasons) elect not to carry out a repair, and that in those cases, a mechanism for calculating the indemnity is required. Indeed, section 69(3) of the Marine Insurance Act 1906 provides:

“Where the ship has not been repaired, and has not been sold in her damaged state during the risk, the assured is entitled to be indemnified for **the reasonable depreciation** arising from the unrepaired damage, but **not exceeding the reasonable cost of repairing such damage...**”

Similarly, the WELCAR form provides that for the partial loss of an item which is not repaired or replaced, the indemnity is:

“...**the reasonable depreciation** arising from the unrepaired damage, deemed to be **the reasonable cost of repairing such damage** on a new for old basis...”

Other policies such as the Nordic Plan and the Institute Time Clauses also include unrepaired damage provisions which refer to the “reasonable depreciation” not exceeding the “reasonable cost of repair”.

Whilst unrepaired damage claims are nothing new, it is reasonable to anticipate that we will see more of them because of the issues identified above. It is also to be expected that such claims will become increasingly contentious as insureds fight for every dollar and cent in order to safeguard their survival.

The first point to note is that calculating the reasonable depreciation of an asset is inherently problematic, but particularly so during a financial crisis where values can swing dramatically. Accordingly, it makes sense for insurers to focus on the reasonable cost of repair given that (i) a justifiable figure can be arrived at by

carrying out a virtual repair scenario; and (ii) that figure will generally represent a limit on an unrepaired damage claim in any event.

However, the concept of the reasonable cost of repair on its own is meaningless. Below are some practical tips to consider when attempting to assess the reasonable cost of repair.

Get robust expert evidence

A “virtual repair” is a hypothetical repair which could be done but has not been done. It is a “desk-top” based plan of work setting out the individual steps and costs of the hypothetical repair. What the

word “virtual” connotes is a simulation. It is a simulated repair where every step is identified, given a duration and costed as if it was being done for real.

A virtual repair estimate is only as sound as the evidence upon which it is based (the data scientist’s maxim “rubbish in, rubbish out” is very apt). In previous cases, insurers have been criticised by the courts for taking a “bargain basement approach”, for “lowballing”, and for plucking figures out of the air. It is crucial, therefore, to base any virtual repair on robust expert evidence.



“Reasonable” does not mean cheapest

The BRILLANTE VIRTUOSO was an oil tanker that was deliberately set alight at the instigation of its owner in 2011. This was found following a 6-month trial in front of Teare J in the Commercial Court last year¹. However, somewhat unusually, the question of whether the vessel was a constructive total loss was decided at a quantum only trial in front of Flaux J in 2015² before the more fundamental question of whether insurers were actually liable at all was decided by Teare J four years later.

The vessel had an agreed insured value of \$55m with \$22m of increased value cover, making a total payout of \$77m in the event of an actual or constructive total loss.

The owners claimed a CTL on the basis that the vessel would have been repaired in Dubai at a cost of \$64.4m, which exceeded the CTL threshold of \$55m. However, insurers contended that the repair would have been done in China at a cost of \$53m, which was beneath the CTL threshold. Accordingly, the critical issue was whether the reasonable repair would have been done in Dubai or China.

The test set out by Flaux J was to ask “what would a prudent uninsured shipowner do?” That is really just a re-statement of the “reasonable cost of repair” concept. What is more helpful, however, is Flaux J’s identification of the factors that the owner is entitled to take into account. Importantly, the judge said that although cost is an important factor, it is not determinative. Also important are safety considerations, the quality of the yard, the cost of the tow and loss of income from having the vessel repaired at a distant yard.

Flaux J agreed with the owners that a repair in Dubai at a cost of \$64.4m was the most reasonable option. He pointed out that the tow to China would have taken longer and was dangerous. Also, that the repairs would have taken longer and might not have been of the same quality.

As it turned out, this was a Pyrrhic victory for the vessel owner whose claim was dismissed a year later for failing repeatedly to comply with a disclosure order. The vessel's bank's claim suffered the same fate in 2019 before Teare J when he found that there was no insured peril because the vessel had been attacked not by pirates but by its owner. However, that does not detract from the guidance which Flaux J gave in the earlier judgment.

“Reasonableness” will be assessed pragmatically

The RENOS was a vessel damaged by fire whilst off the coast of Egypt. When considering the costs of the salvage operation, a question arose as to whether it was reasonable for the owners to have contracted a large tug at a rate of \$15k a day, rather than a smaller, cheaper tug³. The judge sided with the owners, and held the larger tug was reasonable because “what was needed was a tug that could accomplish anything that transpired”.

However, that is not an open-ended position: the judge went on to say that whilst it was reasonable to utilise that tug to start with, as time passed it was open to the owners to explore other arrangements. He allowed \$1.2m of the \$1.9m claimed.

Uninsured property

Another question which often arises is whether the cost of moving uninsured property in order to repair damaged insured property falls within the reasonable cost of repair. It is not

uncommon for energy policies to include express wording which makes it clear that such costs are covered.

However, even in the absence of such wording, such costs will fall to be considered as part of the reasonable cost of repair unless there is clear wording to the contrary. In short, the costs of repair may not be confined strictly within the physical parameters of the insured property.

Repair equipment

The costs of deinstallation and reinstallation will be included. That can be many multiples of the cost of the repair itself because of the need to use heavy-duty kit like semi-submersible floatels and large decommissioning vessels.

Moreover, the cost of big-ticket items, like floatels, can vary enormously depending on the state of the market and the sector in which the floatel is required to operate.

Contingency

Another issue which crops up is the level of contingency which should be applied. Helpfully, the case law says “it depends”. The seminal case from a hundred years ago in fact says “a large margin”. Recent cases on ship repairs have suggested 10% is appropriate. However, it all depends upon the degree of uncertainty about the damage and the novelty and complexity of the exercise.

A more sophisticated approach to a crude contingency is stochastic modelling, which has been used quite a lot in recent large claims. Stochastic or “Monte Carlo” modelling is a tool for estimating probability distributions of potential outcomes by allowing for random variation in multiple inputs over time. In essence, the model runs the hundreds individual steps required for a particular

“virtual” repair thousands of times in chronological sequence (each step necessarily having an impact on the next), but each time with slight variations to the duration (and cost) of those individual steps to reflect the possibility of real life over and under-runs depending on things like weather delay, engineering complexity, equipment availability and so on. It is then able to calculate the most likely outcomes.

Not everything is a reasonable cost of repair

It is not that case that all costs will automatically be a reasonable cost of repair. Any costs that don't actually facilitate the repair will, obviously, not fall to be considered. An example being continuing overheads which the insured would have incurred anyway, or temporary repairs which are not a necessary part of a permanent repair.

A further example was provided in the recent Supreme Court decision⁴ in the RENOS case discussed above. As part of the trial judge's determination that the vessel was a CTL he allowed all costs payable to the salvors, including costs incurred to avoid environmental damage. The High Court and the Court of Appeal accepted those costs on the basis that the insured had acted as a prudent uninsured owner. However, the Supreme Court held that those costs could not be regarded as part of the “costs of repairing the damage” for the purposes of the CTL calculation, because they were paid for an entirely distinct purpose, namely to protect the shipowner (or its P&I club) from a potential liability for environmental damage.

Also, the policy may expressly exclude some costs. For example, costs which relate to alterations in design or betterment are normally excluded.

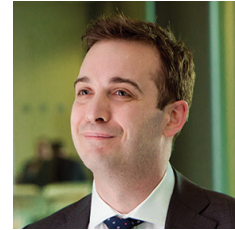
Summary

The key takeaways are:

- reasonable is not the same as the cheapest
- the scope of the reasonable cost of repair can include a whole host of things you might not have expected, especially if the insured asset is physically connected to other items that are not insured. But it won't include everything
- stochastic modelling is a sophisticated alternative to a crude percentage contingency
- finally, the quality of the expert evidence is key to making a virtual repair fit for purpose and resolving claims quickly and at an appropriate figure

Notes

1. *Suez fortune Investments Ltd & Anor v Talbot Underwriting Ltd & Ors* [2019] EWHC 2599
2. *Suez fortune Investments Ltd & Anor v Talbot Underwriting Ltd & Ors* [2015] EWHC 42
3. *Connect Shipping Inc & Anor v Sveriges Angfartygs Assurans Forening (The Swedish Club) & Ors (The Renos)* [2016] EWHC 1580 (Comm). Following a recent finding in the Supreme Court that additional remuneration payable to the salvors for measures to minimise environmental damage could not form part of the cost of repair (discussed below), the case has been sent back to the judge for further factual determination. However, the point regarding the recoverability of the tug costs stands.
4. *Connect Shipping Inc & Anor v Sveriges Angfartygs Assurans Forening (The Swedish Club) & Ors (The Renos)* [2019] UKSC 29



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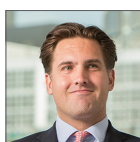
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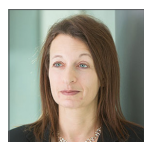
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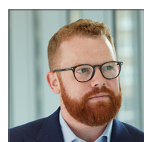
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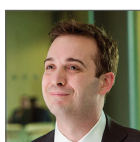
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