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A Broken Promise

By Marilyn Raia

Many marine insurance policies contain warranties. A warranty can be described in one word: promise. It can be a promise by the insured that he will do something. It can be a promise by the insured that he will not do something. It can be a promise that a condition will be fulfilled. It can be a promise that certain facts exist or do not exist.

The breach of a warranty in a marine insurance policy is not a rare occurrence. Indeed, breaches of warranties in marine insurance policies are a good source of business for claims adjusters, marine surveyors, salvors, and admiralty lawyers. This column re-visits the role of warranties in marine insurance policies (see *Pacific Maritime Magazine*, November 2011), and reviews a recent case in which the insured suffered severe economic consequences due to a broken promise.

Purpose of Warranties

Warranties are put in marine insurance policies to limit or define a risk. Marine insurance companies do not have an obligation to insure everything that might befall a vessel, person, or cargo. They have the right to limit what they insure. Warranties serve that purpose in part. It is sometimes impossible or logistically difficult for marine insurers to assess the risk they are going to insure. Instead, they must rely on promises or warranties by the insured to make sure they are insuring what they want to insure.

There are two kinds of warranties associated with marine insurance policies: implied warranties and express warranties. Implied warranties are warranties that are not set forth in the policy's terms and conditions. Rather, they are deemed to be a part of the policy as a matter of law. For example, in every hull and machinery policy there is an implied warranty of seaworthiness. That warranty means when the coverage begins, the vessel is fit for its intended purpose under the expected conditions. In every hull and machinery policy there is also an implied warranty that the vessel owner will not knowingly send the insured vessel to sea in an unseaworthy condition. The policy does not have to mention those warranties. They are part of the policy as a matter of law.

Express warranties are warranties that are set forth in the policy's terms and conditions or in endorsements to the policy. They are found in all types of marine insurance policies. Sometimes express warranties are drafted by the marine insurer, and other times they are drafted by the insured's insurance broker.

Compliance With an Express Warranty

Under the traditional rule and the majority rule in the United States, express warranties in marine insurance policies must be strictly complied with. Substantial compliance is not sufficient. The reason for the strict compliance rule makes sense. For example, vessels are often at sea and not where they can be readily inspected by a prospective hull and machinery insurer. The hull and machinery insurer must then rely on warranties or promises made by the insured about the vessel's condition and usage. If strict compliance with the warranties were not required, the insurer might be fooled and held to have insured a risk it did not intend to insure.

Failure to Comply With a Policy Warranty

Under the majority rule in most federal and state courts, the failure to comply with a warranty in a marine insurance policy voids the policy. Moreover, under the majority rule, the policy is void

even if the failure to comply with the warranty did not cause the casualty giving rise to a claim under the policy. It has been said "(n)o cause, however sufficient, no motive, however good, no necessity, however irresistible" will excuse non-compliance with a policy warranty. Notwithstanding the strict compliance rule, a breach of a policy warranty may be excused if it occurred to save a life or was the result of an insured peril.

Guam Industrial v. Zurich et al.

In 2015, the Ninth Circuit Court of Appeals once again considered the denial of coverage by marine insurers on the ground of breach of an express warranty in a hull and machinery policy. The insured in *Guam Industrial Services, Inc. v. Zurich American Insurance Company, et al.*, 787 F.3d 1001 (9th Cir. 2015) broke its promise to its insurers and suffered severe consequences as a result.

Guam Industrial owned and operated a large drydock in Apra Harbor, Guam. The drydock was insured by two marine insurers sharing the risk 50/50, Zurich American and Starr Indemnity. The hull and machinery policy contained an express warranty drafted by Guam Industrial's insurance broker. In the warranty, Guam Industrial promised: 1) the drydock would be US Navy certified; and 2) the US Navy certification of the drydock would be continuously maintained.

The original insurers of the drydock wanted it to be inspected by the American Bureau of Shipping before they would agree to insure it. Guam Industrial told them it intended to have the drydock certified by the US Navy, a requirement for drydocking certain Navy vessels, and that US Navy certification involved more rigorous standards than the inspection performed by the American Bureau of Shipping. Relying on Guam Industrial's representation about the more rigorous nature of the US Navy certification process, the original insurers agreed to accept certification of the drydock by the US Navy as a condition of coverage, instead of certification by the American Bureau of Shipping. The insured's insurance broker then drafted a policy warranty about US Navy certification. That warranty appeared in the original policy, and in all later policies insuring the drydock, including the policy on which Zurich and Starr were the insurers. Guam Industrial never sent the insurers a copy of any US Navy certification of the drydock. Guam Industrial did, however, send the insurers copies of certifications of the drydock issued by a commercial drydock certification company, which was one of the steps required for US Navy certification.

The drydock sank in Apra Harbor on Sunday, January 2, 2011. At the time of the sinking, the drydock was undergoing repairs and upgrades. Ninety manhole covers and large portions of steel had been removed from the pontoon deck leaving the interior of the drydock exposed to the elements. Valves that prevented the entry of water into the drydock had been removed and left un-blanked, and there was a large opening in the side of the hull for repair of the valve system. Also, the drydock had been left unattended over the holiday weekend of the sinking.

After the drydock was raised, Guam Industrial made a claim against the two hull and machinery insurers for the cost to repair it and related expenses, totaling in excess of \$6 million. In the course of their investigation of the claim, the insurers discovered the drydock was not US Navy certified at the time of the sinking, and indeed had never been US Navy certified. Because of the breach of the express US Navy certification warranty, the insurers denied coverage for the repair costs and related expenses.

The insurers filed suit against Guam Industrial asking the court to enter a judgment of no coverage under the insurance policy, and Guam Industrial filed suit against the insurers for

breach of the insurance policy. The district court held there was no coverage for the damages resulting from the sinking due to Guam Industrial's breach of the US Navy certification warranty. Guam Industrial appealed. The Ninth Circuit Court of Appeals affirmed. It held applicable law requires strict compliance with policy warranties even when breach of a warranty does not cause the loss.

Guam Industrial made several arguments to try to convince the court it should not be held to its promise about US Navy certification of the drydock. It argued the insurers waived the US Navy certification requirement when accepting copies of the commercial certification of the drydock without objection, and when not requesting copies of the US Navy certification of the drydock. (A waiver is a knowing relinquishment of a right, in this case, the right to insist on US Navy certification of the drydock.) The court rejected the argument. It held strict compliance with the policy warranty was required. Supplying a commercial certification rather than US Navy certification was non-compliant. The court noted, however, even if the insurers had waived US Navy certification of the drydock, the commercial certificate had expired at the time of the sinking due to the poor condition of the drydock. Therefore, the drydock was not certified at all which was something the court found the insurers did not intend to insure.

Guam Industrial also argued the insurers were estopped or precluded from insisting on US Navy certification of the drydock because they had accepted a copy of a commercial certification of the drydock. It reasoned the insurers' acceptance of the commercial certification led it to believe US Navy certification was no longer required. Accordingly, it did not take any further steps to get US Navy certification. The court rejected that argument too, especially given the commercial certification was expired when the drydock sank. Guam Industrial was left with no coverage for its multi-million dollar loss.

The very simple lesson to be learned is: a warranty in a marine insurance policy is a promise that should not be broken. Devastating financial consequences could follow.