COMMENTS
COMMENTAIRES

Letters of Indemnity: Should they be tolerated?

In almost every shipping nation of the world, transport by sea is subject to the Brussels Convention on the Carriage of Goods by Sea — August 8, 1924 (the Hague Rules). Great Britain adopted the Rules in 1924, Canada and the United States in 1936, and France in 1937. Over sixty other nations, states and principalities have followed suit and the Hague Rules have become an international private law of almost universal acceptance.

The Rules strike a balance between the responsibilities of the carrier and the rights of cargo owners, both of which are limited in what has been an extremely successful compromise. Central to the bargain between the parties is the contract of carriage by sea, the bill of lading. In addition to serving as evidence of a contract of carriage, the bill of lading is also a receipt issued by the carrier, the terms of which describe the condition of the goods received. Article 3(3) of the Rules states:

> After receiving the goods into his charge, the carrier, or the master or agent of the carrier, shall, on demand of the shipper, issue to the shipper a bill of lading showing among other things,
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> (a) the leading marks necessary for identification of the goods as the same are furnished in writing by the shipper before the loading of such goods starts, provided such marks are stamped or otherwise shown clearly upon the goods if uncovered, or on the cases or coverings in which such goods are contained, in such a manner as should ordinarily remain legible until the end of the voyage;
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> (b) either the number of packages or pieces, or the quantity, or weight, as the case may be, as furnished in writing by the shipper;
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> (c) the apparent order and condition of the goods:
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> Provided that no carrier, master or agent of the carrier, shall be bound to state or show in the bill of lading any marks, number, quantity, or weight which he has reasonable ground for suspecting not accurately to represent the goods actually received or which he has had no reasonable means of checking.[1]

The bill of lading has become a recognized commercial document capable of transfer and endorsement. Thus the issuance of a clean

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[1] Canada adopted the Hague Rules in the *Carriage of Goods by Water Act*, R.S.C. 1970, c.S-9. See Schedule annexed to this Act entitled "Rules Relating to Bills of Lading".

bill of lading, one which describes the goods as having been received in satisfactory condition, is of great importance to the shipper. With a clean bill the shipper can obtain payment or immediate credit.

The integrity of this instrument of commerce has been undermined by a questionable practice whereby the carrier, in an attempt to satisfy his client, the shipper, will issue a clean bill of lading that is, in fact, incorrect and misleading in exchange for a written undertaking by the shipper to indemnify the carrier for any liability incurring from this false bill of lading. This letter of indemnity, then, is a secret, ancillary contract and while most courts[2] have treated the letter of indemnity as the central document to a fraud, it still raises heated controversy in Maritime Law.

This paper will examine the problems created by the letter of indemnity in terms of its effects on the parties to the bill of lading; it will then suggest a solution by means of an analysis of and comment upon present and proposed legislation in this area.

The carrier and third parties to the letter of indemnity

To succeed in an action against the carrier for the issuance of a false bill of lading the consignee or third party holder must establish that the misrepresentation relates directly to the loss or damage suffered. The carrier's defence is restricted to the terms of the bill of lading. In *Continex, Inc.* v. *S.S. Flying Independent* the court stated:

> When a carrier issues a clean bill of lading for goods manifestly damaged, he is estopped to deny the assertion against a purchaser of the bill of lading who has been misled to this damage by reliance on the representation. But the misrepresentation must relate to the damage.[3]

A letter of indemnity, then, which could establish that the goods in question were damaged before receipt by the carrier, cannot be invoked against consignees or third parties.[4] In *Demsy and Assocs.* v.

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[2] See, *e.g.*, the judgment of March 10, 1958 Trib.Comm.Seine, [1958] D.M.F. 414 where it was held that the delivery of a false clean bill of lading at the request of the shipper, and against the provision of a letter of indemnity is a fraud which makes the ocean carrier responsible to the consignee and his underwriters. This decision apparently follows the long tradition of the courts of France in respect to counter-letters. See the note of de Grandmaison, [1958] D.M.F. 421, and his reference to the judgments of July 4, 1927, Cour de Cassation (Dor, Sup., 5. 399) and Nov. 3, 1925, Cour de Paris (Dor, Sup., 3. 881).

[3] [1952] A.M.C. 1499, 1501 (S.D. N.Y.).

[4] The Civil Code of Quebec reflects the jurisprudence in this area and art.1212 C.C. which states that "Counter-letters have effect between the parties to them only; they do not make proof against third persons" is typical of internal legislation of civil law jurisdictions.

The S.S. Sea Star a letter of indemnity showed that a cargo of steel coils was rusted at the time of loading but the United States Court of Appeals held:

> Whereas the sixty-four coils may have been excessively rusted and pitted at time of loading, defendants are estopped from asserting this because Interstate [the consignee] had no knowledge of this condition, and clean bills of lading were issued.[5]

The courts' refusal to acknowledge the letter of indemnity has sometimes led to a carrier being held responsible for damages for which he might normally not be liable. For example, if damaged cargo is accepted by the carrier who then issues a clean bill of lading in exchange for a letter of indemnity and further damage is subsequently done to the cargo, the carrier will not be able to distinguish between the initial and subsequent damage unless the court first recognizes the facts set out in the letter of indemnity.[6]

In *Copco Steel and Eng. Co.* v. *The S.S. Alwaki* a clean bill of lading was issued although the bundles of steel had "light atmospheric rust".[7] While a letter of indemnity reflected this initial damage the purchaser of the goods was nevertheless able to recover his "cost of removing heavier flaking damage".[7a] Similarly in *Empress Central Mercantil* v. *Brasileiro*[8] the carrier alleged that further damage had occurred after loading on board but the court pointed out that:

> The impact of the record in this case leaves me with two firmly rooted impressions: that the respondent was a party to the deception practiced on the libellant, and that respondent has thrust libellant into this litigation as the direct consequence of that deception. If the measure of damages can be said to be less than perfect it is because of respondent's wrongdoing and it has no standing to complain.[8a]

While the courts have refused to acknowledge a letter of indemnity invoked against the consignee or third parties they have, however, allowed the introduction of this document when it favours the complainant. In a recent Dutch case the Netherlands Court found the master liable for a quasi-delictual act (tort) because it was obvious from the letter of indemnity that the bill of lading which stated, "weight of the cargo unknown to the master",[9] was inaccurate.

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[5] [1972] A.M.C. 1440, 1448 (2d Cir.); aff. [1970] A.M.C. 1088 (S.D. N.Y.).

[6] The principle behind the courts' harsh treatment of a carrier in these circumstances is often veiled, but in effect seems to be very close to "poetic justice".

[7] [1955] A.M.C. 2001, 2003 (S.D. N.Y.).

[7a] *Ibid.*, 2004.

[8] [1957] A.M.C. 218.

[8a] *Ibid.*, 222.

[9] Judgment of March 4, 1976, Gerechtshof Te Amsterdam, (1976) 11 E.T.L. 674, 676.

Since the Hague Rules make no mention of letters of indemnity it might be argued that the courts' treatment of this document has resulted in the carrier suffering excessive hardship beyond the intention and spirit of this international agreement. However, if the letter of indemnity is seen as a secret clause in a bill of lading[10] it contravenes article 3(3) of the Rules and is thus struck down by article 3(8) which reads:

> Any clause, covenant or agreement in a contract of carriage relieving the carrier or the ship from liability for loss or damage to or in connection with goods arising from negligence, fault or failure in the duties and obligations provided in this Article or lessening such liability otherwise than as provided in these Rules, shall be null and void and of no effect.

Before turning to the next section it is first necessary to examine a further effect of a letter of indemnity that is of considerable importance but of limited application.

Punitive damages

The Hague Rules do not refer to punitive damages but where the national law allows for such claims punitive damages may be awarded. The Tribunal de Commerce de Rouen[11] held that since the parties to the letter of indemnity, the carrier and the shipper, had fraudulently issued a clean bill of lading the consignee could claim additional damages for improper resistance to the claim in law against them.

The view that the consignee cannot be sufficiently recompensed for loss by ordinary damages was also expressed in *Brown, Jenkinson and Co.* v. *Percy Dalton.* While punitive damages were not in issue in this case, Pearce L.J. felt:

> It is not enough that the banks or the purchasers who have been misled by clean bills of lading may have recourse at law against the shipowner. They are intending to buy goods, not law suits.[12]

If more courts adopted this approach to the fraudulent issuance of bills of lading this costly practice would soon be greatly curtailed.

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[10] See *Hellenic Lines* v. *Chemoleum Corp.* [1971] A.M.C. 2605, 328 N.Y. 2d 858 (App.Div. 1971), [1972] 1 Lloyd's Rep. 350; modifying [1970] A.M.C. 2419 (N.Y. Supr.Ct).

[11] The judgment of Feb. 23, 1962, [1962] D.M.F. 294. In this case an additional 50,000 N.F. ($10,000 U.S.) was awarded for special damages.

[12] [1957] 2 Lloyd's Rep.1, 13, [1957] 2 Q.B. 621, 639.

Charter and vessel owner

With the exception of a demise charter,[13] the various responsibilities of a carrier are shared by the charterer and vessel owner. Under the Hague Rules the voyage is a joint venture and so it seems reasonable that the owner and charterer should both be liable for cargo damaged in transit.

However, a difficult problem arises if the charterer issues clean bills of lading for damaged goods in return for a letter of indemnity and the vessel owner is not a party to the fraud. In *Interstate Steel Co.* v. *The S.S. Crystal Gem,*[14] the charterer issued clean bills of lading against a letter of indemnity but the master who was employed by the owner did not sign the bills of lading although it is not clear that he actually refused. The Court held:

> Under these circumstances, it would be inequitable to impose primary liability on shipowner, and so I find charterer primarily liable for the damage sustained by excessive rusting, with shipowner entitled to a decree over against charterer, should it be required to answer for such damage.[15]

The owner and charterer should be responsible to a third party but where the owner is unaware of a letter of indemnity the charterer should indemnify the shipowner for any loss. It is submitted, then, that the foregoing is the proper and equitable position for the Court to have taken.[15a]

Carrier and shipper

Since a letter of indemnity tends to contradict the terms of a bill of lading it would seem that there could never be any legitimate reason for the issuance of such a document. However, with reluctance and much reservation,[16] the courts have acknowledged the propriety of this contract between carrier and shipper in some limited circumstances.

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[13] In a *demise* charter the ship's control is completely transferred to the charterer.

[14] [1970] A.M.C. 617 (S.D. N.Y.).

[15] *Ibid.*, 626.

[15a] See the discussion of the joint venture and the identity of the carrier in Tetley, *Marine Cargo Claims* (1965), ch.8.

[16] The restricted delay for suit might be attributed to the courts' disapproval of letters of indemnity. In the judgment of June 24, 1952, Trib.Comm.Rouen, [1953] D.M.F. 34, the court limited the delay to one year and this is now reflected in French national law (*Loi du 18 juin 1966,* Gaz.Pal. 1966, 2, 15). However, it is submitted that the delay should be the normal delay between merchants who make a contract, for the letter of indemnity is a contract. In most jurisdictions the delay to sue is five or seven years.

In 1958 the Tribunal de Commerce de la Seine stated:

> [C]ette pratique se justifie, notamment pour parer à des retards dans la transmission d'un document sincère ou, plus généralement, lorsque, à raison de la rapidité des opérations imposées par l'exploitation rationnelle des lignes régulières, il n'est pas possible au capitaine de procéder avec une précision rigoureuse à la reconnaissance des indications que doit lui donner le chargeur avant l'embarquement.[17]

The need for the court to distinguish between proper and improper[18] letters of indemnity will seldom arise in practice since it is usually evident that the object of the letter is to promote a misrepresentation in a bill of lading. Thus, for the most part, the parties to a letter of indemnity are clearly parties to a fraud and the question with which the courts must most often contend is should either party to this contract be allowed to use it against the other party. The response by the courts to this issue has varied from a complete refusal to recognize such a document to a reluctant and restricted acceptance of it.

Although the carrier and shipper in *Brown, Jenkinson and Co.* v. *Percy Dalton*[19] had conspired to make a false statement in the bill of lading, the Court upheld the carrier's claim against the shipper since the parties to the contract of carriage had not suffered any loss due to this conspiracy. On appeal, however, the decision was reversed; the letter of indemnity was a fraud and consequently could not be relied upon.[20] In *Hellenic Lines* v. *Chemoleum Corp.* the New York Supreme Court came to a similar conclusion in holding that the letter of indemnity was,

> ...barred by statute (46 U.S. Code, sec. 1303[8]). Though it may be said that the interdiction of this type of agreement has nothing to do with a private arrangement for indemnity directly between the parties, not involving an eventual consignee — as this claim for damage does not — the

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[17] The judgment of March 10, 1958, [1958] D.M.F. 414, 417. Pearce L.J. in *Brown, Jenkinson and Co.* v. *Percy Dalton, supra,* note 12, 13 expressed a similar opinion: "In trivial matters and in cases of *bona fide* dispute where the difficulty of ascertaining the correct state of affairs is out of proportion to its importance, no doubt the practice [of issuing a letter of indemnity] is useful."

[18] Du Pontavice, *Transports Maritimes et Affrêtements* (1970), G-19 uses the terms *ordinaire* and *frauduleuse.* Rodière, *Traité Général de Droit Maritime* (1968), vol.II, no. 471 notes that letters of indemnity of the second category are not necessarily fraudulent.

[19] [1957] 1 Lloyd's Rep. 31.

[20] *Supra,* note 12.

> very agreement contravenes public policy as expressed in the statute, and should not be enforced.[21]

However, the Court relented somewhat and added that the carrier could "proceed on the theory of negligence, using, if desired, the indemnity document as an admission".[22]

In cases where the courts have upheld letters of indemnity the parties have been strictly confined to the terms of the contract.[23] In *Ben Line* v. *Joseph Heureux*[24] the Court of Appeal, while allowing the carrier to sue the shipper, held that the exact terms of the letter of indemnity applied and no more. "Several bundles dirty before shipment"[25] did not include wet staining of the whole shipment and the carrier's claim was proportionately reduced.

On this issue, then, jurisprudence has not been consistent but this vacillation between qualified acceptance and outright rejection of the letter of indemnity can in part be attributed to an inherent dilemma that the courts are forced to face in these situations. If the court recognizes the letter of indemnity, it is enforcing a contract, the purpose of which is fraud. But if the court refuses to allow the carrier to invoke this contract because of the fraud, the shipper is thus permitted to benefit by that fraud. It is my opinion that while the former view is far from attractive it at least provides a more equitable solution.

Present and proposed legislation

The 1924 Convention did not mention letters of indemnity and, in time, this omission has produced a frustrating series of studies, international conferences and unsuccessful attempts at legislation. The silence of the Hague Rules left the validity of these instruments to be determined according to local national law.

The French *Loi du 18 juin 1966*[26] is one of the more innovative examples of internal legislation and although the law is aimed at local carriage by water, article 20, by dealing directly with letters of indemnity, has had some effect on international disputes. Article 20 states:

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[21] *Supra*, note 10, 2606.

[22] *Ibid.*

[23] See the judgment of June 24, 1952, Trib.Comm.Rouen, [1953] D.M.F. 34 where the Court permitted the carrier to sue the shipper under a letter of indemnity. While the former French local law (*Loi du 2 avril 1936*, Gaz.Pal. 1936, 1, 1162) applied, the principle is the same as in the Hague Rules.

[24] (1935) 52 Ll. L. Rep. 27.

[25] *Ibid.*, 28.

[26] Gaz.Pal. 1966, 2, 15.

> Toutes lettres ou conventions par lesquelles le chargeur s'engage à dédommager le transporteur lorsque celui-ci ou son représentant a consenti a délivrer un connaissement sans réserves, sont nulles et sans effet à l'égard des tiers; mais ceux-ci peuvent s'en prévaloir à l'encontre du chargeur.
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> Si la réserve volontairement omise concerne un défaut de la marchandise dont le transporteur avait ou devait avoir connaissance lors de la signature du connaissement, il ne pourra pas se prévaloir de ce défaut pour éluder sa responsabilité prévue à l'article 28 ci-dessous.

Thus the French law has recognized the distinction found in some jurisprudence between proper and improper letters of indemnity. The first paragraph makes a fair attempt at satisfying the legitimate concern of carriers who, in borderline cases, must accept goods that they cannot properly judge. The second paragraph is concerned with improper letters of indemnity, and here the carrier loses the advantage of the per package limitation of article 28. What is most important is that article 20 assumes, in effect, that letters of indemnity are fraudulent.

This French legislation provides a subtle solution to a problem that has plagued international law since the advent of these dubious contracts between the carrier and shipper. It is unfortunate that this law is limited to courts of French jurisdiction but what is more disappointing is the fact that the "final draft text" of the 1976 United Nations Commission on International Trade Law[27] (Uncitral) has not adopted the French law's more intelligent approach.

Uncitral

The courts have generally disapproved of the use of letters of indemnity but the lack of any international legislation has produced jurisprudence that is neither consistent nor uniform. The Uncitral proposal, by specifically dealing with letters of indemnity, is an attempt to remedy this unsatisfactory situation.

As the French law has done, the Uncitral proposal acknowledges proper letters of indemnity but, unlike its precursor, the new rules have not followed jurisprudence in distinguishing proper from improper letters of indemnity. Article 17 states:

> 3. Such letter of guarantee or agreement shall be valid as against the shipper unless the carrier or the person acting on his behalf, by omitting the reservation referred to in paragraph 2 of this article, intends to defraud a third party, including any consignee, who acts in reliance on the description of the goods in the bill of lading. If in the latter case, the reservation omitted relates to particulars furnished by the shipper for

[27] U.N. Doc. TD/B/C.4/ISL/23 (1976).

insertion in the bill of lading, the carrier shall have no right of indemnity from the shipper pursuant to paragraph 1 of this article.

4. In the case of intended fraud referred to in paragraph 3 of this article the carrier shall be liable, without the benefit of the limitation of liability provided for in this Convention, for any loss incurred by a third party, including a consignee, who has acted in reliance on the description of the goods in the bill of lading issued.[28]

Thus fraud is not presumed and the carrier will not lose his per package limitation unless the consignee or third party can establish intended fraud, proof of which can be difficult to obtain.

In following jurisprudence the Uncitral proposal has taken some useful steps towards developing a more systematic approach to this controversial area of Maritime Law but by not recognizing the method of establishing the distinction between proper and improper letters of indemnity originally put forward by the courts and reflected in the *Loi du 18 juin 1966,* the Uncitral rules will lose much of their effectiveness. One can only hope that the Uncitral text that will be submitted to a Diplomatic Conference convened for the Spring of 1978 will be amended before its final adoption. However, regardless of what solution any international conference or internal system of law finally decides upon it remains essential to protect the integrity of the bill of lading as a commercial document of title that may be relied upon with confidence by merchants thoughout the world.

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[28] *Ibid.,* 26.

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