

## **Demurrage clauses: Carriers must exercise contractual good faith**

A recent decision in London dealt with the question of whether parties have a duty to act in good faith when deciding to affirm a contract when the other party is in repudiatory breach. The good faith issue arose within the context of demurrage clauses and their enforceability.

### **Summary of the Facts**

In 2011, the Carrier Company carried 35 containers of raw cotton to Bangladesh pursuant to five bills of Lading under which the Shipper Company was named as shipper. The Shipper had agreed the sale of the cotton with a Bangladeshi Receiver Company. During shipment, the market price plummeted and the Receiver sought to extricate itself from the contract. When the goods arrived at Chittagong, Bangladesh, the Receiver refused to collect the goods and commenced proceedings to prevent payment under letters of credit which had been issued prior to shipment.

Despite the Receiver's attempts to prevent payment, the banks paid, and title to the goods was transferred. Litigation continued on behalf of the Receiver which resulted in an injunction over the cotton (but not the containers) after which, the litigation stalled. By virtue of the banks' payment, the Shipper had lost title to the goods and therefore could not unload the containers in order to return them to the Carrier, and the Receiver, believing payment had been made in error, refused to accept delivery.

Meanwhile, the Bangladeshi customs authorities refused to allow anyone to unload the containers without a court order. The Carrier began to charge the Shipper demurrage after the fourteen days of 'free time' under the bills of lading, and, after they had lost title to the goods, the Shipper tried to repudiate the contract.

At the time of trial, the 35 containers had been in the port of Chittagong for some three and a half years after they had arrived.

Demurrage under the contract was US\$10 per container, per day, for the first ten days, US\$18 per container, per day, for the next ten days, and US\$24 per container, per day, thereafter. When the Carrier commenced proceedings the total demurrage claimed was nearly US\$580,000, and, by the time of trial, claimed demurrage stood at over US\$1million.

The agreed replacement value of each container was US\$3,262 and therefore, the demurrage claimed was nearly ten times the value of the containers.

### **Legal issues**

#### *Liquidated Damages:*

Liquidated damages under a contract provide a specific sum or formula to calculate damages in the event of a specified breach. The actual loss as a result of the breach may be higher or lower than the sum set out in the liquidated damages clause and will still be enforceable. The purpose of a liquidated damages clause is to make calculation and proof of actual damage unnecessary, thereby saving costs and time, as damages have been contractually agreed between the parties.

However, liquidated damages will not be enforceable if they are so low as to act as a disguised limit on liability, nor will they be enforceable if they are so high as to amount to a penalty. There is traditionally no duty to mitigate losses where a liquidated damages clause exists as damages have been agreed.

### *Repudiatory breach:*

A repudiatory breach of contract is one which deprives the other contracting party of substantially all of the benefit of the contract, or a breach which indicates an intention to abandon performance.

In the circumstances of a repudiatory breach, the aggrieved party has two choices:

1. To accept the repudiation and therefore end the contract; or
2. To affirm the contract, whereby both parties remain bound by their obligations under the contract.

In theory, damages can be claimed in both cases by the aggrieved party in respect of the other party's breach. In practice, these choices are not always available.

Where affirmation of the contract requires the cooperation of both parties, the aggrieved party is left with no choice but to accept the repudiation and pursue the other party for damages.

Where the aggrieved party may continue with its own obligations under the contract, without cooperation of the party in breach, it can choose to do so (and still seek damages) unless it has no legitimate interest, financial or otherwise, in continuing to perform the contract.<sup>1</sup>

### *Duty to act in good faith under a contract:*

Traditionally, under English law, there is no duty to act in good faith in a contract.<sup>2</sup> However in recent years, particularly with the application of EC legislation to English law, a concept of good faith in contracts is increasingly finding its way into statute law and modifying common law as a result.<sup>3</sup>

## **The Judgment**

That demurrage provisions represent liquidated damages clauses is well established and was readily accepted at the trial.<sup>4</sup>

At trial, the Shipper asserted that the Carrier had a duty to mitigate its losses. This was easily dealt with on the facts of the case in that the Carrier was never in a position to unpack the containers itself (although it had authority to do under the bills of lading) as this would have required approval from the Bangladeshi customs authorities which in turn, required a court order from the Bangladeshi courts.

This court order would have required an uncertain amount of cost and time, in addition to uncertainty surrounding the prospect of a successful application. As such, it was not considered reasonable mitigation for the Carrier to pursue this route.

Further, on the facts of the case, the Carrier had offered to sell the containers to the Shipper in order to bring the demurrage accrual to an end, an offer which the Shipper had declined. Accordingly, it was ruled that the Carrier buying replacement containers, or unloading the containers itself, was not to be reasonably expected.

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<sup>1</sup> *White & Carter (Councils) Ltd v McGregor* [1961]UKHL 7

<sup>2</sup> *Interfoto Picture Library Ltd v Stiletto Visual Programmes Ltd* [1989] 1 QB 433

<sup>3</sup> For example, the principle of good faith in contracts of agency and principal is derived from EC legislation: Commercial Agents (Council Directive) Regulations 1993 (SI 1993/3053)

<sup>4</sup> Para 38 and *President of India v Lips Maritime Corporation* [1987] 2 Lloyd's Rep 311

Further, as stated above, there is no *duty* to mitigate where a valid liquidated damages clause exists.<sup>5</sup> Mr Justice Leggatt commented that where there is a valid liquidated damages clause, there is no scope for reducing that amount on the ground that the Carrier has failed to take reasonable steps to mitigate its loss; “*since the claimant’s entitlement to the agreed damages does not depend on whether it has sustained any loss, it cannot follow that its entitlement depends on whether any loss it did suffer ought to have been reasonably mitigated*”<sup>6</sup>.

Mr Justice Leggatt then proceeded to consider the period for which the demurrage was payable. On the facts of the case, the containers in question were still impounded in Bangladesh and could conceivably be so for the foreseeable future, while various legal avenues were explored by the Receiver and the banks. As stated, the demurrage claimed was nearly ten times the value of the containers themselves and rising at the time of trial.

Leggatt J held that if a liquidated damages clause conferred an unfettered right to ignore a repudiation and claim damages indefinitely then this clause would be found to be penal and, therefore, unenforceable.

However, in this instance he did not consider the clause to contain such an unfettered right; instead he found that the clause in question did not provide a legitimate reason to keep the contract alive since the only purpose for doing so would be to claim unlimited demurrage.

An aggrieved party may only affirm a repudiated contract, *if* there is legitimate interest in doing so. Leggatt J found that the Carrier had legitimate interests in keeping the contract alive and claiming demurrage, for as long as there was a realistic prospect the Shipper would be able to perform its obligations under the contract. The daily rate in this respect was not found to be penal. However, on the facts of the case, the issue then arose as to whether a provision which potentially allowed demurrage to accrue indefinitely would be enforceable.

It was held that once the Shipper had received payment for the goods and title to the goods had transferred to the Receiver, the Shipper had lost the ability to take delivery of the goods; the contract was repudiated when the Shipper communicated this fact to the Carrier.

While the court followed the authority that there is no duty to accept a repudiation, on the facts of the case, the Carrier had no legitimate interest in affirming. Following the decision in the “Aquafaith”<sup>7</sup> (which dealt, among other things, with the question of when there will be legitimate interest in a shipowner affirming a time charterparty following a purported redelivery by charterers) it was held that whether or not a party has legitimate interest in affirming a contract depends on essentially the same considerations as whether or not a party has acted reasonably in exercising contractual discretion.

As such, a party wishing to affirm a contract, must act in good faith having regards not just to his own commercial interests but also to those interests of the other party; he must not exercise his option to affirm “*arbitrarily, capriciously or unreasonably*”<sup>8</sup>.

After the contract was repudiated, there was no longer any reasonable ground on which to keep the contract alive; to do so would be to impose an indefinite and penal charge on the other party and would not be in keeping with the legitimate interests principle.

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<sup>5</sup> *Abrahams v Performing Rights Society Ltd* [1995] ICR 1028

<sup>6</sup> Para 71

<sup>7</sup> *Isabella Shipowner SA v Shagang Shipping Co Ltd* (“the Aquafaith”) [2012] EWHC 1077 and *Abu Dhabi National Tanker CO v Product Star Shipping Ltd* (the “Product Star”) (No 2) [1993] 1 Lloyd’s Rep 397

<sup>8</sup> Para 97

## Comment

At first glance, this case appears to extend the principle of good faith from express contractual discretions to limiting a party's ability to act in its own self-interest in its decision to affirm a contract.

However, Leggatt J's remarks on good faith are expressed in general terms, and in the context, do little more than to uphold previous case law that one cannot affirm a repudiatory breach where it would be "*wholly unreasonable*" to do so; i.e. upholding the contract would not be in good faith.

Separately, Mr Justice Leggatt supported his decision by finding that the liquidated damages clause in this context would have been unenforceable as a penalty. The issue of whether liquidated damages are considered penal will be further considered by the Supreme Court this summer.<sup>9</sup>

*MSC Mediterranean Shipping Co SA v Cottonex Anstalt* [2015] EWHC 283 (Comm)

## By

**Fiona Rafla and Andrew Lee**  
Marine, Trade & Energy - Singapore  
Hill Dickinson LLP

8 Shenton Way, Axa Tower, #49-02/03, Singapore 068811  
TEL: +65 6576 4722  
MOB: +65 9155 8404  
FAX: +65 6576 4748

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<sup>9</sup> *El Makdessi v Cavendish Square Holdings BV & Anor* [2013] EWCA 1539 – due to be heard in July 2015