Contractual Defaults – Panel Discussion

24th July 2009 - Organized by the Institute of Chartered Shipbrokers, Hong Kong Branch

In light of the events over the last two years, the idea for the discussion was the brainchild of members of the ICS ExCo Committee. With the market having gone into a free fall, the Committee decided that it might be interesting to have a discussion on the counter-party defaults that were taking place in the industry. They formulated a plan for inviting a few of the best minds in the area of law and commercial shipping, thereby giving birth to the Panel Discussion event. Thanks to a lot of hard work, the Committee managed to make something of the idea, and we got to enjoy free food and drinks in the guise of learning something.

The event took place at Clifton's, Central, with over eighty people attending. Drinks were served before and after the event, giving everyone more time to network. People attended from various segments of the shipping industry, and we even had a couple of attendees who had come from overseas for the event.

(Audience attending the panel discussion)

As attendance had surpassed expectations, in order to fit everyone in, we had to have the room extended by, taking the adjoining areas as well. The discussion was proceeding so well, that it seemed very likely that the lawyers had had their own little panel in a bar earlier to discuss how they were going to present their information.

(Audience attending the panel discussion)

The Emcee introduced the panelists, who actually needed no introduction, although this information was useful to the new members and the youth members.

(Emcee introducing the Panelists and the Moderator)

Mr. Arthur Bowring, Managing Director of HKSOA and this evening's Moderator, opened up the discussion by telling the audience what topic each panelist was going to talk about, and the order in which they were going to go about it. Each of the panelists, Mr. Peter Murphy (Holman Fenwick Willan) , Mr. Chris Howse (Richards Butler), Mr. Tim Eyre (Noble Group) and Capt. Raghu Raghunath (Noble Chartering), spoke for about ten minutes each by expressing their views, giving examples and inviting audience to participate.

Mr. Chris Howse took the floor first, putting forth the topic of Judicial Management, and some recent cases in relation to it. Judicial Management is used to rehabilitate viable, albeit financially troubled companies in order to avoid their liquidation. Judicial Management offers corporations an opportunity to

deal with their insolvency or potential insolvent situation quickly. The judicial management regime provides corporations with 'statutory moratorium' against legal proceedings from their creditors; the judicial manager assesses the business position, and formulates a strategy to take the company forward. The judicial manager will assume the role of top-level management, and will have complete control on the day-to-day operations of the business.

He discussed in detail about the case of a certain multinational owner/operator, starting from the initial problems it started having in Q3 of 2008. The owner/operator, who cannot be named, initially tried to apply for 'Chapter 15' protection, i.e. file for bankruptcy. One of its largest creditors expressed doubt over the operator's debt restructuring plans, and held the view that the position should be thoroughly investigated. The creditor also sought full disclosure from the operator in the Chapter 15 proceedings. All of the creditor's claims were identified and quantified, which included new-build contracts, ongoing charterparties and disputes under process. The operator was placed under Judicial Management near the end of Quarter 2, in 2009. As a result of the openness of the ongoing Judicial Management process, a strong impression has been formed that if the operator's proposed restructuring scheme had been given backing by the creditors, the promised results would not have been as beneficial as those under the Judicial Management process. It is upon this note that Mr. Chris Howse ended.

Mr. Peter Murphy followed up, with his first topic of "Rule B Attachments", alongside which he went through the security and enforcement issues associated with Rule B Attachments. For those not familiar with these, a Rule B attachment is part of the Supplemental Admiralty Rules in the US, and in connection with a maritime claim, can be described as:

> *"If a defendant is not found within the district, a verified complaint may contain a prayer for process to attach the defendant's tangible or intangible personal property – up to the amount sued for – in the hands of garnishees named in the process".*

At the time of the panel discussion, Rule Bs were used as a means to intercept electronic fund transfers passing through banks in New York. In recent months (Late 2008 to early 2009), Rule B cases represented a third of all new cases filed at New York. In a case involving a well-known freight forwarder, it was held that although the defendant was not present in New York, a presence in an adjoining district was held to be sufficient for the implementation of a Rule B clause.

However, a Rule B attachment is not always successful. In April 2009, a bankruptcy court overturned 9 (nine) Rule Bs, totaling US$ 4.3 million, against a single shipping company. In July 2009, a few days before this panel discussion took place, the New York court, in a COA dispute, decided that a certain major Chinese shipbuilding yard had failed to make out an adequate *prima facie* case for a Rule B attachment,

as the yard had failed to provide details of particular contracts under which the defaulting party was likely to receive electronic fund transfers.

Another topic well evaluated dealt with Vessel “Arrests”. The presenter spoke briefly about ship arrests and sister ship arrests in England, Hong Kong, and other common law jurisdictions.
In order to have a ship arrested, (i) a claim must arise in connection with the ship, (ii) the defendant must have had ownership or control of the vessel at the time the claim occurred and (ii) the defendant must also be the owner or demise charterer of the ship at the time the Writ is issued.. Sister ship arrests were also discussed. . In some countries (e.g. South Africa, PRC), it is possible to arrest a charterer’s bunkers, provided that sufficient evidence is provided to the courts, which can then attach bunkers to the arrest order for a vessel.

Briefly touched upon, were Mareva injunctions. The Mareva injunction is another method of freezing funds in the defendant’s bank account. The name is derived from the case of *Mareva Compania Naviera SA v International Bulkcarriers SA* [1975], which was fought out in a UK Court, and is widely recognized in other common law jurisdictions as the defining case-in-point.
In Hong Kong, the courts now have have the express power to grant interim relief in relation to arbitration or court proceedings that have been, or are to be commenced, in a place outside Hong Kong, and are capable of giving rise to an award or judgment, which may be enforced in Hong Kong. Previously, this was not the case, as a "free standing" Mareva injunction was not permitted. Another method to enforce an award is to use ‘garnishee’ proceedings against a third party debtor (of the losing party), who will then be required to pay directly do the claimant. Under HK’s legal conventions, the third party or ‘garnishee’ must have a presence in Hong Kong. The claimant must identify the type and significance of funds due from the debtor to the defendant, and Courts must be conscious of any risk to the garnishee of having to fulfill their debt twice.

An explanation on the use of Attachments in the PRC was also given. Although normally requiring counter-security, the possibility of attaching cargo in the PRC can be an effective, alternative means of securing a claim against a defendant, especially in situations where other avenues of security are unavailable or difficult to implement. There are risks involved, the key issue being ownership or title to the particular cargo that is being attached. The merits appear to vary from Court to Court, with the risk being a challenge to the attachment by an innocent, third party buyer. If the attachment is successful however, it can be very effective as a means to force a defendant to the negotiating table, particularly when commodity prices are rising, and the defendant has a keen interest to have the cargo released for sale.

On this note, Mr. Peter Murphy handed over to Mr. Tim Eyre, who shared his knowledge upon the measures that owners and charterers can adopt, in order to minimize their exposure to counter-party defaults.

Parties can go to any lengths to avoid fulfilling their obligations, Mr. Eyre said. In one case, the CEO of a commodity customer approached the corporation Mr. Eyre works for, Noble Group, pretending he (the CEO) had terminal cancer (apparently, he showed up with a shaved head, and a tube emerging from his shirt), and demanding that Noble should show some sympathy. Happily for Noble, the scam failed, and the aforementioned CEO's commodity dealer is now in liquidation.

Noble's 'Group Risk' department makes extensive use of VaR (Value at Risk) methodology, and other such techniques. Value at Risk is a technique used to estimate the probability of portfolio losses based on the statistical analysis of historical price trends and volatilities. It is commonly used by companies involved in trading commodities, and is able to measure risk as trading happens, and is an important consideration when hedging.

It is also a good idea to try and charter from and to well known companies, who have a good track record, and a reputation in the market. Having to shell out a few extra cents is worth not having to take unnecessary risks. Where there is any uncertainty on a counter party, performing due diligence is of utmost importance. Financial information, market sources, credit investigation agencies, etc, all of these can assist you. It is also recommended to cover market risk, by hedging through FFAs and Bunker hedging. If executed properly, this can allow a business to perform physical contracts, even where the physical market has moved against its position. Some of the companies that have failed or got into difficulties in the last year have simply blamed the markets. However, according to Mr. Eyre, despite the fact that the market produced unprecedented challenges, if proper risk management procedures had been in place, many of those companies may have survived.

Moving on to Mr. Eyre's next topic, he discussed corporate veils. In his words, "Except in very exceptional circumstances, it is not possible to sue the directors of the company in respect of the company's liabilities. Likewise, it is not possible to "pierce the corporate veil" and sue the shareholders of the company." The corporate veil applies not only to a company with individual shareholders, but also to a company within a group – the group holding company cannot be sued for liabilities incurred by its subsidiary. There are several ways of Mitigating risk. A few of the obvious ones are,

- Ensuring the counter party is correctly identified in the CP.
- Ensure than the individual that is agreeing to the contract has the relevant authority.
- Ensure that sensible law and adjudication clauses are in place.
- Ensure that a duly signed original of the CP is in your possession.

- Avoid long CP chains, in order to minimize the risk of a party higher up in the chain going bankrupt, or obtain a guarantee/commitment from the previous disponent/head owners.
- Insert options to terminate CP in the event of the counter party becoming insolvent.
- Brokers should insist on provisions in a CP to the effect that commission is payable, regardless of whether the fixture is ultimately performed.

Finally, a Performance Guarantee can also be obtained. This is a guarantee given by a parent or other company closely connected to the counter party. In the document, the guarantor will normally guarantee to perform the obligations of the counter party, in the event the counter party defaults. This would also mean paying any unpaid sums due under the charter, and also any damages. This is an extremely useful method of mitigating risks with counter parties.
Heed should be taken to the form of the guarantee, as a verbal guarantee is not enforceable under the Statute of Frauds 1677. An unsigned guarantee is yet again unenforceable. Care must also be taken to ensure that the person who is signing the guarantee has the authority to do so.

Mr. Raghu Raghunath took the stage after that, and emphasised on the commercial aspects of handling such defaults. He reiterated the way of mitigating the risks as highlighted by Mr. Tim Eyre. From a commercial point of view, it is extremely important to enter into contracts with sound counter parties. With regards to derivative trading, Mr. Raghunath compared the risks involved in OTC (over the counter) vis-à-vis cleared trades. Even though the parties involved in trades through clearing houses have to account for margin calls in their P&L, it is a safe way as evident from the problems encountered by many companies when the market went into a free fall.

It was one of the most interesting panel discussions that I have been to. The bottom line was that a contract is a legally binding agreement, into which the parties have entered of their free will. A change in the market conditions does not and should not give a right for default to either of the parties.

One of the questions raised by an attendee was: Could the contract not have been made (by renegotiation at the behest of one party) more flexible in completion, if that party was not able to perform due to reasons which were threatening his survival? As a practical example, would the ship owner consider delaying the shipments if the charterer was not able to provide cargoes because there were no buyers to whom he could sell the cargoes to? Alternately, would the ship owner extending the duration of the Contract of Affreightment (COA) if the charterer was willing to increase the cargo quantity at lower prevailing rates as compared to the COA rates, in order to average the rates for performance. These were some of the questions raised. Another interesting question that I can recall is related to the effect of the default on the broker, and what he or she is expected to do under such circumstances.

Rule B attachments were also discussed. At that time, this was the in-thing and audience was delighted to learn more about this tool to force the other party to perform. Today, however, the situation is very different. In some cases, when certain publically listed companies did not perform, or in plain and simple terms “defaulted”, share prices actually went up. This brings up a question about whether the public is rewarding the companies from not meeting their obligations, or whether this is only a small part of the actual reason for the rise.

Branch Chairman Mr. YK Chan thanked the panelists for their consent to be part of the panel, Mr. Arthur Bowring for his willingness to be the moderator, and the audience for attending the discussions.

(Panel members with the Chairman and Vice Chairman of ICS Hong Kong Branch)

Unfortunately, one of the panelists had a flight to catch, or the discussions could have gone on for hours. The event ended with dinner, which was presented in the common area. However, most of the attending professionals preferred to socialize and network, rather than eat. It seems that we have more in common with mechanical engines than was previously believed, and can operate on a ‘liquid’ diet.

Overall, it was a very successful evening, reinforcing the Institute’s determination to continue having large-scale events.

The organizers are indebted to Noble Group and Valles Shipping for their generous sponsorship for this event.

Abhinav Makkar

ICS Student 2008-2010