

Ship finance workouts: a Hong Kong perspective

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In today's market, there is increasing likelihood that ship finance banks and their borrowers will need to consider options available when the borrower faces difficulty in servicing its loan facility. To place matters in context, there are a number of comparisons to be made between the current crisis and previous shipping downturns.

For those of us in Asia the last downturn we experienced was 2003's SARS-related crisis, which was short-lived and regional. A vessel could be re-possessed and re-positioned from Asia to Europe and be operated profitably. In marked contrast, the present recession is a global phenomenon.

In the past, the shipping market cycle was not always in synch with the wider economy, often managing to experience "bust" when other sectors were booming. The October 2008 collapse in the dry bulk market exactly coincided with the free-fall of stock markets worldwide.

Previously, a ship finance "work out" would often see the mortgagee bank utilise a nominee company to buy back the ship from a court sale, so as to avoid a "fire sale". The method required the multi-million dollar purchase price to be paid into court. Whether that degree of liquidity can be restored and maintained within the present banking system remains to be seen.

And lastly, for older tonnage, there was always the scrap buyer – whereas, at the time of writing, the demolition market has also collapsed.

Amidst all this doom and gloom, when considering the options that are realistically available, any lender and struggling borrower must bear in mind the cyclical nature of the industry.

The number one option to consider in a default situation has to be a re-structuring of the loan, with the borrower being given more time to pay and both parties looking to benefit mutually when the market cycle turns.

A similarly consensual approach would be to try to agree to sell the vessel in a private sale in the normal way, and thereby hopefully draw a line under the loan and realise the vessel's market value.

If no solution on these lines can be found, consideration needs to be given to the fact that the prolonged operation of the ship could see substantial debts and claims accruing against the ship. Depending on the country/jurisdiction in question, such debts can take priority over the bank's mortgage. As this process continues, the bank's security and interest in the vessel can be dangerously eroded and the borrowers indebtedness increase. The worst-case scenario would see the ship detained by third party creditors and port authorities in a country which favours local interests over the rule of law.

If action is taken to enforce the mortgage, there may be an exposure on the part of the bank, as well as the ship owner, to claims from third parties, such as charterers and cargo interests, whose rights are affected by the enforcement action.

The classic situation involves the arrest by a bank of a vessel under charter and/or laden with cargo. The court has to resolve the conflicting interests of the various parties contracting with the shipowners. Financial disaster, like any other marine disaster, is likely to inflict losses on the innocent.

On the one hand, the ship owners will have entered into contracts with charterers and bill of lading holders. They will wish their contracts of carriage to be completed and for the vessel to sail to the discharge port. On the other, the ship owners will have concluded a loan agreement and mortgage with the lending bank, who will have been granted the right to take possession, or to arrest the vessel, upon default as defined in the loan documentation.

The most common situation will involve a mortgage executed prior to the contract of affreightment. Under Hong Kong law, ship owners are entitled, subject to one exception, to deal with the ship in the same way as they would be entitled to do if the ship were not mortgaged. The one exception is that the ship owner may not deal with the ship in such a way as to impair the security of the mortgagee. Thus the mortgagee is entitled to exercise his rights under the mortgage without regard to any such contract made by the shipowner with a third party for the employment of the ship in two cases:

(a) where the contract is of such a kind that the security of the mortgage is impaired;

(b) where, whether this is so or not, the ship owner is unwilling and/or unable to perform the contract.

If the facts of the matter do not fall within (a) or (b) and the mortgagee nevertheless interferes with the contract of affreightment, the mortgagee may be held to have acted unlawfully as against the third party.

However, it may be the case that taking possession of the ship is sometimes a necessary (and lawful) short-term measure, as an adjunct to arranging a court sale.

The principal benefit of an arrest and court sale is to wash the ship clean of liens and claims – by achieving a clean title the value in the asset can hopefully be restored.

Determining the correct option in a situation where a borrower faces difficulty in servicing his loan facility will require careful assessment of all the circumstances of any given ship(s) and account – plus a measure of luck in second – guessing the market.

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