

# WATSON FARLEY & WILLIAMS

BRIEFING

## SCRUBBER FINANCING & ENFORCEMENT

APRIL 2019

“THE LOW SULPHUR REGULATIONS WILL COST THE SHIPPING INDUSTRY AN ESTIMATED US\$60BN ANNUALLY”



Shipowners are scrambling to install exhaust gas cleaning systems or “scrubbers” on existing vessels to meet the fast approaching low sulphur fuel requirements going into effect on January 1, 2020. Scrubbers are expensive, ranging in price from US\$2m to more than US\$5m depending on the size and configuration of the vessel. Many shipowners are seeking financing for this large capital investment, however, banks are reluctant to lend without obtaining a security interest in collateral.

One of the main problems for small shipowners in obtaining financing is the inability of the lending bank to obtain any security interest in the scrubber when there is an existing mortgage on the vessel. This is because once the scrubber is installed it becomes part of the ship, or at least an “appurtenance”, and is therefore subject to the existing first mortgagee’s lien. Larger shipowners generally have better financing options. Some owners have been able to obtain export credit agency guaranteed loans. Other owners have mortgaged unencumbered vessels in order to finance scrubber acquisitions on other vessels under common beneficial ownership. Some have obtained credits from the yard installing the scrubber system.

Examined below are various finance scenarios with a brief analysis of enforcement options and prospects for each.

### IMO regulation

In 2016 IMO confirmed that as of Jan 1, 2020 Vessels are not permitted to burn fuels with sulphur contain excess of .5% – such as the 3.5% now commonly used. Low sulphur marine fuel oil (LSMFO) is currently much more costly than marine fuel oil (MFO). Recently, LSMFO cost US\$255/ ton more than MFO. This is because MFO is residual stock while LSMFO requires blending with distillate. The low sulphur regulations will cost the shipping industry an estimated US\$60bn annually. However the low sulphur regulations include a provision allowing vessels to continue to use MFO if exhaust gas cleaning systems are installed.<sup>1</sup>

### Types of security interests and enforcement scenarios

#### *Mortgages*

If a vessel is unencumbered an owner can obtain financing from traditional lenders by granting a first mortgage lien on the vessel. However, few newer vessels are unencumbered by a mortgage and installing an expensive exhaust gas cleaning system on older vessels is a questionable economic decision considering the cost and the uncertainty of future cost of LSMFO.

Assuming the loan to value ratio is acceptable, the existing lender may agree to increase the amount of the mortgage loan to finance the scrubber and installation. Such an amendment relates back to the date the original mortgage was filed, if done properly, and therefore enjoys the same priority. The addition of an exhaust gas cleaning system may also increase the value of the vessel, thereby lessening the loan to value ratio risk.

The existing lender may be unwilling to make available additional financing particularly considering the uncertainty of the value of scrubber system and the view of some that the cost of LSMFO will drop when refiners increase production. In such instances an owner could potentially obtain financing by granting a second mortgage to a new lender. However given that second mortgages are generally fully subordinated to the existing mortgagee, and that enforcement scenarios usually arise when the vessel's value falls below the amount of the first mortgage, the benefit of such a security interest is questionable.

Registered mortgages are enforced by arrest and foreclosure proceedings. Depending on the place of arrest, the mortgage has priority over most claims other than true maritime liens such as those for seamen wages and salvage.

#### *Guaranties*

Some lenders may be willing to accept a parent guaranty of larger companies as security. However such guaranties are generally not supported by any specific collateral and in an enforcement or bankruptcy situation such a lender would be an unsecured creditor. As noted previously, export credit agency backed guaranties may be available to larger owners where the exhaust gas cleaning system is made in a country where such an agency is active and this is, of course, more valuable than an

<sup>1</sup> MARPOL Annex VI

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unsecured parent guaranty. Companies and export credit agencies often publicize these loans as "green" and this may provide additional incentive to the parties by way of good publicity. However recent environmental concerns over open loop scrubbers which discharge the exhaust gas cleaning sludge into the ocean have caused many to question the green designation.

#### *Finance Leases*

Some lenders have suggested a finance lease of the exhaust gas cleaning system as a potential solution. However, under US law, the scrubber becomes part of the vessel, or as an appurtenance, and is therefore subject to any existing mortgages. There is also the more practical problem of how to repossess a scrubber installed on a vessel. A recovered system is likely only worth its scrap value. The final problem is that finance leases are subject to recharacterization under US law in a bankruptcy or arrest proceeding. In fact, the pertinent part of the Uniform Commercial Code required that finance leases be deemed financings, in which case the shipowner will be considered the owner of the system and lessor will lose title and likely be deemed unsecured.

#### *Yard Credit*

If the yard provides a credit for the scrubber and installation it would constitute a maritime lien for necessities under US law. Such a maritime lien outranks a *foreign* preferred mortgage under US maritime law (i.e. any non-US mortgage). The maritime lien follows the vessel through a private sale, but not an admiralty auction. Liens for repairs and necessities are usually "permitted encumbrances" under most loan documents. Such a maritime lien and the connected account receivable can be "purchased" by a financing bank, thereby giving the yard's lender financing the scrubber a higher priority than the first mortgagee on non-US flag vessels. The maritime lien may come into existence even if the repairs are done outside of the US. For example, courts are statutorily required to honor the choice of New York law in a contracts worth over US\$250,000. Most courts have held that such a choice of law clause invoking US law also incorporates the maritime lien law. In contrast, under UK law the yard only has a right to arrest which would fall behind the mortgage in priority and would be extinguished by any sale to a third-party. Under US law, a maritime lien for repairs may be enforced by an arrest proceeding where the vessel is sold at auction to satisfy the debt.

The US maritime lien for necessities may only be enforced by arrest of the debtor's ship if/when she calls at a US port (or in a country that recognizes foreign maritime liens, such as Canada). Under English law, by contrast, and the law of those other nations that have ratified the Ship Arrest Conventions of 1952 or 1999, the creditor yard's claim would be a 'maritime claim', that would entitle the creditor to arrest the debtor ship, but would neither outrank a mortgage nor 'follow the ship' into her new ownership.

The fact that a mortgage will outrank a 'maritime claim' may not deter the creditor from arresting: in many parts of the world, where the judicial sale process moves at a glacial pace, a mortgagee may prefer to fund its borrower to pay off a lower

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ranking creditor arrest than to enforce its own security. In some other parts of the world, such as South Africa, necessities claims are also given priority ranking.

#### *New York Law Lien*

While a lien is difficult to obtain for an appurtenance installed on a vessel for anyone other than the repair yard, a seldom used section of New York State's lien law appears to permit such a security interest under some circumstances if the appropriate filing is made. More particularly, New York lien law provides:

*A debt which is not a lien by the maritime law . . . on a sea-going or ocean-bound vessel . . . shall be a lien upon such vessel, her tackle, apparel and furniture, and shall be preferred to all other liens thereon, except mariners' wages, if such debt is contracted by the master, owner, charterer, builder or consignee of such ship or vessel, or by the agent of either of them, within this state, for either of the following purposes:*

1. For work done or material or other articles furnished in this state for or towards the building, repairing, fitting, furnishing or equipping of such vessel. . .

In order to perfect the lien the creditor must file a verified notice of lien and a copy of the contract upon which it is based in the office of the clerk of the county in which the debt is contracted. However, if it is contracted for in the city of New York the notice shall be filed the county of New York (as opposed to the Bronx or Queens County).

The lien is freely transferrable and can be enforced by the prejudgment arrest of the vessel, although the arresting party must furnish a bond for costs. In addition, such a lien can be filed on a vessel under construction whereas a maritime lien can only arise if the vessel is already in service. While there are some limitations on the amount of time the lien lasts, it appears to be a viable alternative and likely also primes a foreign preferred mortgage.<sup>2</sup>

#### **Conclusion**

It appears that the shipping industry favors the installation of scrubbers as the best method to deal with the upcoming low sulphur fuel regulations. This allows the vessel to operate on the same fuel currently used, thereby avoiding operational issues that may arise from burning LSMFO, and also avoids the risk of a shortage of LSMFO driving up the price. Lenders have responded with inventive financing methods for the exhaust gas cleaning systems. Consideration should therefore be given to enforcement issues for these loans and how they affect existing financing.

<sup>2</sup> See, *Natl. Liab. & Fire Ins. Co. v. Rick's Marine Corp.*, 268 F. Supp. 3d 371 (E.D.N.Y. 2017) (concluding that New York Lien Law is not pre-empted by federal Maritime Lien Act); *Lih v. Wagner*, 316 N.Y.S.2d 497, 499 (N.Y. Sup. Ct. 1970) (finding that a lien for repairs against the vessel, given by Section 80, Lien Law, were in the nature of a maritime lien, the foreclosure of which is a proceeding in rem)

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## FOR MORE INFORMATION

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Should you like to discuss any of the matters raised in this briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.



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Publication code number: 80655700\© Watson Farley & Williams 2019

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