LESSEE/CHARTERER ISSUES IN SHIP LEASING TRANSACTIONS

27 APRIL 2020 • ARTICLE

As leasing becomes an ever more important source of finance for the global shipping industry, it is timely to draw attention to some structural and documentary issues which Lessees/Charterers should bear in mind.

Ship leases take many forms. They are often documented by using the BIMCO BARECON form of bareboat charter, extensively modified and supplemented by lengthy additional clauses. This has the effect of turning a document which is intended to be an industry-standard bareboat charter into a bespoke financial or quasi-financial instrument. Increasingly, however, leasing companies are moving away from the modified BARECON approach and producing self-standing forms of lease. The parties in a BARECON-based document are called "Owners" and "Charterers", whereas in a self-standing form they are often called "Lessor" and "Lessee". There is no significance to these names in the current context, however. For consistency in this note, the terms "Lessor" and "Lessee" are used throughout.

> "With legal title to the vessel vested in the Lessor, a Lessee is potentially exposed to the vessel being made subject to non-consensual liens arising from the actions or failures of the Lessor."

Depending on the state of the market at the time, Lessees can sometimes find themselves in a relatively weak bargaining position when documents are negotiated. Lessors might put forward a form of lease as their "standard form" in order to discourage extensive Lessee comments on significant issues. Many of the issues highlighted below are better raised by Lessees at the term sheet stage, rather than being left until documentation starts.

SOME BACKGROUND LEGAL ISSUES

A lease is not a loan in a different form. The Lessor/Lessee relationship is very different in legal terms from that between lender and borrower. This fundamental point crops up in many different ways. Two of the most important are: (i) a Lessor holds legal title to the asset, as opposed to a security interest granted by the holder of legal title; and (ii) the protections which English law gives to a borrower in respect of its "equity of redemption" are not given in the same way or to the same extent to a Lessee.

EFFECTS OF LESSOR HOLDING TITLE

Lessor Liens

With legal title to the vessel vested in the Lessor, a Lessee is potentially exposed to the vessel being made subject to non-consensual liens arising from the actions or failures of the Lessor. This would in any event lead to a breach of the Lessor's quiet enjoyment undertaking to the Lessee which is invariably to be found in any lease. Even so, from a Lessee's perspective, bespoke provisions prohibiting the Lessor from creating, or allowing to exist, "Lessor Liens" (as defined) should be included. That said, this issue should be seen in perspective. The Lessor will usually be a passive entity which is not otherwise trading and incurring liabilities. Even if it is not, it is unlikely itself – not being a vessel operator – to be incurring maritime claims in respect of the leased vessel, or any other vessel which it leases, which would give third parties the right to arrest the leased vessel. Lessees often in any event prefer their Lessors to be single purpose vehicles, owning no assets apart from the leased vessel in order to minimise the risk of even a wrongful arrest arising from a Lessor's ownership of other vessels.

Lessor Insolvency

Claims against the leased vessel arising from other activity of the Lessor leading to the arrest of the leased vessel are not the only risks to a Lessee by reason of legal title being vested in the Lessor. There is the more general risk of insolvency proceedings in relation to the Lessor, which could have serious implications for a Lessee. The rights which a Lessee, with a possessory right in respect of the vessel, has in the Lessor's insolvency is a complex issue and will, not least, vary depending on where the insolvency proceedings take place. The best protections which a Lessee can have are contractual restrictions on other activities of the Lessor and, to the extent possible and consistent with applicable market practice, lessor parent support (see below)."

Lessor Financing

The risk of Lessor liens or insolvency might be regarded as somewhat remote, contingent risks to a Lessee. Much more likely is that the Lessor will wish to finance its acquisition of the vessel by bank debt secured on the vessel, either at inception or subsequently by way of "back financing". This gives rise to the need for the Lessee to have the benefit of a quiet enjoyment agreement so as to ensure that its rights in respect of the vessel (and the vessel's insurances) are not capable of being interfered with by mortgage enforcement action, following a default under the Lessor's financing. If such financing is in place at inception the quiet enjoyment agreement will be entered into then. If such financing is contemplated at some time in the future, the Lessee's consent should be required, subject to a satisfactory quiet enjoyment agreement being entered into before completion of the financing.

"The Lessee might seek to impose a limit on the amount which can be secured on the vessel and include a total prohibition on it being used as collateral security for financings secured on vessels being leased to other lessee groups."

If the Lessee is potentially to acquire title to the vessel through the exercise of a purchase option, or performance of a purchase obligation, whether during the term of the deal, following payment in full of all amounts owing following default termination or at expiry, it should require specific assurance that the security granted by the Lessor in favour of its financiers will be released on payment of all amounts owing under the lease. This should be the case even where – indeed especially where – the amount able to be secured on the vessel is cross-collateralised across other vessels leased by the Lessor group to the Lessee group (i.e. a fleet lease financing) or is otherwise capable of being more than the Lessor's investment in the vessel itself. The Lessee might seek to impose a limit on the amount which can be secured on the vessel and include a total prohibition on it being used as collateral security for financings secured on vessels being leased to other lessee groups.

Financing entered into by a Lessor can present issues for a Lessee in addition to protection of its quiet enjoyment. The Lessor might seek to pass on to the Lessee tax, increased costs and other contingent liabilities for which the Lessor is liable to its lenders under its financial documents. There is a commercial issue as to whether this should in principle be the case, which will turn on the structure of the overall transaction and market practice, to the extent applicable, in relation to the particular type of lease. In many transactions it will not be appropriate and should be resisted by the Lessee. In any event, a Lessee should beware of taking on an obligation to reimburse or indemnify the Lessor for amounts which could be substantial and uncapped, bearing in mind that the terms of the Lessor's financing documents will usually not be disclosed to, and almost certainly not be approved by, the Lessee. Of particular relevance in this context are break costs, especially where there is fixed rate funding or where swaps are entered into by the Lessor. Such liabilities can be covered by broad, general language in the lease, the scope and significance of which might not be immediately apparent to a Lessee.

Lessees should consider carefully provisions which give the Lessor's financiers direct or indirect control over the exercise by the Lessor of its rights and discretions under the lease, at least in the absence of default under the Lessor's financing and/or default by the Lessee under the lease. Such rights of the Lessor's financiers can be variously achieved by the wording of the lease, including a "third party rights" clause and/or by assignment by the Lessor to the agent under its financing documents. The Lessee will ideally want to know that, as far as possible, it is dealing with its contract counterparty (the Lessor) whose freedom of action is not unduly constrained by the fact that it is has raised finance. This is really an aspect of the Lessee's right of quiet enjoyment.

PROTECTING THE LESSEE'S "EQUITY"

In any lease which has the features of a finance lease, the Lessee will be looking either to acquire the vessel itself, or at least receive any upside in vessel proceeds after the Lessor has recovered its investment, following termination or expiry. English law is generally protective of the rights of a borrower to redeem debt which is secured on its asset and, specifically, imposes duties on a mortgagee to an owner in relation to enforcement of its security. The protections which English law affords to a borrower are not similarly or so clearly available to a Lessee. So, a Lessee should seek to achieve some protection through language in the lease. The sensitivity around this is that the issues arise mainly in the context of the Lessor's rights and remedies on and following termination for Lessee default in circumstances where the Lessee has not paid in full any termination sum required by the terms of the lease (which payment will usually require the Lessor to transfer title to the Lessee or otherwise give the Lessee control over the sale of the vessel). Hence, a Lessor might have little sympathy with the Lessee. Nevertheless, the Lessee can justifiably seek some assurances in the lease. It will want the Lessor to be obliged to sell the vessel for more than just a knock-down price and for the sale proceeds to be credited against the Lessee's obligation to pay any termination sum. It will want to be paid any surplus proceeds once the Lessor's investment has been recovered. Last but not least, it will not want the Lessor to be able to "have its cake and eat it", in the sense of being able to sue the Lessee for a termination sum which pays out the Lessor and keep the vessel and trade it. These concerns can sometimes be difficult to resolve successfully in negotiation. They have added significance to the Lessee when, as is frequently the case, the Lessee has contributed to the Lessor's cost of acquiring the vessel in one form or another, for example by way of a subordinated loan or, more commonly, by an advance instalment of hire. These issues can also have potential relevance to the Lessor in the context of the English law rule against penalties – which will be covered in a later briefing.

LESSOR SALE AND TRANSFER

The Lessee should seek to negotiate restrictions on the ability of the Lessor to assign or transfer its rights and obligations under the lease – and to sell the vessel itself. For the reasons addressed above, such restrictions have even greater significance to a Lessee than assignment and transfer restrictions on a lender would have to a borrower under a loan agreement. A Lessee is especially interested in the identity of its Lessor counterparty.

"A Lessee might well seek to protect itself by some kind of support undertaking from an intermediate or even the ultimate shareholder of the Lessor."

LESSOR PARENT SUPPORT

Undertakings are only as strong as the party giving them. A Lessor might well be a single purpose company; indeed, as indicated above, there are some good reasons why it should be. A Lessee might well seek to protect itself by some kind of support undertaking from an intermediate or even the ultimate shareholder of the Lessor.

Such support can take many different forms, ranging from a full payment and performance guarantee to a non-binding letter of comfort – or anything in between. Leasing companies have differing policies and positions on the type of support they are prepared to offer, if any, and the level in their corporate structure at which it is given. There are regulatory issues (SAFE approval) around the giving of guarantees by the PRC-incorporated parents of Chinese leasing companies. Some leasing groups take the position that no parent support is available, pointing to reputational issues as being of comfort to a Lessee.

Apart from support for the contractual obligations of the Lessor, a separate concern for a Lessee is Lessor change of control. Restrictions in the lease on Lessor assignment and transfer, and sale of the vessel (see above), can in effect be undermined if the parent company of the Lessor is freely able to sell the shares in the leasing company itself. Protection against this risk can be addressed by provisions in the lease itself or, more robustly, in a parent support undertaking.

A mortgage granted by the Lessor in favour of the Lessee to secure the Lessor's obligations under the lease would be an alternative method of protecting the Lessee against certain risks. This enhances the Lessor's undertaking not to sell the vessel, in addition to giving certain other protections to a Lessee. Depending on the vessel's flag, there can be technical legal issues with the enforceability of such a mortgage. In any event, Lessors are generally not well disposed to granting them, not least because they cause complications in respect of a Lessor's ability to raise and secure its own financing.

A right of the Lessee to terminate the lease voluntarily in specified circumstances is another possible risk mitigant, above all, a right to terminate on shorter notice than otherwise specified in the lease can be useful. The circumstances which would be of concern to a Lessee include Lessor default under the terms of the lease, Lessor insolvency events and the Lessor becoming subject to sanctions.

TIME CHARTER ISSUES

If the vessel is employed by the Lessee on a long-term time charter the obligations of the Lessee under the time charter will need to be addressed, not least any restrictions on change of ownership (i.e. to the Lessor) or the granting of mortgages (i.e. by the Lessor to its financiers). It is very likely that the provisions of a long-term time charter will require there to be a quiet enjoyment agreement entered into by the Lessor and by any financiers of the Lessor taking a mortgage in favour of the time charterer (note this will be in addition to or in combination with any quiet enjoyment agreement required in favour of the Lessee).

> "Lessees, to no less an extent than Lessors, should bear in mind that circumstances can change over the life of a leasing transaction."

CONCLUSION

The issues referred to above are among the most important which a Lessee may wish to consider during documentation and, preferably, at the term sheet stage. Apart from the usual "debtor points" which arise whether a financing transaction is a lease or a loan, there are other Lessee points to consider, including:

- Flexibility generally on voluntary termination, as regards both timing and amounts payable;
- Representations and warranties by the Lessor;
- Flexibility for the Lessee on change of flag, without undue control (either positive or negative) imposed by the Lessor;
- Some control by the Lessee over the Lessor's ability to settle third party claims which are covered by the Lessee's broad operational indemnity; and
- Not giving the Lessor a windfall in respect of bunkers and luboils at redelivery.

The extent to which the issues flagged in this note can be addressed successfully from the Lessee's perspective will depend in part on the relative bargaining strength of the parties, which is in turn affected by the state of the finance market at the time. However, Lessees, to no less an extent than Lessors, should bear in mind that circumstances can change over the life of a leasing transaction.

KEY CONTACTS

PATRICK SMITH
PARTNER • LONDON

T: +44 20 7814 8011

psmith@wfw.com

MADELINE LEONG
PARTNER • HONG KONG

T: +852 2168 6710
M: +852 6822 1255

MLeong@wfw.com