

## GOING ONCE! GOING TWICE! SOLD! – ENGLISH COURT GIVES HELPFUL GUIDANCE ON SHIP AUCTION SALE PROCEDURE

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In these times of continued woes inflicted by the Covid-19 pandemic, distressed sales of ships, whether by mortgagees, liquidators or through an Admiralty Court auction process, are taking place with ever increasing frequency. The ship sale and purchase market has been so adversely affected, especially in the offshore drilling and cruise sectors, that bidding interest may be thin and bid levels disappointingly low.

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In a recent judgment given by the English Admiralty Court in the long-running case of *The Sertao*<sup>1</sup>, in which WFW acted for the mortgagee bank that was security agent for a group of US noteholders, the court gave useful insight to its approach in relation to two discrete issues which will be of interest to both maritime lawyers and ship financiers.

### SALES AT BELOW THE RESERVE PRICE

First, the court had to determine whether to approve the sale of a seventh generation drill ship, that had been laid up under arrest for several years, for less than her 'appraised value' (the term used for what is, in effect, an auction reserve price). Under the English Admiralty Court procedure, the appraised value is not made public. The 'appraised value' will have regard to the ship's actual condition, following a physical survey or 'appraisement', and will build in a discount to reflect the 'forced' nature of the sale. Accordingly, the appraised value will usually be

exceeded on the first auction, unless there is little or no interest or the ship's market value is difficult to assess. The Admiralty Marshal, who is the court officer responsible for conduct of the sale, may sell a ship for less than the appraised value – but only if the Admiralty Judge or Admiralty Registrar approves the sale<sup>2</sup>. This procedure is rather different to that in most codified legal systems where the reserve price is made public and, if not met, will result in the auction being re-run. The approach of the English court generally works better to avoid the unnecessary costs and delays of re-running an auction a month or so later if the reserve price is not met, during which time ship maintenance costs will continue to accrue.

In *The Sertao* court auction, conducted by inviting sealed bids, the highest bid fell below the appraised value, although not by a significant margin (less than 10%). The court's brokers were then authorised by the Admiralty Marshal to invite a second round of sealed bids within a very short deadline (a couple of days) from those parties who had entered bids in the first round. This produced an improved best bid, albeit still below the reserve. The issue of whether that improved bid should be accepted then came before the Admiralty Judge. Having heard the evidence of expert S&P brokers, he was satisfied that the market had been adequately tested, that the best bid fell within the range of prices achieved for similar stacked drillships and that there was no evidence of any impending market recovery. In approving the sale of the ship to the highest bidder (Turkish Petroleum), the Judge also had regard to the fact that the ship had already remained laid up for four years and the costs of reactivating her were substantial and "ever increasing".

In this case the mortgagee supported acceptance of Turkish Petroleum's bid. However, in cases where the court is not satisfied that re-offering the ship for sale will produce a better bid, it will, nevertheless, re-run the tender process upon provision of an undertaking by the mortgagee to make up the difference if the second process produces a lower price<sup>3</sup>. This may enable a mortgagee reluctant to make or to finance a protective bid at the first round of bidding to avoid the melt-down scenario of a huge loan write-down on a sale of the mortgaged ship for a deeply distressed price on the first round of bidding.

## PROPERTY ONBOARD BELONGING TO THIRD PARTIES

The Judge's ruling in *The Sertao* also considered the position of an unpaid supplier that claimed to have spares remaining onboard the ship to which it retained title.

The starting point here is that the Admiralty Marshal's terms and conditions of sale provide that what is comprised in the sale is the ship "*with everything on board belonging to her but excluding any equipment on hire*" (Clause 1). This means that goods leased to the shipowner will be excluded from the sale as "*equipment on hire*", as will goods supplied to the ship on retention of title (ROT) terms as goods not "*belonging*" to the ship. This does not give much comfort to a bidder, who will not be entirely sure of precisely what will or will not be included in the sale.

Items such as satcoms equipment, oxygen cylinders and spare parts are often leased or supplied to cargo shipowners on ROT terms. In the offshore oil and gas sector, major items of kit such as ROVs and even drilling rigs may be in separate ownership. In today's market, many candidates for court sale are cruise ships in lay-up. In the cruise industry, much of a ship's hotel inventory, including TVs, furniture and furnishings, artworks, casino equipment, catering equipment, restaurant-related items such as cutlery and crockery and stock held in onboard shops, health spas and other onboard concessions will not belong to the owners but to different cruise operators or concessionaires.

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Typically, third party owners and unpaid vendors who retain title to such equipment will begin by claiming *in rem* against (or filing a caution against release of) the arrested ship. If it then becomes clear that the *in rem* claim will be outranked by that of a mortgagee, or that only a small *pari passu* recovery will be shared between numerous maritime trade creditors, those parties may wish to remove their equipment, unless the costs of doing so are disproportionate. A mortgagee which has applied for a court sale may wish to oversee any such attendance onboard for removal of such items to verify that they correspond to what the mortgagee has satisfied itself does not belong to the ship. The notification of claims to the court, as well as the removal of such property over the period of the arrest, ought to give bidders a fairly reliable indication of what will be excluded from the sale. If the mortgagee is applying for the sale with the owner/borrower's cooperation, it may be that the mortgagee can give further clarity to bidders.

Whether a ROT provision is effective will also depend on whether the goods supplied retain their identity. For example, the unpaid supplier of a scrubbers system installed inside the funnel which cannot be removed without significant hotwork is unlikely to be able effectively to reserve title to the system (even assuming that there were any value in such second-hand equipment after deduction of removal costs).

"The Court held that there could be no prejudice to the unpaid supplier of spares on ROT terms if the ship were sold because it would be free to argue that it should be paid "a sum equal to the value of its interest in those parts".

In *The Sertao*, the Court also held that there could be no prejudice to the unpaid supplier of spares on ROT terms if the ship were sold because it would be free to argue, at the later priorities hearing, that it should be paid "*a sum equal to the value of its interest in those parts*". The Judge did not explain the basis on which the unpaid spares supplier might be able to claim against the fund in court for the value of items to which it retained title, that were, in any event, excluded from the sale. The Judge may have been alluding to a number of Commonwealth cases in which unpaid suppliers of goods to ships have sought to contest the mortgagee's priority ranking in their favour. In one Canadian case, a repair yard was given priority over a mortgagee in the amount which certain repairs enhanced the value of the ship. This was despite the fact that, in that case, the mortgagee had no knowledge of the repairs being carried out<sup>4</sup>. Another Canadian case suggests that for priorities to be disturbed in such a party's favour, it would also have to be shown that the

mortgagee benefitted from the lower ranking claim by being enriched by the relevant supply of necessities<sup>5</sup>. In the Singapore case of *The Posidon*<sup>6</sup>, an unpaid bunker supplier sought to have the mortgagee's priority disturbed in its favour. The court distinguished between the "*physical, tangible benefit*" of repairs, which might benefit a mortgagee, and the intangible 'benefit' of a supply of bunkers giving the ship "*motive power*", which would not, unless the supply had been intended to reposition the ship to a favourable jurisdiction for arrest by the mortgagee. The Singapore court further indicated that in order for the mortgagee's priority ranking to be disturbed, the court would also need to be satisfied that the mortgagee had stood by and knowingly allowed the trade creditor to act to its detriment by supplying the goods on credit.

Although this issue remains to be tested, the writers of this briefing note consider that the English court would follow the Singapore decision, that reflects an earlier English authority<sup>7</sup>, rather than the Canadian authorities, so that a trade creditor, such as an unpaid repairer or supplier of spares or bunkers, would need to show some sort of unconscionable conduct on the mortgagee's part in order to impugn the mortgagee's priority ranking.

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- [1] *Deutsche Bank Trust Company Americas v The Owner of the Motor Vessel "Sertao"* [2020] EWHC 2590 (Admlty)
- [2] *The Halcyon the Great (No. 2)* [1975] 1 Lloyd's Rep. 525 (Adm) and *Armco Pacific Ltd v Lim Juliano* [1989] 2 HKC 237
- [3] *The Halcyon the Great (No. 2)* [1975] 1 Lloyd's Rep. 525 (Adm)
- [4] *Fraser Shipyard and Industrial Centre Ltd. v Expedient Maritime Co. (The Atlantis Two)* [1999] FCJ No. 947
- [5] *JPMorgan Chase Bank v Mystras Maritime Corporation (The Lanner)* [2006] FC 409
- [6] [2017] SGHC 138
- [7] *The Pickaninny* [1960] 1 Lloyd's Rep 533

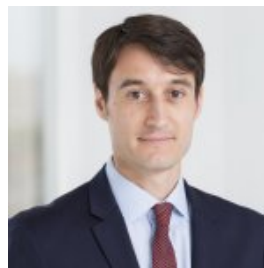
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