

DUTIES OWED BY MORTGAGEES OF SHIPS WHEN EXERCISING THEIR "POWER OF SALE"

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In the recent case of *Close Brothers v (1) AIS (Marine) 2 Limited and (2) Paul Chandler*¹, the English Admiralty Court has reviewed and provided a helpful summary of a mortgagee's duties under English law on sale of a ship. The decision is a useful reminder that a mortgagee will need to consider more than its own interests in such a situation.

BACKGROUND

Ship mortgages registered in many flag states (including the UK, Singapore, Hong Kong, Gibraltar, Cyprus, Malta, the Marshall Islands and Liberia) entitle the mortgagee, when the mortgage becomes enforceable to sell the mortgaged ship by using its 'power of sale' in the mortgage and/or its appointment as the owner's attorney under the general power of attorney granted in the mortgage. These rights, sometimes known as 'self-help' remedies, may give much quicker and more cost-effective relief than formal court arrest and sale processes, which can take many months or even years in some parts of the world.

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A mortgagee who enforces its security by exercising its 'power of sale' must not, however, overlook its defaulting owner's interest in the ship, sometimes called the 'equity of redemption', when concluding such a sale. This is of paramount importance where the value of the ship exceeds, or could be claimed to exceed, the secured loan debt. In such event, the mortgagee who sells a ship may face claims by the owner (or defenses, if the mortgagee claims under collateral security, such as a personal guarantee) that it failed to obtain the best price for the ship.

A MORTGAGEE'S DUTIES UNDER ENGLISH LAW

In *Close Brothers*, the bank had repossessed and sold a wind farm support vessel, and then sought to recover a shortfall from the mortgagor and a personal guarantor. The defendants argued that the vessel had not been sold at the best price reasonably obtainable.

The Court summarised a ship mortgagee's duties on sale of a ship under English law as follows:

- A ship mortgagee's duties of care in relation to the sale are the same as those of any other mortgagee (including one of land or real property)²;
- The duty is to take reasonable care to obtain the best price reasonably obtainable at the time³, which would ordinarily equate with the true market value⁴;
- Although the mortgagee may decide the timing and manner of sale, the mortgagee will be liable to the mortgagor if he fails to act with reasonable care to obtain a proper The property must be fairly and properly exposed to the market, absent cases of real urgency⁵;
- The mortgagee will not be adjudged to be in default unless he is "plainly on the wrong side of the line". In this context, a true market value can have an acceptable margin of error and so, for example, in one case a range between

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£1.6-1.9m was accepted⁶;

- The mortgagee must behave as a reasonable man would behave in the realisation of his own property, so that the mortgagor may receive credit for the fair value of the property sold⁷;
- If the mortgagee breaches his duty, the remedy is not common law damages, but an order that the mortgagee account to the mortgagor, not for what he actually received, but for what he should have received;
- The mortgagee must act fairly towards the mortgagor. He can protect his own interests but he is not entitled to conduct himself in a way which unfairly prejudices the mortgagor. He must take reasonable care to maximise his return from the property⁸;
- The mortgagee owes the same duty to a guarantor of the loan⁹;
- The mortgagee's duty to take care to sell for the best price reasonably obtainable is not He does not perform his duty merely by appointing a reputable agent, such as a shipbroker, to conduct the sale¹⁰. If the mortgagee is held liable to his mortgagor in such circumstances, the mortgagee may have recourse against his broker;
- The mortgagee is not entitled to act in a way which unfairly prejudices the mortgagor by selling hastily at a knock-down price sufficient to pay off the debt¹¹;
- A sale at just above the sum required to discharge the mortgage may be looked at carefully by the court, although there may well be occasions when that is the proper price or true market value¹²;
- The mortgagee cannot sell to himself, either alone or with others, or to a trustee for himself, nor to anyone employed by him to conduct the sale, unless the sale is ordered by the court and he has obtained permission to bid¹³;
- Where the mortgagee sells to a 'connected' person, the burden of proof is reversed and the mortgagee must prove that he took reasonable care to obtain the best price¹⁴; and
- The reason for considering whether the mortgagee and the purchaser are or may be 'connected' is the need to guard against unconscious bias as well as the risk of other forms of skulduggery¹⁵.

The vessel in *Close Brothers* had been sold for £1.7m. The court held that to be a price falling within the acceptable market range, “albeit perhaps on the low side”. The court relied on expert evidence to determine this and preferred the evidence of the expert called by the bank, an accredited broker whose firm maintained a database of similar sales, to the defendant’s expert, a surveyor and marine consultant who had had some involvement with sales and valuations “over the years”. The court noted that to determine a ship’s market value was “a difficult operation requiring a wide and intimate knowledge of the relevant markets which have been known to fluctuate rapidly and significantly” and held the best guidance to market value was evidence of actual sales of similar vessels. The court held that the bank had acted reasonably to appoint Braemar ACM Shipbroking and that the latter’s marketing efforts, that involved circulating the ship to more than 300 recipients, were “more than adequate”, despite their not advertising the sale.

THE POSITION AS REGARDS LIBERIAN AND MARSHALL ISLANDS FLAG SHIPS

These are helpful clarifications as far as English law is concerned. The laws of most Commonwealth flag states will usually be very similar. When dealing with Marshall Islands or Liberian flag vessels, US common law will apply in the absence of controlling local precedent.

The US Ship Mortgage Act allows extrajudicial remedies to be exercised so long as the “remedy is allowed under applicable law”.¹⁶ Under US law the private sale by a lender of most collateral, including a vessel,¹⁷ is governed by the Uniform Commercial Code (UCC), a version of which has been enacted in every state. The UCC includes numerous specific rules on notice, timing and marketing that govern the private sale of repossessed collateral. For example, under most states’ version of the UCC, if the secured party wishes to keep the collateral in full satisfaction of the debt it must send notice of this intention to the debtor. If the debtor fails to respond within twenty days¹⁸ or consents in writing the lender may proceed with the so-called “strict foreclosure”. If the debtor objects, the lender must sell the collateral in a commercially reasonable manner consistent with the UCC. In some situations a public auction is required.

Although neither the Republic of the Marshall Islands nor Liberia have adopted the UCC, both countries look to US common law to supplement their own. In the US, courts sitting in admiralty often adopt the UCC as maritime common law when there is no established common law rule.¹⁹ Thus, in a recent decision of the Supreme Court of the Republic of the Marshall Islands in which Watson Farley & Williams represented the prevailing party,²⁰ the Court adopted as the law of the Marshall Islands the section of the UCC detailing where shares of stock may be attached or executed upon. Accordingly, lenders whose mortgages are governed by the laws of Liberia or the Marshall Islands would be well advised to at least substantially comply with the UCC’s strictures in connection with extrajudicial foreclosure of collateral.

PRACTICAL ISSUES

A number of practical issues that often arise in such sales also deserve further mention. First, if the market is volatile or illiquid, including where the ship is of a specialist nature that is difficult to sell, the true market value of the ship will be difficult to determine. In such cases, a mortgagee will be well-advised to obtain several valuations from reputable S&P brokers. Further it may wish to structure any sale to include a provision for possible upwards price adjustment in three-to-six months’ time, when the historic price at the time of sale can be better determined. This is particularly so in the case of a sale to a mortgagee affiliate, a so-called ‘debt warehousing platform’, which a court would scrutinise much more closely.

Secondly, in many cases it may not be practicable for the mortgagee to circulate the ship for sale through brokers for inspection and sale, a process that is likely to drag on for many weeks, during which time other creditors may arrest the ship. In such cases, the mortgagee may prefer to finance a favoured customer to purchase the ship to conclude a quick sale. Although there is no specific legal requirement for a mortgagee to test the market by formally circulating the asset for sale on the open market through brokers and/or conducting a private auction or tender process, if the mortgagee simply sells to a preferred customer without taking such additional steps, then it is all the more important to obtain evidence to bear out the robustness of the price.

Thirdly, in *Close Brothers*, it is fair to observe that the bank repossessed the ship from owners in liquidation, apparently without resistance. But in many cases, this will not be so. The power of sale is a 'paper right' that depends on the mortgagee's ability to repossess and physically to deliver the ship to the purchaser, as well as to permit the buyer to inspect the ship and her Class records. That may be practically impossible in the face of opposition from the ship's technical managers and/or crew. In practice, in a hostile enforcement, a mortgagee's ability to repossess the ship may depend on either the crew being long unpaid and willing to cooperate with the mortgagee to get paid or the ship being managed by a third party unrelated to the owner, who may be more disposed to cooperate.

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MARITIME LIENS

Finally, it is worth mentioning how 'maritime liens' against the ship are dealt with on such sales. Sales by mortgagees are typically documented in the same way as those by the ship-owner, i.e. under a sale contract or 'memorandum of agreement', typically on Norwegian Saleform 1993 or 2012 (NSF). Clause 9 of NSF provides for the seller to warrant that the ship is delivered to its buyer free of maritime liens, debts and encumbrances.

That warranty is especially important to a buyer because maritime liens may be enforced against the ship even after a change of ownership (unless the ship is sold by a court in the context of an arrest process). Further, other maritime claims can be secured by issuance of an Admiralty writ in rem before the change of ownership (a protective procedure available in England and a number of Commonwealth

countries) and then enforced against the ship post-delivery if the ship trades to that jurisdiction. A mortgagee who may have little or no knowledge of what maritime debts the ship carries, will be very reluctant to give such a warranty. Unless the mortgagee is providing 100% finance, the price is deeply discounted, or a portion of the price is placed into escrow for an agreed period (typically 6-24 months) to secure claims against the ship post-delivery, buyers are unlikely to waive this warranty or indeed to risk their reputation by purchasing a ship that may be exposed to the risk of arrest.

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That said, specialist maritime liens insurance can be purchased (and is offered by some P&I Clubs) to protect against the risk of unascertained liens. In some cases, the buyer may also be able to take a commercial view that the risk of hidden liens is small. Under English law, the only claims that are given maritime lien status are those of crew, for unpaid wages, and of salvors and collision victims. Salvage and collision claims are typically insured and bonded at the time of the incident. Crew will usually be paid off on repatriation upon delivery. However, maritime liens are more widely defined in some other jurisdictions, particularly in the USA, where claims of suppliers contracted for under US law (that often governs marine fuel sales contracts, for example) are given maritime lien status.

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