

BRIEFING

SECURITY MAINTENANCE CLAUSES IN
SHIP FINANCE TRANSACTIONS:
ARE THEY ENFORCEABLE?

JULY 2019

- ENGLISH HIGH COURT CONFIRMS BANK ENTITLED TO RELY ON BREACH OF LOAN TO VALUE RATIO COVENANT IN SHIP FINANCE AGREEMENT TO ENFORCE SECURITY
- LENDERS SHOULD ENSURE THAT VALUATIONS ARE COMPLIANT AND TIMELY



“THE WRITTEN TERMS OF THE LOAN AGREEMENT ARE PARAMOUNT IN DETERMINING WHETHER A LENDER MAY ACCELERATE ITS LOAN AND ENFORCE ITS SECURITY.”

In an important recent judgment in *NatWest Markets PLC v Stallion Eight Shipping Co. SA (“The Alkyon”)*, the claimant bank, represented by Watson Farley & Williams LLP, has succeeded in relying on the borrower’s breach of a security maintenance covenant in a loan agreement as an ‘Event of Default’ to accelerate its loan and enforce its security by the arrest and judicial sale of the ship concerned. This judgment confirms that the written terms of the loan agreement are paramount in determining whether a lender may accelerate its loan and enforce its security, and that, if the loan agreement so provides, breaches of covenant may amount to Events of Default even where the borrower is fully up to date with repayments of principal and interest and the value of the mortgaged ship exceeds the loan debt. As a result, lenders can with greater confidence protect their own security by accelerating and enforcing without necessarily waiting for a payment default.

As the English courts observed a long time ago, “*the values of ships are notoriously subject to market fluctuations*”¹. For this reason, ship finance loan agreements usually require the ship owner/borrower to maintain a minimum ratio between the loan indebtedness and the ship’s market value from time to time. For secured lenders, such provisions are crucial to ensure that the lender has adequate security for its lending exposure throughout the tenor of the loan. These ‘loan to value ratio’ (“LTV” or “VTL”) or ‘security cover maintenance’ covenants typically provide that the value of the mortgaged ship (and, sometimes, other assets such as pledged cash balances) does not fall below a certain percentage of the loan debt, typically

¹ Per Kerr J in *The Odenfeld* [1978] 2 Lloyd’s Rep. 357 at 360, col. 2

“IT IS NOT UNCOMMON FOR MARKET PARTICIPANTS TO CONSIDER THAT, AS LONG AS A BORROWER MAKES TIMELY REPAYMENTS OF PRINCIPAL AND INTEREST, A LENDER CANNOT AND/OR WOULD NOT RELY ON AN LTV BREACH TO ACCELERATE AND ENFORCE. THE ENGLISH COURT’S RECENT JUDGMENT IN *THE ALKYON* CONFIRMS THAT THAT THIS IS A MISCONCEPTION.”

between 110% and 150%. The greater this percentage margin, the greater protection the lender will have against further market falls in the period between its initial reliance on an LTV clause and the eventual sale of the ship/application of her sales proceeds to repay the loan. That aside, a greater margin will facilitate a full recovery even if the ship is sold for a low ‘forced sale’ price following enforcement. Where the LTV ratio falls below the minimum, the loan agreement will entitle the lender to give notice to the borrower to restore the shortfall, whether by a cash prepayment or by provision of additional security, within a cure period of, typically, 30 days. Usually, the lender must support its notice by one or more ‘desk’ valuations of one or more approved ship sale and purchase brokers, certifying the market value relied on.

Lenders are sometimes reluctant to damage their customer relationships by enforcing LTV provisions. By the same token, it is not uncommon for market participants to consider that, as long as a borrower makes timely repayments of principal and interest, a lender cannot and/or would not rely on an LTV breach to accelerate and enforce. The English court’s recent judgment in *The Alkyon* confirms that that this is a misconception and that LTV clauses are valid, such that if their breach is an Event of Default, that Event of Default can form the basis of an enforcement. The judgment also highlights the importance for lenders to invoke such clauses methodically and with care.

The judgment

The background to the recent judgment was the bank’s reliance on a clause of the loan agreement that required the borrower to maintain a LTV ratio at all times of 125%. In early 2018, the bank issued a notice requiring the borrower to restore the LTV ratio within 30 days, which the borrower failed to do, leading to the bank accelerating its loan and arresting the m.v. “Alkyon” in the port of Tyne, in the north of England, in June 2018.

The borrower contended that the LTV clause should be read, whether as a matter of construction of the loan agreement or by a term being implied into it, to provide that the broker’s valuation relied on by the bank was to have been made using a conventional procedure or methodology in good faith and not arbitrarily, capriciously or for an improper purpose. As to this, the court held that the broker’s valuation which was relied on, that had been given by Barry Rogliano Salles (“BRS”), was within the range of acceptable values that a reputable broker could have determined the ship to be worth and so fulfilled such a term. It was not therefore necessary for the court to go on to consider whether or not such a term applied. Interestingly, the borrower had earlier contended that a desk valuation was insufficient and that the bank ought to have engaged a broker to conduct much fuller research having regard to data that included historic press information as to the ship. Clearly for banks to obtain more than one desk valuations to invoke such a provision would be onerous, if not unrealistic, and in this respect this finding will be welcome.

In addition, the borrower contended that the bank must act in good faith and not arbitrarily, capriciously or for an improper purpose both when it appointed BRS as valuer and when it relied on BRS’s valuation to invoke the LTV clause. The court held that BRS was an independent broker and that the bank had acted in good faith. Therefore the court did not need to consider the specific terms contended for. Finally, the borrower argued that the market was rising at the time of the arrest and that the

lender was adequately secured. The court made clear, relying on the express terms of the LTV clause, that the fact that the market may have been rising during the LTV cure period did not oblige the bank to withdraw its notice and that the bank, in accelerating and enforcing based on a LTV Event of Default, had acted within the commercial terms agreed in the finance documents.

The court had no hesitation in holding, therefore, the LTV provision itself and the manner of its exercise by the bank, to be valid and binding on the borrower.

What lessons should lenders learn from this decision?

First, borrower covenants in ship finance loan agreements are an important part of the lender's package of rights and may be relied on, even where the borrower is repaying the loan and interest in a timely manner. The court will not re-write the finance documents. If the LTV ratio dips below the agreed threshold but debt service is up-to-date, most commercial lenders will prefer to give the owner time to refinance the loan or to sell the ship through brokers. These factors may explain the market misperception that LTV clauses cannot be enforced. However, this case puts the ability of lenders to rely on LTV clauses beyond doubt (at least as far as English law is concerned). Indeed, the issuance of notices to ensure LTV covenant compliance and reliance on non-compliance as Events of Default should be vital tools for any lender to maintain security at a level that not only covers the loan but does so by a margin great enough always to make a full recovery.

Secondly, the lender needs to take care to appoint an 'approved' broker, which the loan agreement will usually either define or confer a right of appointment on the lender to select any reputable, international broker. It should be noted that, since the economic downturn of 2008, most ship brokers have incorporated valuation arm affiliated entities to ring-fence their liability in negligence, to which the loan agreement ought properly to refer.

"THE LENDER SHOULD ENSURE THAT THE VALUATION ITSELF IS COMPLIANT, IN PARTICULAR THAT IT HAS BEEN CARRIED OUT ON A 'WILLING BUYER, WILLING SELLER' BASIS."

Thirdly, the lender should ensure that the valuation itself is compliant, in particular that it has been carried out on a 'willing buyer, willing seller' basis. That term may mean different things to different brokers. In the legal context, the courts have referred with approval in a number of judgments to the definition of the term by the International Valuation Standards Council². In one case, the court defined 'willing seller' to be one not acting under compulsion³. In a very depressed market, in which a borrower may not unfairly contend that no ship owner in his right mind would voluntarily sell his ship, this may be a sensitive issue. That aside, the valuation should track the terms of the LTV clause. Valuation ranges, for example, are best avoided, and if the broker insists on valuing a vessel within a range of, say, US\$10-11m, the lender should use the higher end of the range to determine LTV, rather than to refer to a mid-point, unless the clause expressly so permits.

Part of the process of verifying the correctness of the valuation is likely to be to review the small print in the desk valuation itself. It is not uncommon for brokers to include, for example, disclaimer language in their desk valuations, such that the valuation

² *Platform Funding v Anderson & Associates* [2012] EWHC 1853 (QB); *Premier Telecom Communications Group Ltd v Webb* [2014] EWCA Civ 994; and *Alliance Bank JSC v Baglan Abdullayevich Zhunus* [2015] EWHC 714 (Comm)

³ *IRC v Clay* [1914] 3 KB 466

“LOAN AGREEMENTS WILL OFTEN REQUIRE ANY VALUATION RELIED ON TO HAVE BEEN OBTAINED WITHIN A FIXED NUMBER OF DAYS BEFORE THE NOTICE IS ISSUED, TO ENSURE THAT ONLY ‘FRESH’ VALUATIONS ARE RELIED ON.”

may not be relied on in evidence before a court. This would obviously conflict with a bank’s need to do so in the event the validity of its notice is challenged.

That aside, loan agreements will often require any valuation relied on to have been obtained within a fixed number of days before the notice is issued, to ensure that only ‘fresh’ valuations are relied on, and/or will provide for LTV ratios to be stress-tested only at specific intervals. Further, the lender must ensure accurately to calculate the LTV shortfall the lender seeks to be restored. In cases where other assets, such as cash balances in accounts with the lender, other security and/or actual or projected swap gains or losses, need to be taken into account, this calculation may be delicate and not an easy one to perform.

Last, but by no means least, a lender would be well-advised to have in mind that ship brokers depend, for their business, on the trust and support of the ship owning community. The provision of desk valuations and other services to ship finance lenders forms only a very small part of their workload. It is not unknown for brokers to face pressure from defaulting owners not to assist lenders seeking to crystallise an event of default against them. Obviously lenders should be aware of this risk and should, as far as they can, ensure that the broker whom they appoint can and will substantiate a valuation intended to be relied on to support an LTV notice, especially where the lender expects resistance from the owner.

FOR MORE INFORMATION

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