SHIP FINANCE CHALLENGES IN THE CURRENT CLIMATE

By Lindsey Keeble and David Osborne, Watson Farley & Williams LLP

This article focuses on some issues arising under ship finance documents – and more generally the relationship between shipowners and their financiers – since the onset of Covid-19 (we do not address issues arising under shipbuilding contracts, which is a subject in its own right). At the risk of stating the obvious, Covid-19 has its most direct and immediate effect on crewing and operational matters, which in turn have an impact on safety and regulatory issues. The physical, psychological and humanitarian aspects of difficulties and delays in crew rotation are severe and not to be underestimated. This has been commented on with increasing intensity by industry bodies, and in the industry and general media. In the commercial context, this has translated into problems with completing second-hand S&P transactions and taking delivery of newbuildings: delays in completion; changes of delivery location; and problems with carrying out surveys. Anecdotal evidence from our experience indicates a general willingness of the parties to work around these problems – but inevitably there will be cases where commercial drivers mean that one party or the other is not incentivised to do so.

Class surveys can potentially be affected, and owners have had to seek extensions from class in some cases. Shipowners will always need to be mindful of the need to ensure that class issues do not jeopardise insurance cover. Class societies have, however, moved towards remote surveys and audits where possible. Flag states have shown some flexibility with respect to inspections. Liberia is known to have pioneered remote annual inspections.

In terms of finance documentation, all this manifests itself in issues which fall broadly into three categories: (i) possible breaches of undertakings arising from operational issues (see above); (ii) reduction or interruption of cashflow; (iii) other covenant or default issues.

OPERATIONAL ISSUES

As regards breach of operational undertakings, discussions with our clients indicate that financiers are taking, at least for now, a reasonably tolerant and pragmatic approach. An overriding concern will be to ensure that nothing is being done or omitted which could jeopardise insurance cover. In this context, financiers should be wary of regarding MII cover as a panacea that responds to all problems with the shipowner's insurances. Most MII policy wordings do not cover risks that fall outside the scope of the shipowner's insurances and also do not respond if the mortgagee is privy to the occurrence of the insured peril under the MII policy.

Many facilities contain an undertaking not to lay up or deactivate the relevant ship. If and when shipowners consider this - and we believe it has not yet been generally done outside the cruise industry – they will need to approach their financiers under the relevant facility.

VESSEL EMPLOYMENT AND CASHFLOW

The main focus of shipowners and financiers will be on cashflow, whether it is reduced or interrupted by general market conditions and employment prospects or by issues under existing charterparties. As regards the latter, operational difficulties (see above) increase the risk of off–hire. In some charterparties, prolonged off-hire will give rise to an express right of the charterer to terminate. However, the length of time to quarantine a vessel (understood to be 14 days in most ports) would not usually be long enough to trigger express termination provisions relating to prolonged off-hire. Another consideration is where charterparties contain detailed operational and maintenance obligations on the part of the shipowner; charterers might seek to invoke these, opportunistically or otherwise, against the backdrop of a falling market.

English law does not have a general doctrine of force majeure (unlike many other laws) which operates to relieve one party or the other from its liability to perform – but force majeure clauses are sometimes expressly included in medium or long term charters. Where

such clauses are present, it is quite possible that they will now be invoked, depending on the underlying commercial circumstances and the precise wording. Experience has shown that, when a party does invoke a force majeure clause, it frequently leads to litigation. The English law doctrine of frustration of contracts does not depend on express language in the contract – quite the opposite. However, it is a doctrine of narrow application. It is unlikely that Covid-19 will (yet) give rise to frustration of contracts – but the longer the effect continues, the greater the prospects of it being successfully invoked in some cases.

CASHFLOW AND FACILITY AGREEMENTS

The actual or potential impact on shipowners' cashflow is likely to result in requests for payment holidays and waivers of financial covenants. At the time of writing, this has not (yet) been seen by the authors to a great extent – outside the passenger/cruise industry, which has been affected immediately and severely by Covid–19. If and when shipowners do turn to their financiers for temporary debt service and limited covenant relief, they should be mindful of widely drafted insolvency events of default in their facility agreement. In documents which are based on the LMA form, it can be an event of default if the borrower "by reason of actual or anticipating financial difficulties commences negotiations with one or more of its creditors…with a view to rescheduling its indebtedness." Shipowners might well also seek to renegotiate payments with trade creditors – and that is likely in itself to be looked upon favourably (or even required) by financiers who are themselves being asked to provide relief. It should be noted, however, that the event of default language quoted above does not only operate in relation to discussions with financial creditors, but is wide enough to capture discussions with trade creditors. Any such discussions, therefore, require approaches to creditors to be carefully planned to avoid unintended defaults arising from cash management steps. A uniform approach across all financings will also be prudent, as otherwise cross-default provisions could be triggered where waivers are not uniformly achieved.

OTHER COVENANT OR DEFAULT ISSUES

Although immediate cash flow and debt service issues are likely to be at the front of the minds of all concerned, other covenants – and also events of default - might become engaged. Many facilities have loan-to-value covenants which are likely to be put under increased pressure by the market impact of Covid-19. Financiers might begin to consider whether material adverse change (MAC) or material adverse effect (MAE) events of default might be triggered (or can be used as a drawstop). MAC/MAE clauses have, from time to time, successfully been invoked by financiers, even in the face of challenges by borrowers in the courts. Financiers are, however, justifiably wary about calling them in all but the clearest circumstances. Incorrectly invoking such an event of default could potentially result in a claim for substantial damages – leaving aside possible reputational damage. The precise wording of such an event of default is important. In the current situation, a number of factors suggest that it is unlikely that financiers will seek to rely exclusively on Covid-19 being a MAC or MAE event of default:

- the change cannot simply be temporary - a permanent adverse effect needs to be shown and it is accepted that global pandemics do subside;
- the financier needs to provide evidence that there is an adverse effect on the relevant obligor. Such evidence might well not be immediately available and, if it exists, will more likely be used in relation to a potential breach of any financial covenants. A lender cannot simply point to general economic or market changes and say that these must have an adverse effect;
- a change in financial condition is only going to be materially adverse if it significantly affects the company's ability to perform its obligations under the relevant finance documents or simply its payment obligations (depending on the drafting). If it is currently performing them, then that is very hard to prove and, if it is not, no doubt other events of default will have already been triggered;
- a financier cannot rely on a MAE/MAC provision based on circumstances of which it was aware when it entered into the agreement, so it could not be invoked under facilities entered into following the emergence of Covid-19; and
- there is also case law that might be relevant if the adverse effect is expressed to be 'in the reasonable opinion of' the majority lenders' or that the effect is 'reasonably likely' - both of which are fruitful areas for potential litigation.

Based on what we have seen, some observations and (tentative) predictions can be made – always bearing it in mind that things could change even between the time of writing this and going to press. We would expect financiers generally to be – albeit resignedly – both sympathetic to shipowners and tolerantly pragmatic in response to a request for payment holidays and covenant waivers. There will be cases where this suggested approach is tested or simply does not apply. Different types of financiers have different business models and approaches, whether in bilateral financings or as part of syndicates. Some financiers see themselves as relationships lenders rather than asset financiers, and are accordingly likely to be more accommodating. As one senior shipping banker has pointed out, financiers will be alert to distinguishing between customers who are genuinely, even if prudently, seeking relief because of the impact of Covid-

19, and those who are using it as a cloak for pre-existing problems. It is in any event likely that financiers who do agree to requests for debt holidays or covenant waivers will require dividend lock up, an increased focus on capex and, possibly ask for cash sweep provisions in return. We make no comment about the position on fees or repricing arising as recompense for waivers or consents.

GOVERNMENT SUPPORT?

Leaving aside any applicable government support which might be directly available to shipowners, to what extent might financiers be compelled by law to give relief to their customers? As pointed out above, English law does not have a generally applicable doctrine of force majeure. Unlike commercial documents such as shipbuilding contracts and (sometimes) charterparties, force majeure clauses are never included in English law finance documents, so there is no comfort for shipowners there. The Cypriot government has introduced a law requiring all Cypriot banks, subject to certain conditions being satisfied, to give all customer (irrespective of sector or nationality) a moratorium until the end of 2020, and a corresponding extension of final maturity. The European export credit agencies have taken steps to promote relief from upcoming debt repayments in the cruise and passenger industries which they are supporting. More recently, there have been indications from two Asian countries of government support for locally incorporated container companies. It is doubtful, however, more generally if direct government support will be available to shipping companies or if financiers of the shipping industry more generally will be compelled by government intervention to provide accommodation to their customers. Closer to home, possible government support for the UK ferry industry has become a hot topic.

Generally, shipowners will need to seek relief from their financiers as and when required. Care should be taken when taking government support which might be directly available to shipowners not to breach contractual restrictions in their financings (for example, prohibitions on incurrence of indebtedness and the insolvency events of default discussed above).

Source: Trafigura Images

PROCEDURAL MATTERS

In terms of processing of registrations and documentation generally, things have adapted remarkably quickly and effectively to ensure that those aspects of business at least continue. Many ship registries were already processing and accepting documents electronically in any event, and most of the major registries that were not have swiftly adapted their requirements. Lawyers have moved to remote execution and completion of both sale and purchase and finance documentation, subject to careful compliance with applicable laws and regulations. Transactions need a bit more planning, but are quite feasible to complete. Last but not least, the English courts and the London maritime arbitration community are dealing with dispute resolution on a remote basis.

THE SECONDARY MARKET FOR MARITIME DEBT:

THE NEW NORM

By George Macheras, Watson Farley & Williams LLP

The last few years have seen a rapid growth in the secondary market for maritime debt – not just in terms of the volume of deals being done, but also as to the innovation in the structures implemented when conducting such transactions. Whilst the large-scale portfolio transfers naturally attract more attention in the press, the number of individual trades (being single, two or three asset positions) is not insignificant. The reasons behind this trend have been widely reported: the exit of traditional players from the industry (such as some commercial banks), the entry of new participants from the private equity / alternative investment space and the general change in the availability of capital.

So, what are some of the key considerations which participants (sellers, buyers and financiers) usually take into account in relation to such projects? What are the various types of structures commonly used for the sale and purchase of loan portfolios? Lastly, what is the impact on this market following more recent developments, such as the introduction of ESG regulatory frameworks and, not least, what effect COVID-19?

To identify the key considerations from a participant's perspective, it is first useful to briefly go through the commercial context. The majority of the recent maritime portfolio disposals have originated from commercial banks which, in a previous life, have been very active in shipping lending. Frequently, the loans included in such portfolio sales have, for the most part, been non-performing (or, at least, highly stressed, i.e. 'NPLs'). This is not to say that there have been no disposals of performing loans, but, in practice, sellers have mostly been banks (with a significant maritime exposure), driven, due to a variety of regulatory, commercial and/or political reasons, by a desire to either exit the market altogether or, at the very least, significantly reduce their non-performing book.

As a result, and price aside, a determining factor in deciding to sell a maritime portfolio is how prompt and smooth the exit can be for the seller. In other words, a vendor may be attracted by a buying bid which contains assurances of a swift completion with no residual involvement remaining after the loans are 'elevated' to the purchaser (i.e. the legal transfer of title to the loans from the seller to the buyer). Of course, a quick elevation is not without difficulties. Several of the loans in question may require borrower consent, may be subject to disclosure obligations and other KYC checks and will generally contain contractual prerequisites before transfer can occur. Completion of such steps takes time and in certain situations may not even be feasible, for instance where the underlying customer is uncooperative.

There are interim solutions, most notably sub-participation, where the vendor remains the lender of record and legal title holder of the loan, but the economic risk and benefit transferring to the purchaser. However, getting 'stuck' on sub-participation for an uncertain period until legal formalities are completed is far from a satisfactory solution, both for a bank which is wishing to end its sector exposure or curtail its distressed book and for an investor who may be looking to capitalise on its acquisition directly without having to involve the seller in the conduct of its business.

Transactions in recent months have therefore shown the usage of some innovative structures, deployed for the purposes of overcoming a number of the practical challenges mentioned above. The NPL market in Greece is a notable example of this. Vendors have as of late started to take advantage of legislation introduced to assist with the disposal of 'red loans' (as they are colloquially known in that market) in a fast and efficient manner. Particularly helpful in this regard have been the Greek Securitisation Law ('GSL', Articles 10 and 13 of Law 3156/2003), where the purchasing entity is a securitisation vehicle compliant with the GSL (and backed by an otherwise largely conventional securitisation structure), or the Law on Non-Performing Loans (Law 3454/2015). In each case, the relevant legislation applies to override contractual requirements (the obvious one being borrower consent) and transfers

the subject loan asset automatically as a matter of Greek law, once the relevant perfection formalities are carried out. Such laws are not unique to shipping and have been used in the Greek NPL market more widely. Similar legislation has also been passed in other jurisdictions with a maritime presence (a loose analogy being Part VII of the Financial Services and Markets Act 2000, in England & Wales).

This is not to say that such structures are a panacea for the various difficulties, either from a seller or buyer viewpoint. Some contractual provisions may be overridden, but other regulatory and legislative requirements remain. A classic such example is banking secrecy – most jurisdictions will have quite stringent rules in relation to this which may not be easily superseded (if at all). In any event, given that shipping is a multi-jurisdictional industry, the effectiveness of these structures needs to be reviewed through the prism of all relevant laws. Sometimes local law requirements will mean that additional steps may be required in respect of the 'manual' transfer or perfection of at least some of the security.

Operational issues aside, there are also commercial considerations. It is not uncommon for buyers of such portfolios to part-fund their acquisitions through secured bank financing. Financiers will therefore need to get comfortable with the acquisition method generally, and in particular the effectiveness of what security is available to them – especially if such security is to be restricted to the underlying loan assets.

In addition to addressing the above structural sensitivities, financiers will also need to get comfortable with the regulatory/compliance framework pertaining to such loans. In today's environment, banks are showing an increasing desire for ESG-compliant borrowers (most profoundly highlighted by the introduction of the Poseidon Principles and the banking industry's general push to support green shipping). Hence, buyers (as the new lenders) and their financiers together may raise the threshold of ESG requirements beyond the levels the underlying customers have been accustomed to previously. That said, it is worth noting that such regulatory frameworks are neither meant to increase regulatory obligations (rather, they are a tool for banks to monitor their borrowers meeting their regulatory duties) nor are they utterly novel to shipping (other industries have been using similar regimes for some time, such as the Equator Principles in project finance).

In today's environment, banks are showing an increasing desire for ESG-compliant borrowers (most profoundly highlighted by the introduction of the Poseidon Principles and the banking industry's general push to support green shipping).

In fact, the recognition of effective corporate and environmental governance may be relevant not just to buyers' financiers but to buyers in their own right. They might be banks themselves (so the Poseidon Principles should be of direct applicability) or because of their own requirements to external investors (especially in a private equity / hedge fund set up) who have commonly come to expect such criteria on the value of their investments. The extent to which any insufficiency in this context in loan books to be traded in the future will affect the conduct of the transactions (in terms of pricing but also in terms of process) remains to be seen.

On a final note, it is inevitable that the secondary debt market will not be immune from the global impact of COVID-19. The extent to which maritime portfolio sales and purchases will be affected is difficult to be predict at this stage, given the current unprecedented circumstances. Secondary debt trading has always been a cyclical market (not least, in shipping) but it will be a safe assumption that COVID-19 and its consequences could influence any immediate appetite for new business, across sellers, buyers and financiers alike. Of course, there will still be a need for such deals to be done (both in terms of portfolios which were designated for disposal pre COVID-19 but also in relation to loans that have become necessary for sale due to downturn conditions post COVID-19). In relation to the latter, there will be a consequent need to potentially readjust expectations as to how parties proceed with actually completing the transactions; a desire to do a deal is one thing, but the practicalities of completion in a new, not yet-tested environment may be quite another – not least because the desire for swiftness of execution referred to at the beginning will not necessarily be compromised by the relevant participants.

In summary, recent months have been particularly interesting in the trade of maritime loan portfolios on the secondary market. The volume of such deals has been steady and of varying degrees of size, but the introduction of more complex and innovative structures has stood out. The need for such innovation will hopefully continue, at least as necessitated by the new realities – be it the ever-increasing stringency for more transparent ESG compliance (as best exemplified by frameworks such as the Poseidon Principles) or, due to the impact of COVID-19. Even if, as of today, its scope and its extent may too be early to predict.