

THE SHIPPING LAW REVIEW

EIGHTH EDITION

Editors

Andrew Chamberlain, Holly Colaço and Richard Neylon

THE LAW REVIEWS

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PREFACE

The aim of the eighth edition of this book is to provide those involved in handling shipping disputes with an overview of the key issues relevant to multiple jurisdictions. We have again invited contributions on the law of leading maritime nations, including both major flag states and the countries in which most shipping companies are located. We also include chapters on the law of the major shipbuilding centres and a range of other jurisdictions.

As with previous editions of *The Shipping Law Review*, we begin with cross-jurisdictional chapters looking at the latest developments in important areas for the shipping industry: competition and regulatory law, sanctions, ocean logistics, piracy, shipbuilding, ports and terminals, offshore shipping, marine insurance, environmental issues, decommissioning and ship finance.

Each jurisdictional chapter gives an overview of the procedures for handling shipping disputes, including arbitration, court litigation and any alternative dispute resolution mechanisms. Jurisdiction, enforcement and limitation periods are all covered. Contributors have summarised the key provisions of local law in relation to shipbuilding contracts, contracts of carriage and cargo claims. We have also asked the authors to address limitation of liability, including which parties can limit, which claims are subject to limitation and the circumstances in which the limits can be broken. Ship arrest procedure, which ships may be arrested, security and counter-security requirements, and the potential for wrongful arrest claims are also included.

The authors review the vessel safety regimes in force in their respective countries, along with port state control and the operation of both registration and classification locally. The applicable environmental legislation in each jurisdiction is explained, as are the local rules in respect of collisions, wreck removal, salvage and recycling. Passenger and seafarer rights are examined, and contributors set out the current position in their jurisdiction. The authors have then looked ahead and commented on what they believe are likely to be the most important developments in their jurisdiction during the coming year. This year, we welcome Costa, Albino & Lasalvia Sociedade de Advogados as the new contributors of the chapter focusing on maritime law within Brazil. There are also two new jurisdictions in this edition – Israel (Harris & Co) and Mexico (Adame Gonzalez De Castilla Besil) – and Portugal makes a return, with Andrade Dias & Associados as the new contributors.

The shipping industry continues to be one of the most significant sectors worldwide, with the United Nations Conference on Trade and Development (UNCTAD) estimating that the operation of merchant ships contributes about US\$380 billion in freight rates within the global economy, amounting to about 5 per cent of global trade overall. Between 80 per cent and 90 per cent of the world's trade is still transported by sea (the percentage is even higher for most developing countries) and, as of 2019, the total value of annual world shipping

trade had reached more than US\$14 trillion. Although the covid-19 pandemic has had a significant effect on the shipping industry and global maritime trade (which plunged by an estimated 4.1 per cent in 2020), swift recovery is anticipated. The pandemic truly brought to the fore the importance of the maritime industry and our dependence on ships to transport supplies. The law of shipping remains as interesting as the sector itself and the contributions to this book continue to reflect that.

Finally, mention should be made of the environmental regulation of the shipping industry, which has been gathering pace this year. At the International Maritime Organization's (IMO) Marine Environment Protection Committee, 72nd session (MEPC 72) in April 2018, it was agreed that international shipping carbon emissions should be cut by 50 per cent (compared with 2008 levels) by 2050. This agreement will now lead to some of the most significant regulatory changes in the industry in recent years, as well as much greater investment in the development of low-carbon and zero-carbon dioxide fuels. The IMO's agreed target is intended to pave the way for phasing out carbon emissions from the sector entirely. The IMO Initial Strategy, and the stricter sulphur limit of 0.5 per cent mass/mass introduced in 2020, has generated significant increased interest in alternative fuels, alternative propulsion and green vessel technologies. Decarbonisation of the shipping industry is, and will remain, the most important and significant environmental challenge facing the industry in the coming years. Unprecedented investment and international cooperation will be required if the industry is to meet the IMO's targets on carbon emissions. The 'Shipping and the Environment' chapter delves further into these developments.

We would like to thank all the contributors for their assistance in producing this edition of *The Shipping Law Review*. We hope this volume will continue to provide a useful source of information for those in the industry handling cross-jurisdictional shipping disputes.

Andrew Chamberlain, Holly Colaço and Richard Neylon

HFW
London
May 2021

SHIP FINANCE

Gudmund Bernitz and Stephanie Koh¹

I INTRODUCTION

The financing of ships is as ancient as international trade itself, but the way that financing is done has continuously evolved over history and continues to change today – maybe at a faster pace than ever. The types of financing products available has become increasingly diverse and the financiers offering them include, to name a few, banks, leasing houses and emission control areas, as well as bond and equity markets.

However, when providing financing against the security of a ship, it remains as important as ever to understand the nature of the secured asset and the legal landscape in which she operates.

II THE SHIPPING LOAN AGREEMENT

In its simplest form, a shipping loan agreement is fundamentally a contract documenting the lender's obligation to advance the loan (if certain conditions are met) and the borrower's obligation to repay that loan with interest. The loan agreement is designed to ensure the loan is used for its proper purpose and to protect the lender's security in the ship that is being financed.

Consequently, the lender's obligation to lend is its only material obligation and, as far as the lender is concerned, the loan agreement will chiefly concern itself with the manner in which the loan is advanced and how the lender deals with information concerning the borrower. On the other hand, the borrower's obligation to repay the loan will be augmented by other obligations to preserve the lender's security and to keep the lender informed about the borrower, the borrower's business and the operation of the ship.

A shipping loan agreement can be divided into three constituent parts: (1) the commercial terms; (2) the key operative provisions; and (3) the boilerplate clauses. The following discussion is based on a bilateral term loan agreement between one lender and one borrower; club or syndicated shipping loans come with additional considerations beyond the scope of this chapter.

¹ Gudmund Bernitz is a partner and Stephanie Koh is an associate at HFW.

i Commercial terms

The commercial terms in a loan agreement include the tenor of the loan (i.e., the term of repayment) and, closely related to the tenor, the repayment schedule of the loan (including the distribution of the repayments – for example, whether the loan is amortised and the size of any balloon repayment at the end of the term of the loan).

Other important commercial terms include any fees that might be paid to the lender (although these may also be set out separately in confidential fee letters if the loan is syndicated), the interest rate (usually expressed as the margin above the interbank lending rate or the lender's cost of funds) and the availability of the funds.

ii Key operative provisions

Many of the operative provisions in a shipping loan agreement are general in nature and would be recognisable to general finance practitioners, whereas others are very specific to shipping loans and, in some cases, specific subsectors of the shipping industry.

These key operative provisions include the following:

- a representations on and warranties of the borrower's condition and that of any other obligor, and its respective assets and businesses at the time the loan agreement is signed and, in respect of some representations and warranties, other agreed points during the tenor of the loan (often at each drawdown and at the beginning of each interest period);
- b conditions precedent that must be satisfied by the borrower before it is entitled to draw on the loan. These conditions precedent protect the lender from having to advance the loan before it is comfortable with the condition of the borrower and all other obligors (including providers of security), and their respective assets and business; for example, the lender will want evidence that the borrower has good legal title to the ship, that the ship has been adequately insured and that she has all relevant trading certificates and, if the transaction has a project financing element, that the ship is employed under an acceptable charter for the duration of the loan;
- c covenants on the borrower (and in some cases, some or all other obligors) whereby the borrower undertakes to do (or not to do) certain things throughout the tenor of the loan. These are designed to ensure the borrower (and some or all other security parties) maintains itself and its asset and business in a condition that remains acceptable to the lender. From the borrower's perspective, however, they should not be too onerous to fulfil since they would usually be aligned with what a prudent shipowner should be doing anyway;
- d events of default, which delineate the circumstances in which the lender may demand its money back. The key event of default would be a failure to repay the loan or pay interest on time; however, there are other defaults that indicate that the borrower (or other obligors, or both) has failed to make payments to other creditors on time or failed to maintain itself and its ship and business in the required manner, or when the borrower has failed to perform its other obligations under the loan agreement (or other finance documents); and
- e mandatory prepayment events whereby the borrower is obliged to repay the loan immediately (or after an agreed grace period) but with the respective event not being treated as a breach by the borrower, usually because it would be outside the borrower's control. Some examples of mandatory prepayment events include the total loss of the ship, the sale of the ship, a change of control or ownership of the borrower, it becoming illegal for the lender to maintain the loan and, in the case of pre-delivery financing, the

non-delivery of the ship or the termination of the shipbuilding contract. Whether an event is an event of default (which may trigger cross-default provisions in other facilities the borrower or other group companies may have) or a mandatory prepayment event is commonly a matter of discussion between the parties.

iii Shipping-specific operative provisions

As a ship is an expensive asset that is subject to a variety of risks during its operations and is (by virtue of the ship mortgage) normally the most important piece of security the lender will have, the lender will want to ensure the ship is adequately and appropriately insured and operated. Therefore, most shipping loan agreements will contain extensive vessel-specific undertakings, some of which relate to the insurance arrangements of the ship and others to the operation of the ship.

The loan agreement will contain insurance undertakings whereby the borrower undertakes to insure the ship for certain types of risks and, in respect of some insurances, the minimum amount for which the ship should be insured. This minimum amount is usually linked to the agreed value of the ship, which is determined by the valuations the borrower is expected to procure (often from brokers agreed in advance with the lender) annually or semi-annually.

The lender will also expect the borrower to undertake, among other things, to pay premiums punctually and trade the ship within any limits set by her insurers. The insurance undertakings will also deal with what happens if the ship becomes a total loss or suffers a major casualty, and the borrower would usually undertake not to settle any claim in respect of these events without the prior consent of the lender.

The lender will also have a direct interest in ensuring the ship is operated by the borrower in a prudent manner, both for reputational reasons and because the value of its security may decrease if the ship is poorly maintained. In that regard, the borrower will undertake to keep the ship in a good and seaworthy state of repair, and procure that the ship is kept in class. The lender will also want the borrower to undertake to ensure that the ship is not used for any illegal purpose and, in some cases, the lender will want the borrower to obtain its consent before employing the ship on certain types of charters (such as demise charters).

Apart from giving vessel insurance and operation undertakings, the borrower will further be required to undertake to keep the lender apprised of developments in respect of the ship and her employment and, further, to provide the lender with material information about the ship, such as any arrest of the ship or any material incident involving the ship.

iv Boilerplate provisions

The boilerplate provisions are usually not negotiated at length and commonly include the following non-exhaustive list:

- a* a further assurance clause that obliges the borrower to do anything that may be required to perfect the lender's position under the loan agreement and security documents;
- b* a severability clause to deem unenforceable provisions to be deleted without impinging on the validity of the rest of the loan agreement;
- c* a governing law and jurisdiction clause that sets out, among other things, the dispute resolution mechanism and the governing law of the loan agreement;
- d* the notices provisions, which set out the methods of communication between the parties; and
- e* the transferability of the loan and security.

III SECURITY

In the context of taking security in a ship financing, there are various characteristics of ships to consider and these factors will dictate the structure of a typical security package given in favour of a lender and distinguish ship financings from other forms of finance.

Ships are movable assets and as such it is required that they maintain a national character. Broadly, this means that they must be registered with a nation state. Each state maintains its own public shipping register (or registers) that typically records ownership and security interests (most notably mortgages) over ships registered with that state. This is fundamental when taking security in connection with a ship financing, as shipping registers will generally provide prospective lenders with (1) a reliable source showing registrable encumbrances over a ship, and (2) a fairly straightforward way of perfecting registrable security interests over a ship.²

Other important considerations include the fact that ships are wasting assets with a limited economic life and that their market value and earning capacity are prone to fluctuation. They can be lost or completely destroyed or damaged beyond economic repair; they can be compulsorily requisitioned by their flag state; they can be captured by pirates or hostile states; they are potential sources of pollution; and they are subject to various regulatory regimes that may prevent them from navigating. These and other factors will determine the security interests that will be of practical value to a lender.

The security package will vary from deal to deal, depending on factors such as the bargaining position of the parties, regulatory considerations, the ownership structure of the ship, whether the ship is chartered out and current market conditions, as well as the condition of the ship itself. Nevertheless, most secured ship financings will include most, if not all, of the following security documents:

- a* ship mortgage (and collateral deed of covenants where relevant);
- b* assignment of insurances;
- c* assignment of earnings;
- d* assignment of charters;
- e* account security;
- f* shares security; and
- g* subordination undertakings from managers and charterer.

Given that ships tend to be owned by single-purpose companies, the lender may also seek a parent company guarantee (or a personal guarantee from an individual shareholder).

i Ship mortgage

A ship mortgage is fundamental to any secured ship financing, as it provides a lender with the power of sale and the power to take possession of a ship to satisfy the borrower's loan obligations. A ship mortgage will be governed by the laws of the flag state, which determine both perfection requirements and the rights conferred by the mortgage. Any potential lender is able to inspect the public register maintained by the flag state to determine whether a ship

2 Aside from maintaining their respective registers, national ship registries administer regulatory oversight over ship operations. This generally covers technical and maintenance requirements, rights of seafarers, the tax treatment of ships and their earnings, and ship ownership requirements, which are of particular interest when discussing security. Some registries may require that a ship is owned by a locally registered entity.

is subject to other mortgages. The aim is to provide a lender with a degree of certainty with respect to where its mortgage will rank in comparison with competing mortgages (if any). Not all interests that attach to ships are registrable (some of which will take priority over a mortgagee's rights) and, as such, a lender is unable to ascertain with absolute certainty whether a ship is free from all encumbrances.

Apart from the laws of the flag state, the lender's rights and remedies are contained in the mortgage instrument (in the case of a 'long form' mortgage) and, where appropriate, a separate deed of covenant that supplements the mortgage instrument (in the case of a 'statutory' mortgage). Whether a long form or statutory mortgage is appropriate depends on the ship's flag state. As discussed in Section IV, the lender's right to take possession of a ship can be important in the event of enforcement.

ii Assignment of insurances

The operation and navigation of a ship in international trade exposes it to perils, unlike most other asset classes. Hence, the terms of the loan agreement will impose an obligation on the borrower to maintain appropriate insurance for the ship. The type of insurance will depend on, among other factors, the type of ship, her intended use and where she will be employed.

Recourse to insurance proceeds of a ship is a key component of a secured ship financing. For instance, if the vessel has suffered damage, the lender will want to see that the insurance proceeds are applied in repairing the ship. Further, if the ship becomes a total loss, the lender will want to be able to directly apply the insurance proceeds in prepayment of the loan.

An assignment of insurances will generally also include an assignment of any requisition compensation, which is payable by a flag state to a shipowner in the (unlikely) event that the flag state appropriates title to the ship.

Pursuant to English law, there are various requirements to perfect a legal assignment.³ In the context of security documentation, of particular relevance is the requirement to give notice to the other party to the assigned rights,⁴ which, in the case of an assignment of insurances, will be the relevant insurer. In addition to the notice, a lender will usually require a letter of undertaking from the insurer in which the insurer typically undertakes to notify the lender of any material changes to the ship's coverage (for example, should coverage cease or the borrower not make premium payments), confirms that the lender's interests are noted and undertakes to pay out in accordance with the agreed loss payable clause (which notes the lender's interest).

iii Assignment of earnings and accounts security

Like other assets, commercially operated ships derive most of their value based on their capacity to generate earnings. Since ships tend to be owned by single-purpose companies, the ship's employment earnings are commonly the only way that a borrower can satisfy its loan obligations. As earnings are so important in a ship financing, it is desirable for a lender to have a degree of control over them, and this often takes the form of an assignment of earnings in favour of the lender.

³ Law of Property Act 1925, Section 136.

⁴ Should a legal assignment be defective because the notice requirement has not been satisfied, the assignment will be equitable in nature.

As part of the security package, the loan agreement will generally provide that the borrower must procure that the ship's earnings are paid into a specified account or series of accounts in its name, held with the lender, over which the lender will take security. The account will typically not be blocked unless a default has occurred but the borrower will be under an obligation to apply the ship's income in a predetermined way, possibly by distributing funds to specific blocked accounts to satisfy certain loan obligations; for example, interest payments.

iv Assignment of charters

When a ship is employed on a long-term charter (rather than being employed on the spot market), it is not unusual for the lender to require a specific assignment of that charter and the earnings under it. This is to give the lender a degree of control over the charter to be able to preserve it should the borrower fail to do so.

Just as in the context of assignments of insurances and earnings, notice is required to perfect an assignment of a charter. Although an acknowledgment is not required to ensure that the assignment is perfected, a lender often requires this from the charterer and includes a contractual obligation for the borrower to obtain this from the charterer. This acknowledgment from the charterer to the lender creates a direct contractual link between the lender and charterer and often includes additional rights in relation to the charter (for example, a right for the lender to step in and perform the charter) or obligations (for example, an obligation for the charterer to notify the lender directly of any breaches by the borrower) rather than the lender relying solely on its rights as an assignee.

The content of such notices and acknowledgements will depend on the commercial agreement between the parties and agreement with the charterer.

v Shares security

Another common requirement by lenders is security over the shares in the borrower. The typical ownership structure of a ship, in which she is owned by a single-purpose company, is advantageous here for a lender, as it effectively provides the option to take control of a ship in the capacity of shipowner in the case of an event of default, without exercising a ship mortgage. One risk of exercising share security, however, is that liabilities in connection with the ship can attach to the owner, which can inadvertently expose a lender to certain claims (for example, certain environmental liabilities).

vi Subordination undertakings from managers and charterers

As a result of the commercial operation of a ship, there are potentially numerous third parties that may have claims against the borrower, which, in the event of the borrower's insolvency, will compete with (and may rank higher than) claims of the lender. To minimise the risk of competing claims against the borrower, a lender may request that certain third parties provide undertakings that subordinate their claims to those of the lender arising under the finance documents, and only once the borrower's obligations to the lender are satisfied may those third parties commence enforcement.

Typically, these undertakings are given by charterers, ship managers (both commercial and technical managers where relevant) and other co-assureds to the ship's insurance policies. Whether subordination undertakings form part of the security package will depend on the parties involved and their respective bargaining positions.

IV DEFAULT AND ENFORCEMENT

Other than as specified in the loan agreement, a lender does not normally have a right to demand early repayment of the amounts outstanding under a term loan. Therefore, the loan agreement will specify certain events of default (i.e., events, circumstances or conditions that would give the lender the right to demand early repayment of amounts outstanding under the loan agreement).

The loan agreement may provide the borrower with the opportunity to remedy some defaults, particularly in respect of matters that are of comparatively less importance to a lender. Only with the expiry of the relevant grace period would the lender be able to exercise its rights and remedies under the loan agreement and to enforce its security.

Even so, when an event of default has occurred, in practice the lender is likely to reserve its rights in the first instance while it assesses its options. The earliest decisions the lender will have to make include whether to negotiate with the borrower or to enforce its security. What the lender will choose to do often hinges on the state of the shipping market, the nature and severity of the default, the strength and outlook of the borrower, among other things.

i Negotiation

If the lender chooses to remain in the loan, instead of enforcing its security, it has a number of options:

- a not to do anything (for example, if it expects an upturn in the market); or
- b reschedule or restructure the loan; for example, by agreeing a moratorium on the principal, extending the maturity date of the loan (and agreeing a balloon payment at the end of the maturity period), or advancing more funds to the borrower as working capital with the intention that the borrower will get back on its feet and service its debt properly again.

ii Enforcement of the ship mortgage

The lender's most valuable security is the mortgage over the ship. Therefore, although the lender has the option of appointing a receiver and the right of foreclosure, in practice the lender will commonly exercise one of the following options:

- a arrest the ship and realise its security by way of a judicial sale;
- b arrange a private sale; or
- c take possession and operate the ship.

The viability of arresting a ship depends on where the default is effected. Each jurisdiction will have its own characteristics and the lender will want to consider carefully the procedure for arrest, the efficiency of the judicial system, the procedure for a judicial sale (including how long it would take for sale proceeds to be released) and, importantly, the relative ranking of different creditors. The lender should also consider the timing of the arrest – is the ship laden with cargo, and is she currently chartered out?

A judicial sale has a number of advantages: first, the borrower will find it difficult to allege that a proper price has not been paid; and second, the buyer of the ship will obtain good title, free of maritime liens and encumbrances. However, the procedure can be costly and may take some time, depending on the jurisdiction.

However, a private sale can be a more timely and cost-effective option (relative to arrest proceedings). The lender could either request that the borrower sells the ship itself or,

depending on the jurisdiction, exercise its power of sale under the mortgage. In the case of a private sale, any maritime liens will follow the vessel and this may negatively affect the price that the lender can achieve.

Finally, the lender could simply take possession of the ship and operate it. This may be a temporary measure taken prior to selling the ship in a more favourable location, or the lender may choose to wait for an upturn in the market. Either way, however, the lender has certain obligations as a mortgagee in possession; for example, the lender becomes liable to pay the expenses incurred in the future operation of the ship (including any crew wages earned).

V RECENT DEVELOPMENTS

This new decade promises to be an eventful one as the world copes with the implications of the covid-19 pandemic and shifts in the price of oil. However, even as the world grapples with widespread disruption, the market will have to address the impending discontinuance of a number of interbank lending rates and the growth of interest in environmental, social and governance (ESG) issues.

i Discontinuance of interbank lending rates

At the time of writing, several major interbank lending rates (otherwise known as screen rates) used as benchmarks for the setting of interest rates under shipping loans are scheduled to be discontinued. Most tenors of the widely used US dollar London Interbank Offered Rates (LIBOR) will be discontinued on 30 June 2023. Although there is not yet a single settled market standard for a replacement rate (or rates), it is anticipated that, in practice, many future benchmarks will not match what LIBOR currently does (i.e., provide a forward-looking rate reflecting the cost of funds of interbank borrowing in the future) so parties will need to engage in the process of agreeing a suitable replacement.

ii ESG criteria

The general rise of impact investing has also led to the growth of interest in ESG criteria within the shipping industry, where many lenders are taking an increasingly close interest in the way borrowers' businesses are run. This in part is leading the rapid development of the kinds of environmental undertakings in loans, as well as the stringency of the undertakings. For instance, it is becoming increasingly commonplace for borrowers to undertake to ensure ships are recycled in an environmentally responsible fashion (commonly known as green recycling) and to provide lenders with data on carbon dioxide emissions that is specific to the financed vessel.

Concomitant with that has been an increasing interest in sustainability-linked pricing in loans, with lenders exploring the possibility of offering borrowers lower margins in exchange for meeting certain sustainability improvement criteria. With such attractive financial benefits now available and the opportunity of improving operations in an age where society at large, and the media in particular, are paying increasing attention to ESG standards, it is perhaps not surprising that borrowers are also adapting their business models.

It remains to be seen whether the growing interest in ESG criteria and the rise in sustainability-linked loans will mark the next stage in the evolution of ship finance. Nevertheless, we would expect both to be key factors going forward.

Appendix 1

ABOUT THE AUTHORS

GUDMUND BERNITZ

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Gudmund Bernitz is a finance lawyer with specialist experience in shipping, offshore and export financings. He acts for a range of finance providers and borrowers or sponsors on a variety of matters, including new financings, leasing transactions, restructurings, work outs and enforcements. He also advises a variety of corporates, particularly in the shipping and offshore sectors, on sale and purchase, charters, building contracts and other commercial matters.

He has spent time on a number of client secondments, including to the export finance team of a major international bank, the legal team of a specialist international asset finance bank, a geophysical services company and a leading shipping company. He regularly lectures on shipping and ship finance and has contributed to a number of publications on the subject.

According to *The Legal 500*: ‘Gudmund Bernitz provides “very clear and efficient advice” for banks and borrowers in the shipping sector.’ Gudmund is qualified as a solicitor in England and Wales and as an *advokat* in Sweden.

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Stephanie Koh is a transactional shipping lawyer with experience in commercial and yachting transactions. She has worked on a variety of asset finance, sale and purchase, and yacht construction transactions. She also has experience in trade finance.

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