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Rough Waters Ahead: Non-Performing Shipping Loans—Solutions Are Available

By SIMON G. GRIESER, FREDERICK D. HYMAN, STUART MCALPINE and JÖRG WULFKEN*

The authors explain that once a review by the European Central Bank of the quality of the collateral held by ship finance banks is completed, many banks may need to strengthen their balance sheets and offload risky assets.

INTRODUCTION

The global ship finance community is facing a number of issues given the high levels of secured shipping debt held by many banks in this community, which shipping companies are struggling to meet from operations suffering from surplus capacity and low demand. In addition to the major structural challenges faced by the industry as it seeks to recover from the crash of 2008, the European Central Bank ("ECB") now is reviewing the quality of the collateral held by ship finance banks as security for these loans. Once the ECB's review is complete, many banks may need to strengthen their balance sheets and offload risky assets.

REGULATORY ENVIRONMENT

Bank Perspective

European banks account for approximately three-quarters of the world's ship financing portfolio of approximately $475 billion, with German banks having by far the highest exposure followed by banks in Scandinavia and the United Kingdom. As a result, German banks are particularly exposed to any negative market developments in the shipping industry. Although there are signs of recovery in shipping markets, this only applies to certain sectors.

For lending banks, the onus is now on them to find creative and effective portfolio management solutions in addition to monitoring the run down of their portfolios as debt is repaid. In our opinion, we are very likely to see an increase in the volume of whole or partial shipping loan portfolio sales to bank and non-bank investors. This is very likely to be accompanied by distressed asset acquisitions by highly liquid market participants as well as trading by such investors in debt of shipping companies going through Chapter 11 (and insolvency/restructuring proceedings in other jurisdictions).

Basel III and CRD IV Burden Ship Financing

The stricter capital requirements under Basel III and the European Capital Requirements Directive IV ("CRD IV") will make the sale of shipping loan portfolios more attractive, because risky assets such as these will in future need to be backed by

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more equity capital to reflect the actual market risk. In particular, the proposed leverage ratio will limit a bank's volume of overall business, without distinguishing between assets' risk levels, thus limiting the growth potential for new business. It may therefore make sense for banks to sell long-dated loans in whole or in part in the secondary market to investors outside the banking sector.

Apart from the regulatory aspects, there are other reasons for believing that the ship finance market will evolve into something more "dislocated" than it is today. In Germany, the majority of the KG funds are in crisis, many being insolvent or under restructuring outside of formal insolvency proceedings. For the foreseeable future, tax advantages will no longer be available for shipping funds. In addition, the industry is struggling with cost challenges and there remains an imbalance between supply and demand with too many vessels chasing too few cargoes. Across all sectors of the shipping industry, the last five or six years have been unremittingly tough for many ship owners and their financiers.

The shipping industry is fragmented, the fleets of most ship owners are small and ship owners struggle to operate on a profitable basis. Rising fuel prices and additional costs due to the new emissions standards of the International Maritime Organization ("IMO") adopted in 2008, which have to be implemented gradually by 2020, also exert pressure on the shipping industry. On the other hand, foreign private equity investors and the capital markets demand new high-return investment opportunities.

Investor Perspective

Against this background, and in an effort to mitigate their problems banks have begun entering into cooperation agreements with shipping companies, private equity investors and strategic investors. In addition, we have seen some loan portfolio transfer activity even if, up to now, such activity has been modest. The current shipping industry situation is very similar to the crisis in the real estate industry last decade, which resulted in many banks selling distressed, nonperforming and non-strategic real estate loan portfolios primarily to international private equity investors.

Through joint venture solutions and the outsourcing of real estate management functions, new structures were created in the real estate finance industry. International private equity investors thus became one of the significant owners of real estate and real estate financings in Germany. This raises the question whether the shipping industry is able to benefit from the experience of the real estate industry in crisis management and the innovation of these investors; and whether similar transaction structures and techniques can be applied.

THE POTENTIAL IMPACT OF U.S. CHAPTER 11

In previous shipping market downturns, banks were free to enforce their mortgages by repossessing or arresting ships and putting them through admiralty court sales. The admiralty judicial sale is a swift and cost-effective method to extinguish trade debt and other liens attaching to a vessel, thereby transferring clean title to a buyer and maximizing the sale proceeds in the process. The sale procedure in jurisdictions such as the U.K. and Hong Kong can be accomplished in a matter of weeks.

However, such sales are certainly frustrated, and may be prevented altogether, if a ship owner files for Chapter 11 bankruptcy protection in the U.S., given that the U.S. courts seek to impose a worldwide "automatic stay" on any attempts by creditors to enforce claims against the debtor ship owning company. Faced with the possibility of secured lenders enforcing security by arresting ships and freezing access to cash and where out of court arrangements look likely to fail, distressed shipping debtors are looking to Chapter 11 as a tactical approach.

The threshold for jurisdiction in Chapter 11 cases is low, making the process available to international companies where a debtor has a domicile, place of business or property in the U.S. Over the past few years ship owners have become more comfortable with U.S. bankruptcy laws and are beginning to take greater advantage of their broad protections. For example, the ongoing cases of Taiwan Maritime Transportation and its affiliates (collectively, "TMT") saw the U.S. bankruptcy court in Houston assert jurisdiction on the basis that TMT had limited property interests in the U.S. The property in question was the Debtors' collective interests in minimal funds remaining in retainer accounts with their U.S. professionals on the filing date. Shipping companies that have little or no connection to the U.S. may be able to establish jurisdiction there by the simple expedient of remitting a fee retainer to lawyers or other professionals in the U.S.

The result is that ship finance banks whose borrowers had no prior business dealings with the U.S., and who had therefore never factored into their credit decisions the very considerable costs and delays associated with U.S. litigation, might now find themselves exposed to their borrowers' restructuring in the U.S. Moreover, enforcement of tried and tested security documents operating under recognized English law procedures will be significantly hampered by the U.S. automatic stay, notwithstanding the borrowers' negligible or non-existent nexus with the U.S.

Having attempted to recover their loans, such banks may be dismayed at being invited to lend further money by way of "debtor-in-possession financing," and the consequences of failure to do so which include loss of immediate priority. Further, existing management will continue to run the borrowers' business after the Chapter 11 filing and will generally control operations during the case.

Faced with such restructuring proceedings, ship finance banks may well choose to sell their debt so as to achieve certainty and an early exit from a distressed loan.

TRANSFER TECHNIQUES FOR SHIPPING LOAN PORTFOLIOS

Europe (Germany, U.K. (including Bermuda), Malta, Cyprus, France)

In General

Loan portfolios are often sold by assignment and assumption of contract.The majority of cross border ship finance transactions done by the larger banks will have been documented under English law. In other words, the governing loan agreements and many, if not all, of the security documents will be subject to English law and to the jurisdiction of the English courts. As is mentioned in greater detail below, the principal security under a shipping finance transaction, the ship mortgage, will be governed by the laws of the relevant ship's flag state (e.g. Liberia, Panama or

another—see below) but typically the remaining collateral or security (often comprising assignments of a ship's earnings and insurances and assignments of charterparties), as well as corporate or personal guarantees, will be governed by English law.

Under English law, there are essentially three ways for a lender to transfer a loan to a third party: novation, assignment and participation. The economic effect of all these is broadly the same—the lender disposes of its economic interest in the loan. However, the legal effect of each is slightly different.

Novation

This involves the cancellation of the loan agreement between the lender and the borrower, and the entry by a "new lender" into a loan agreement with the borrower on identical terms. All of the existing lender's rights and obligations fall away; all of them are taken up by the new lender in its new contract. In the context of the secondary syndicated loan market, novation is the most widely used form of transfer in the London market pursuant to a pre-agreed transfer certificate attached to the loan agreement which will be executed by outgoing and incoming lenders. The security trustee continues to hold the security for the benefit of the buyer and the remaining syndicate members. In other words, unless the security trustee resigns, there is no need to transfer the security. However, since this transfer method requires the borrower's consent (unless consent is otherwise provided in the loan documents) and a related transfer of the security for the loan in the case of a bilateral loan or resignation of security trustee, the use of novation, in the context of a loan portfolio transaction, is often impractical. Further novation of security may reset any hardening periods, where for a period after new security is created, that security may be challenged in the event of the security provider's subsequent insolvency and may not be attractive to a purchaser of the debt.

Assignment

This involves the transfer of a lender's rights in respect of the loan to a third party. There are various legal requirements to effect a valid assignment but the underlying loan remains intact (i.e. no new contract is created unlike in the case of novation). The assignment mechanism works quite well in relation to the transfer of most consumer receivables and mortgage portfolios since the ongoing servicing relationship of the originator or third party servicer with the borrower is maintained. Care must be taken where a loan is not fully drawn since the obligation to make the loan cannot pass to the new lender via assignment. One possible solution to this may be to link the assignment to an "assumption of obligations," although this may be subject to scrutiny with regard to the effect on priority and reviewable transactions.

Participation

A funded participation is a limited recourse arrangement between a lender and a third party. In the context of a portfolio of shipping loans, a participation structure is not likely to be a feasible alternative. An assignment and assumption technique is often described as an "asset deal." However, asset deals are often impossible or at least impractical: for example, because of assignment restrictions or the lack of cooperation

of borrowers or other parties involved. In these cases, as well as in the context of very large portfolio transfers in the German market, transactions are designed as "share deals," where loans are hived down and servicing functions frequently outsourced to independent servicers.

Share Deals

The German Transformation Act (Umwandlungsgesetz) provides legal outsourcing options by spin-off or hive-down and outsourcing without leading to a legal transfer of the loans and collateral (assets). However, the transformation also has a number of problems, such as a five-year continuing liability of the investor for obligations of the selling company, which exist on the date of transformation. However, that disadvantage can be minimized by additional effort in the structuring of a transaction.

With regard to loans and collateral, the question arises as to to what extent a transformation under German law is accepted in other jurisdictions. This issue is particularly important because investors normally seek a transfer that provides them with an insolvency-proof claim. Relating to this issue, significant experience has been acquired in the multi-billion-dollar transfers of non-performing and nonstrategic assets into the so-called German "bad banks" (Erste Abwicklungsanstalt and FMSW).

Shipping Loans Are More International Than Real Estate Loans

For shipping loan portfolios, the issue of other jurisdictions recognizing transfers is especially relevant because, as already mentioned, the financing agreements, particularly syndicated financing agreements, often are governed by English law. The governing law of the ship mortgage depends on the flag state, with Panama, Liberia, Marshall Islands, Malta, Cyprus, Singapore, Hong Kong, Bermuda and The Bahamas playing significant roles. These jurisdictions have recognized ship registers, as Germany has. To what extent non-European countries recognize a transformation under German law, is not an easy question to answer. Therefore, synthetic transfers in the form of guarantees, sub-participations or credit derivatives have been applied. What these solutions have in common is that loans are only transferred economically, the legal ownership remains between the original financing bank and the borrower.

Essentially, all transfer techniques used in real estate financing transactions could be applied to transferring shipping loans. However, the differences in the collateral structures between real estate financing and shipping loans need to be taken into account. While, in property transactions, land charges are the predominant security instruments (with mortgages playing a minor role) in ship financings the ship mortgage is the principal security document.

In the case of a portfolio sale, it is important to note that under German law, but also in most other relevant jurisdictions, ship mortgages may be enforced only by foreclosure (Zwangsvollstreckung), but not sequestration (Zwangsverwaltung). Other typical collateral in ship financings such as the assignment of insurance claims and claims arising under shipbuilding contracts, accounts pledges and assignments of charter agreements are often governed by English law and always should be assigned separately. In the financing of newbuildings, refund guarantees (Fertigstellungsgarantien) play a significant role.

For all collateral, the applicable laws need to be carefully identified in order to achieve an effective transfer. Ultimately sales of shipping loan portfolios require extensive due diligence investigation, as is also the case for real estate transactions. This experience can be used, whereby the legal and factual characteristics of shipping loans require particular industry and legal knowledge, especially outside of Germany. In an asset deal, as well as in a share deal, the transfer documentation has to reflect the specifics of ship finance as an asset class and will differ from the standardized documentation of transactions for real estate loans. In particular commercial (such as chartering and special reporting) and technical management arrangements (such as technical and vessel inspection) have to be considered.

Asia (HK and Singapore)

Hong Kong and Singapore adopt the same methods of bank debt sales customarily used in the U.K., in other words they are "asset deals." Each loan that is secured by a ship mortgage will require the seller to execute a transfer of mortgage in a prescribed form and register it in the flag state registry. The buyer becomes the mortgagee of record and the registration constitutes constructive notice to the world that priority of the ship mortgage is transferred into the name of the buyer. The remainder of the security can be transferred by the same way as in the U.K.

Americas (including Panama, Liberia and the Marshall Islands)

As far as Panama, Liberia and the Marshall Islands are concerned, their relevance to a ship finance transaction is usually limited to two aspects: flag state of the mortgaged vessel and jurisdiction in which the shipowner is incorporated. These jurisdictions do not have a prescribed form of transfer of mortgage but will require the transfer document to comply with their mortgage transfer requirements. Each jurisdiction has its own execution and notarization requirements. It is therefore advisable to pre-clear documents and arrangements with the relevant flag state in advance and allow sufficient time to arrange execution and notarization of documents. The loan agreement and the remaining security documents are rarely governed by laws of these jurisdictions and therefore may be transferred in accordance with their respective governing laws.

TRANSFER OF THE VESSEL RATHER THAN A LOAN

From an investor perspective, the outright purchase of a vessel (rather than the purchase of a loan secured by way of mortgage on the vessel) is an option to consider. Indeed, Howard Marks, group founder and chairman of Oaktree Capital Management was recently quoted as saying, "Over the last couple of years, we've invested in shipping in a number of ways, in each instance taking advantage of the opportunity to supply capital at a depressed point in the capital cycle—from purchasing new vessels, to purchasing loans secured by ships from European banks, to purchasing the distressed debt of shipping companies." If the investor takes a transfer of ownership of the vessels then this may be linked with the retention of management (commercial or technical) by the selling shipowner.

JOINT VENTURE STRUCTURES

The restructuring of shipping loan portfolios requires new restructuring platforms

outside of bank balance sheets, where problem ships can be refinanced and newly employed. Emergency sales might be prevented by such platforms enabling banks to preserve the value of their shipping loan portfolio and, if necessary devalue and build the necessary provisions over a longer period of time.

Joint ventures have been formed between ship owners and private equity investors in the shipping industry. In structuring such joint ventures, the shipping industry should again look to the experience of the real estate industry (and, of course, other industries). In a joint venture, the shipping loan portfolio is transferred to a joint venture (usually a joint venture company), where the transferring credit institution and a ship owner, and possibly other partners (private equity investors), are involved. Typically, the portfolio comes from the relevant banks by way of contribution in kind and the investor supplies equity capital by cash contribution (Bareinlage). Ship owners or outside third-party servicers are brought into joint ventures in order to contribute specific shipping industry know-how (such as charter and restructuring expertise). A joint venture opens up a variety of structuring options that permit the inclusion of other strategic investors. However, joint ventures are very often fragile structures, where a lot of experience is needed for structuring in order to minimize the risk of premature failure.

One additional problem in the context of raising fresh funding for the shipping industry from private equity and from the international capital markets is that most ship owners and charterers may be unable to take advantage of the capital markets. Therefore, the bundling of capacities and the construction of larger units is necessary. This creates a need for new, independent servicers with specific industry experience in order to provide compliance and reporting structures meeting the standards of capital markets and international investors which allow institutional investors to invest in shipping as a new asset class. Again, experience from the real estate industry may support this development without, however, repeating the mistakes that led to the outbreak of the financial crisis.

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