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Portfolio Due Diligence

Essential Exercises for Shipping Banks



Recent events have been dramatic in shipping markets. Freight and charter rates have plunged. Apart from the tanker sector, almost every other sector has been affected, especially the offshore sector and dry cargo.

So far, few loan defaults have been acted on. While accepting the temporary waivers of non-payment defaults like loan-to-value covenants, the central monetary authorities and shareholders (particularly governmental) may not allow such latitude with payment defaults. In light of this, prudence would dictate that banks should feel 100 percent comfortable with their ship security. With the exception of ship finance lawyers no one wants to look at mountains of paper, but during the quiet spring and summer months, banks are well advised to conduct a thorough review of their loan documents. Early discovery of errors and omissions can avoid problems later, and it is crucial to avoid priority being lost.

Tier 1 for Asset
Finance: Shipping
finance (Hong Kong)

- *The Legal 500 Asia
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Band 1 for Shipping
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- *Chambers Asia
Pacific (2008-2016)*

International
Shipping & Maritime
Firm of the Year

- *China Law &
Practice Awards 2015*

Ship Finance Award

- *Seatrade Maritime
Award Asia 2015*

Security Check List

There is no quick fix other than to check every single set of documents, but banks with large loan portfolios could concentrate first on customers heavily dependent upon one charterer or whose vessels are in an over-tonnaged sector.

In addition to your central bank reporting requirements, for quick and ready access from time to time, your customers can be divided into three groups. For ease of reference, these groupings can be colour coded as follows:

- Green – Performing Loans
- Amber – Warnings/Watch List
- Red – Default

● Performing Loans

The loan has been advanced and is being serviced. So far as you are aware there is no default, but are any conditions precedent (and subsequent) outstanding? Included in the bank's records should be:

- Insurance letters of undertaking from underwriters and P&I club
- Copies of current insurance policies and certificate of entry
- Satisfactory opinion from independent consultants that insurances are in order
- Charterer's consent and agreement
- Builder's/seller's consent and agreement
- Refund guarantor's consent and agreement
- Swap bank's consent and agreement
- Manager's consent and agreement
- Account bank's consent and agreement
- Process agent's letter of acceptance of appointment
- Personal security provider's letter of acceptance of risks and having received independent legal advice (or waived it)
- Proof the mortgage has been registered against the vessel in the relevant shipping registry
- Proof the security documents have been registered in the relevant companies registry (e.g. for Hong Kong, Singapore, England, etc.)

“They are excellent – professional, diligent, punctual, innovative – and they are problem solvers.”

– *Chambers Asia Pacific 2017*

“The firm is a go-to for shipping finance.”

– *Chambers Asia Pacific 2016*

“They are experts in ship finance; they are commercial and proactive to find solutions for their clients.”

– *Chambers Asia Pacific 2016*

“They are very good on client care – they always put in extra work to accommodate timelines and challenging ideas and structures.”

– *Chambers Asia Pacific 2016*

- Up to date valuation certificate from independent valuer/ship broker
- Share certificates and instruments of transfer of customer (if a charge of shares is a security document)
- Executed copy of each security document
- Opinion letters from domestic and overseas law firms
- Up to date financial statements

It is at this stage that you should immediately remedy any omissions in your security such as unserved notices of assignment, or seek specific legal advice.

● Warnings/Watch List

The customer has not missed a payment deadline but you are concerned about cash flow, or the customer’s request for covenants to be waived or amended, or the financial condition of an important revenue source such as a charterer.

- Calculate the outstanding indebtedness
- Update your checks for ● **Performing Loans** and ensure the outstanding indebtedness is fully secured
- Review your loan documents and check your rights following a Default (this is normally a defined term and means an event or occurrence that could lead to an Event of Default)
- Call for a meeting with your customer (and invite the manager to attend) to discuss the state of its finances over the next 12 months and practical issues such as the following:
 - » Is the crew being paid on time and are there unpaid invoices
 - » Are there maintenance or class-related issues
 - » Are any insurance premiums or P&I calls outstanding
 - » Is the vessel trading on the spot market and can current rates meet operating costs and debt service
 - » If the vessel is under a time charter, does the charterer have the right to quiet enjoyment, or a purchase option, and has charterhire been paid on time without deductions for offhire
 - » When is the vessel’s next major expense such as a dry-docking, special survey or repair and are there cash reserves
 - » (For a newbuilding) is the construction schedule on time and are there any concerns as to quality or supervision
 - » If there are any problems, seek a solution by drawing up a coordinated action plan, and consider ways to maximise revenue or reduce costs through re-scheduling the loan or advancing bridging funds under the mortgage or re-flagging
- Test the loan-to-value ratio of the vessel with an updated valuation
- Consider an inspection of the vessel, especially if any conditions have been imposed by the classification society

“The team takes commercial considerations into account to give us comprehensive advice.”

– *Chambers Asia Pacific 2016*

“They are very efficient and the transactions are quick and smooth.”

– *Chambers Asia Pacific 2016*

“It is a top-class firm. It has a dedicated team that is very knowledgeable on shipping finance and they understand what we need.”

– *Chambers Asia Pacific 2015*

- If there are potential challenges ahead (such as a charterer’s letter of quiet enjoyment or a second mortgage) attach a red or yellow marker as an aide-memoire for your colleagues
- If there is a trading pattern, ask your lawyers which ports might be suitable for a ship arrest in the future
- If shareholders have provided a shareholders’ loan, arrange for a subordination if not already in place
- Check if there have been changes in directors and officers, the customer’s address or contact details
- Consult with lenders (if syndicated)

● **Default**

An Event of Default has occurred, or is inevitable with the lapse of a grace period or inability to satisfy some other conditions. It is time to protect your security interest and consider whether to accelerate the loan and take enforcement steps.

- Appoint a work-out team within your bank
- Instruct your lawyers to help you draft a notice of default to your customer, the guarantor and all other security providers requiring remedial action be taken within any permitted grace period and reserving rights
- Consult lenders on whether the loan should be accelerated (if syndicated)
- Serve a demand notice once the applicable grace period for remedy has expired and the breach remains unremedied
- Retrieve your ● **Warnings/Watch List** records and consider options
- (Through the IMO number) conduct a vessel search to verify its location, or check with customer or manager on location, current schedule and cargo status
- Check on outstanding operating expenses
- Carry out vessel and writ search at port of registration
- If the trading pattern is known, carry out writ searches in major ports
- If there is a lucrative charter with time to run, consult with the charterers to ensure continued payment of charter hire subject to control of the customer (and continued availability of the vessel under the charter) being taken over by one of your other customers or a warehouse nominee or your leasing arm
- If the customer and manager are cooperative, continue to work with them but, if not, you may appoint a receiver, a new manager or consultants with expertise in ship re-possession, financial work-outs, chartering, private sale and purchase, or in admiralty law
- Notify insurers, charterers, managers and other relevant third parties of the customer’s default

- Consider whether to open a suspense account and notify insurers, charterers, managers and other relevant third parties to pay sums to the new account
- If an arrest and sale through the courts is selected, prepare to arrest the vessel in Hong Kong or other favourable jurisdictions through an overseas correspondent
- Consider enforcement of your other security

Protection and Preservation

Let our network of offices advise you on every step of the way. We have considerable experience in helping you from the time of early breaches through to restructuring your customer's debt or ultimate recovery of your loan.

Contact Us

We look forward to the opportunity of discussing your legal requirements in more detail.

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