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An uncomfortable ménage à trois

*The assignment of a charter in a ship finance transaction can be a fine balancing act of the competing interests of owner, financier and charterer. **Amy Lindemann**, Senior Associate at CJC, considers implications arising.*

Valuations versus valuable charter

Ship finance, as a subset of asset finance, traditionally differs from project finance with the lender relying, or being expected to rely on the value of the subject asset as sufficient security for repayment of its loan.

There has been some evolution and crossover in this regard especially in the financing of offshore units or LNG vessels, where the limited recourse nature of the transaction results in lenders looking to the long-term employment of the asset for further comfort and security. Lenders will seek to ensure the contracted hire payments are sufficient to service their debt.

An owner's response to proposed financing terms is likely to be market driven. In a good market where asset values are high, an owner will expect lenders to rely on a loan to value covenants and be less concerned with taking assignment of a charter or similar service contracts. If vessel values are low, an owner might argue that the requirement to meet financial covenants should be waived where the asset continues to be on hire and the lender has the benefit of the assignment of a lucrative charter.

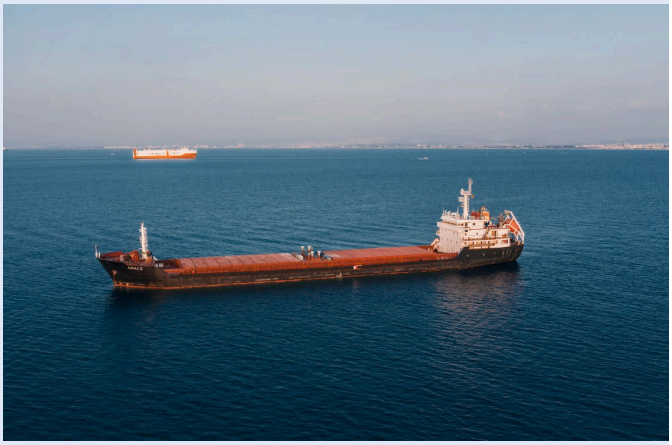
Assignment of earnings, charter or both

Typical ship finance transactions will involve a ship owner granting an assignment of the ship's "earnings" to the lender(s). The term "earnings" will be broadly defined, including not only hire under charters but also any salvage remuneration, demurrage moneys and any payments received in respect of the ship. This can be distinguished from the assignment of a specific charter which is a different beast under English law.

An assignment of earnings, without assignment of a specific charter and the associated rights that it bestows on a lender, is appropriate where a vessel is employed on short term charters and/or on the spot market. Under English law an assignment of contract is only binding on the contract counterparty, where notice of the assignment has been given to that party. Providing notice to multiple counterparties in circumstances where the charterer of a vessel is changing repeatedly throughout the life of the loan because the vessel is chartered for periods of 3 months here, 6 months there, in order to create and perfect a valid and binding legal assignment in accordance with s. 136 of the Law of Property Act 1925, is impractical.

Trying to please everyone… often pleases nobody

Parties may have agreed prior to the full legal documentation stage that the lender(s) will have the benefit of an assignment of a medium to long term charter (typically longer than 12-18 months, and in the case of offshore units and LNG carriers and storage units significantly longer). However often the specifics of the rights attaching to that assignment may not have been agreed. The lender would at least expect a right to direct the charterer to pay the lender or per its instructions following a default, but is it intended that the lender shall have full step-in rights allowing the lender to step-in to the shoes of the owner in the event of default? Must the lender be consulted in the event of, or prior to any material change to the terms of the charter? What is material? A change to the rate of charter hire only or does this extend to other provisions?



The owner will want the operational and commercial freedom and flexibility to conduct business with its customers without needing to consult the lender. In larger organisations the commercial arm of a ship owner may have little or no understanding or awareness of restrictions imposed within finance documents. Charters may have been signed long before negotiation of the loan documentation commences. Indeed the owner may only have been able to secure the financing on the back of securing long term employment for the asset (or the financing and chartering may be inextricably linked in a more project finance style arrangement). There will need to be a cohesive approach ensuring all interested parties are aware of any lender consent or notification requirements to avoid an inadvertent breach of provisions of the loan agreement or assignment deed, in relation to dealings under a charter.

Is the contract assignable? A common provision in a charter would be a prohibition on assignment of such contract without the consent of the charterer. Ideally, for owner and lender, such a provision would go on to say that such consent is not to be unreasonably withheld. In such circumstances, early engagement amongst the parties is key. Often the borrower has agreed to grant an assignment at term sheet stage but has not verified the relevant provisions of the charter.

Evidence of express consent to the assignment of the charter is often a condition to the lender(s) advancing funds. Notice of the assignment of the charter must be provided to the charterer to ensure the assignment is legally valid and binding on the charterer in the event of default by the borrower. The astute negotiator of the term sheet would resist any requirement to obtain an acknowledgement from the charterer of such notice which is often a market convention but not a legal requirement.

However, the lack of obligation to obtain the acknowledgement is not sufficient to obviate the need to obtain that consent, both because evidence of consent is required as a condition but also because proceeding to grant the assignment without having obtained such consent would be a breach of that underlying commercial contract. It is then incumbent on the owner to approach its customer to obtain the consent. Here is another source of three-way tension. Often the relationship between the owner and charterer is conducted at a commercial level. The charterer may not wish to trouble itself with matters it believes are not its concern – the owner's financing arrangement. The relevant person within the charterer company may not have a full understanding of the issue at hand and may have no authority to sign anything other than charter contracts with which he or she is familiar. The owner is usually, understandably, reluctant to push the matter with its hard-won customer, not wishing to (pun intended) rock the boat.

Banks in the meantime will be reluctant, or more likely unwilling, to advance funds without seeing evidence of the charterer's consent to assignment and comfort that it has valid security against which it agrees to lend.

Even if a charterer is willing to agree to the assignment, it may request a letter of quiet enjoyment from the lender in return to get comfort that a lender would not exercise its rights and interrupt the charterer's use of the vessel, despite the charterer not failing in any way to perform its obligations under the charter and continuing to pay hire as required.[1]

Early engagement with the relevant stakeholders is key. It is important to ensure an early dialogue, and even more importantly with the right people. It may be that a notice and request for consent needs to go through internal, time consuming, channels. For example, a central legal department, located in a jurisdiction different to the one where the commercial contact is located, may be required to approve signing of any request for consent or other related documentation. Chasing down a consent which is on the critical path to imminent drawdown is suboptimal where it could, for example, lead to a delay in delivery of a newbuild, which would please nobody.

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[1] The letter of quiet enjoyment provides the charterer with written assurance of the right it already enjoys under English law as a result of the leading case in this area The Myrto [1977] 2 Lloyd's Rep. 243, whereby a mortgagee with actual notice of a charter is prohibited from taking action which would prevent performance of the charter.

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