SHIPPING FINANCE

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Chapter 1

The Cyclical Nature of the Shipping Business

Learning Objectives

By the end of this Chapter you should understand the nature of the shipping cycle and its relevance for the shipping finance decision, appreciate the principal reasons why shipping companies fail and be able to identify the main sources of shipping finance.

Contents

1.1 The Shipping Cycle

For the investment community, the shipping industry has traditionally offered opportunities for exceptional profits, but also for high levels of losses. Most industries are subject to booms and slumps and times of great gains followed by losses incurred during downturns, but shipping is in many ways different. Shipping has long suffered, or benefited, from its defining characteristic of extreme volatility or cycles, characterised by times of plenty when freight rates move apparently ever-upwards and followed by market corrections during which rates appear to chase ever downwards, bottoming out only when the demand and supply for tonnage re-align in response to trends in the wider economy. However, if cyclicality is one of the fundamental features of the shipping business, its second feature is the extraordinary capital intensive nature of the industry. In a business in which a single vessel, for example a panamax, can cost $25 million, it is often the case that banks are unwilling to solely shoulder the risk of an entire vessel purchase or construction. Risk has to be shared with other lenders or other banks, perhaps through a syndicated loan in which each member undertakes to take up a portion of the financing, perhaps in the form of a bond issue distributed to its own investors.

During boom times borrowers often find that capital is relatively easy to obtain; exuberance grips the market, asset prices spike upwards along with share prices of the companies controlling them, and principles of cautious lending are 'eased'. Shipping company loans become a large portion of banks' loan portfolios and the riskiness of the loans is discounted in line with rising market optimism, reducing the capital provision that is set aside to provide for the possibility of default. When the inevitable downturn arrives, borrowers fail as earnings dwindle to nothing, reducing their ability to service debt repayments. Banks that have over-committed to the sector experience sharp falls in the value of loan portfolios, exacerbated by an inability to get full repayment by seizing and selling assets, ie the ships themselves, which were offered up as security for the loans.

The essential task in ship finance is to accommodate two, sometimes conflicting, objectives: those of the borrower, who is looking for certainty of loan obligation in terms of interest payments and the flexibility to take advantage of steeply rising asset values, with those of the lender, who is looking for the greatest security possible and avoidance of long term commitments from which extrication may be difficult in an industry renowned for its cyclical downturns. Shipowners criticise lenders for being too short term in their outlook in an industry in which short term peaks and troughs are the norm, for demanding excessive security and for being unwilling to share the risk. Lenders, by contrast, criticise shipping companies for not understanding either the capital adequacy requirements that lending to the industry entail or their fundamental fear of losses and potential failure.

Three principal sources of security are available to banks in any typical shipping loan transaction. First, there is the ship itself. Traditionally, banks would take this as security in the form of a ship mortgage, but with the proliferation of 'one ship' companies in the 1970s and afterwards, cross-collateralisation in the form of mortgages over vessels held in other companies that are owned by a single holding company have become usual.

During the 1960s and 70s, banks obsessed about asset quality as the principal or sole source of security, excluding consideration of the earning capacity of the vessel. Regarding these decades, Drury and Stokes'[1] observed:

> *'A great deal of the lending that took place was straight asset financing, with minimal attention to the employment position of the ship concerned'.*

Second, if the vessel to be financed is to be deployed in a long term charter or contract, the earnings from that contract may be an additional form of security. If shippers were willing and able to give long term time charter parties to shipping companies, perhaps of up to ten years' duration, the companies could in turn use this contract as a form of security in respect of a loan for ship building. The danger is that, when the time charter party comes to an end and rates need to be renegotiated, the value of this security may be significantly less if the market has entered a downturn. Third, loan guarantees may be taken from either a suitable asset-rich holding company or, if wealthy individuals own the company, from them in their personal capacity. Again, Drury and Stokes observe;

> *'Another substantial slice of the business done could be described as 'name' lending, where as long as the borrower was a leading figure in shipping….relatively few questions were asked'.*

For a lender, it is never possible to have a loan over-secured. The greater the security, the less will be suffered should the company fail and the asset realisation raise less than the value of the outstanding amount on the loan. From the borrower's perspective, loan security may be offered if the offsetting benefit is a reduction in the interest rate payable. However, this should be provided sparingly if it results in an inability to make quick asset sales to take advantage of a rising market (the lenders perhaps being reluctant to see a diminution in the value of the security underpinning the loan).

A shipping company's earnings are derived from three principal sources. First, earnings from vessel deployment in the form of freight. This may be from short term trading on the

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[1] Ship Finance: The credit crisis. Can the debt/equity balance be restored? Drury, C. and Stokes, P. A Lloyds Shipping Economist Study, 1983, at p. 25.

spot market, or from voyage or time charter parties. A voyage charter party is a contract for the hire of a vessel for a journey from point to point, the owner providing the crew, Master, bunkers and other necessities and, to all intents and purposes, remaining in control of the vessel. The time charter party, by contrast, is a contract for the hire of a vessel for a pre-agreed period of time, the longer the contractual commitment the greater its worth as a form of security. Although the owner remains in control of the vessel's management, the charterer assumes responsibility for its deployment and may, in turn, sub-charter it on a voyage or time charter, subject to restrictions that may exist in the head charter.

1.2 The Shipping Cycle and its Implications for the Loan Finance Decision

Martin Stopford (in his book 'Shipping Economics', Routledge: 1997), identified four stages in the shipping cycle with components that are distinct but overlapping. First, there is the 'prosperity' stage. At this time freight rates are rising steeply, responding to optimism and increasing levels of trade in the wider economy. It is important to note the importance of lags at this time. Although the wider economy may have reached its zenith in terms of a boom and is commencing its decline from the peak, a time lag exists where the shipping cycle's trajectory is 'out of synch' with this new period of adjustment. During this time of market exuberance, shippers are willing to commit themselves to long term charter parties to lock in rates. Orders for new buildings are placed with shipyards and, because of the delay in construction and delivery, existing tonnage is no longer scrapped or laid up as owners increasingly 'sweat the assets' or work vessels to their full capacity without having time to break for routine maintenance. The value of secondhand tonnage also increases as shipowners make purchases to try to capitalise on the increased level of demand. At this time, banks have a tendency to be caught up in the market fervour, loosening lending criteria and abandoning, in part, the basic principles of prudent lending. Taking security becomes almost a secondary consideration, particularly if long term charter parties are available.

In the second stage of the cycle, 'recession', the consequences of over-investment begin to appear. New tonnage is delivered into a market precisely at the time when the wider economy is well into a downturn. Shippers become less willing to commit to long term charter parties, preferring instead to take advantage of the declining freight rates in the spot market. As new tonnage is delivered into a declining market, shipowners compete with each other to chase declining fixtures, prepared to accept much lower freight rates than was anticipated when the order for the new building was placed. Freight rates and asset values begin to spiral downwards as shippers hold back in anticipation of a bottoming out of the market.

In the third phase of the cycle, 'depression', the bottom of the market is reached. This stage is accompanied by a frenzy of scrapping of old tonnage and a laying up of new buildings, often brought into the market at a time when no fixtures are available. The spot market booms as shippers take advantage of ever decreasing freight rates. In the wider economy, in response to rising levels of unemployment, governments tend to provide shipyard credits at this time to secure new building contracts, exacerbating the downturn in the freight markets as a consequence. The problem of overcapacity and its exaggeration by over-generous government funding for shipbuilding to protect shipyard employment is perhaps best illustrated by Shikumi-Sen finance provided by the Japanese government during the late 1970s. This policy represented a coordinated approach between the Japanese government, the Japanese banks and the 'Big Six' Japanese shipping companies. The policy comprised the provision of exceptionally low interest rate loans, repayable over an extended period, including several years of no repayment at all. The owner was not required to contribute equity and its interest payments were subsidised by the government.

As scrapping of old tonnage continues apace and lay-ups of vessels persists, demand and supply eventually realign and the market moves into a new state of equilibrium. As freight rates begin to recover, coinciding with improved economic activity in the wider economy, a shortage of tonnage develops, caused in part by the overreaction of shipowners in scrapping tonnage during the recession stage. The new boom commences and a new prosperity stage of the cycle begins.

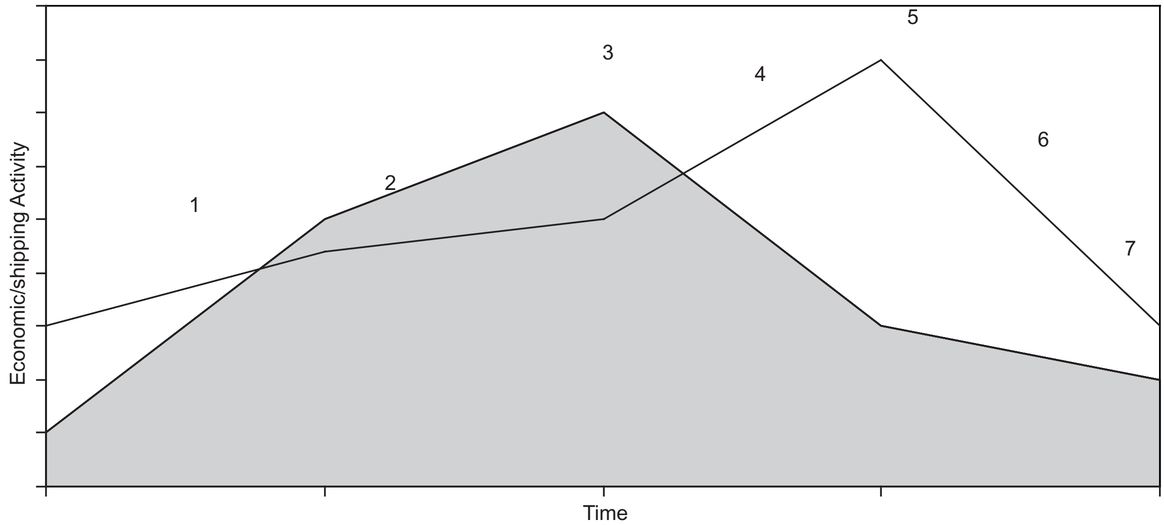


Figure 1 The shipping cycle

Figure 1 shows the interaction between the shipping cycle (the single line) and the wider economy (the shaded section). At Point 1 both the wider economy and the shipping cycle are moving in an upward direction as both recover from a previous depression. By Point 2 orders for newbuilds are being placed with shipyards as demand for tonnage starts to outpace supply. As optimism takes hold in both markets, S&P activity increases, and as the markets move upwards towards Point 3, newbuilds start to be delivered. At Point 3 the wider economic cycle has reached its zenith or peak; activity is at its highest point and the economy starts to manifest symptoms of 'overheating'. As the wider economy starts to slow, at Point 4 newbuilds continue to be delivered, the shipping cycle lagging behind the commencement of the wider downturn. At Point 5 the shipping cycle has reached its peak, but this is 'out of synch' with the wider economy. The downturn in the wider economy results in a diminution in the demand for tonnage precisely at a time when supply has become inflated. At Point 6 the shipping cycle moves into step with the wider economy, both now on a downward trajectory. By Point 7 the shipping cycle has passed through the recession and now languishes in a depression or nadir. Of course the diagram is simplistic in several respects but the lagging effect between the shipping cycle and the wider economic cycle and the delivery of new tonnage into a collapsing market are widely recognised phenomena. Zenith and nadir are characteristic points in the shipping cycle: the trick for the shipowner is recognising when the cycle is in a process of transition from one phase into another. This is often more a matter of intuition-'sensing the direction of the wind'- than usage of complex software or simulation models constructed on the basis of the perfect wisdom of hindsight.

Michael Hampton has observed two cycles, a short and long cycle, in the shipping industry (Seatrade, January 1986. Analysis: shipping cycles I, Hampton, M. at p. 19). The short cycle is characterised by improvement in the wider economy coinciding with a depressed shipping market. This is a manifestation of the lag between both markets. As demand for tonnage rises the earnings of shipowners also improve, giving them the confidence and optimism to make purchases in the S&P market as well as placing orders for newbuilds. Order books increase until freight rates plateau. As economic growth begins to slow, so freight rates start to decline, precisely at a time when newbuilds start to be delivered. This additional tonnage depresses rates further, eventually leading to a lay-up and demolition of ships.

Hampton estimates that the short cycle usually runs for 3-4 years from trough to trough. Regarding the long cycle, Hampton suggests that this runs concurrently with the short cycle, with a build-up phase and a correction phase of 20 years' duration in total. The build-up phase has three regular cycles of three to four year's duration, each rising to a successively higher peak, while the correction phase is approximately 8 years' duration, but with less clearly identifiable cyclical points due to the impact of minor rallies founded upon a market psychology of 'wishful thinking', rather than a rational consideration of asset values and freight rate realities.

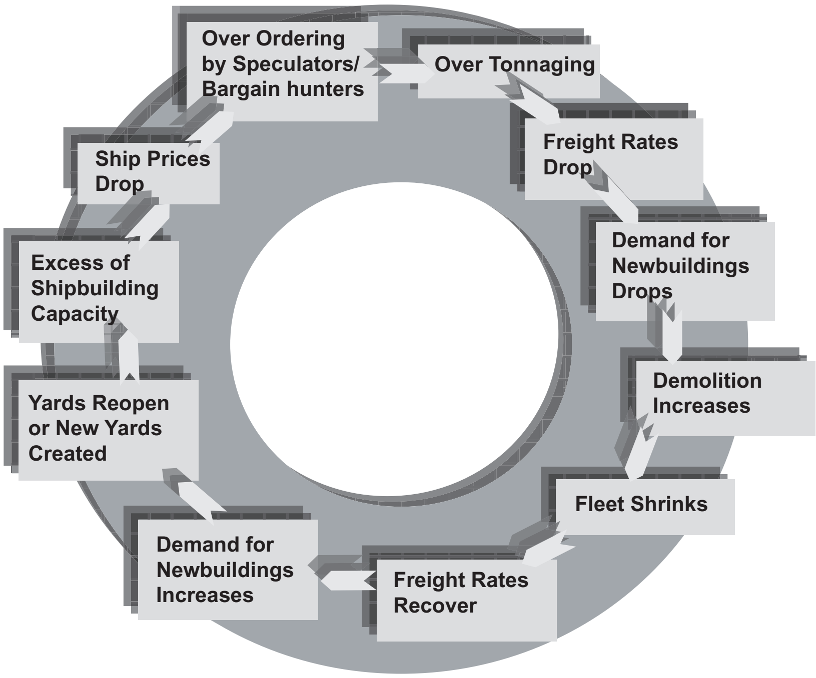
1.3 Misreading the Cycle: Shipping Company Failures

In the best case scenario for a bank, loan default on the part of a shipping company borrower can be addressed through a 'workout', in which borrower and lender renegotiate the terms of the loan and reach a compromise where the company remains in existence but perhaps defers its payment obligations for a better day when its freight receipts (and the value of its assets) are in better shape. However, if such a compromise cannot be reached, or if the borrower's condition is so hopeless that further trading or survival is a practical impossibility, foreclosure remains the only alternative option. The main action of foreclosure is the sale of the company's assets for the best prices possible. This may be less than desirable from the bank's perspective or the shareholders in the company given that in most cases this will be undertaken in a depressed market in which the 'buyer is king', and so can dictate the sale price. The history of ship finance is littered with banks that have suffered enormous losses on their shipping loan portfolios or, even worse, have been destroyed by the collapse of the company to which loans have been made.

Commenting on the shipping depression of the 1980s, Martin Stopford identified the following consequences of the 'easy credit' policies that had been pursued by the banks in the preceding years:

> *During the years 1983 to 1987, borrowers defaulted on US$10 billion of shipping loans.*
>
> *The amounts written off by commercial banks and leasing companies, because of defaults by shipping companies during this period, were between US$3 billion and US$4 billion.*
>
> *Three Japanese banks wrote off US$700 million of loans to a single shipping company.*
>
> *Several ship financing financial institutions withdrew from the sector completely.*

Figure 2 illustrates the basic features of the newbuilding-scrapping cycle in the global shipping business.



Source: DVB Bank, 2005

Figure 2 The newbuilding-scrapping cycle

1.3.1 Tidal Marine

In 1972, the shipping company 'Tidal Marine' failed. Drury and Stokes identified the causes as failure on the part of the banks to check the adequacy of the loan security, naivety and inexperience on the part of the lenders, and fraud on the part of the borrowers. Over-borrowing on the part of the company was also a significant factor. Drury and Stokes commented:

> *'Taking the true worth of the ships, however, and the actual charter position, Tidal's gearing was impossible to sustain.'*

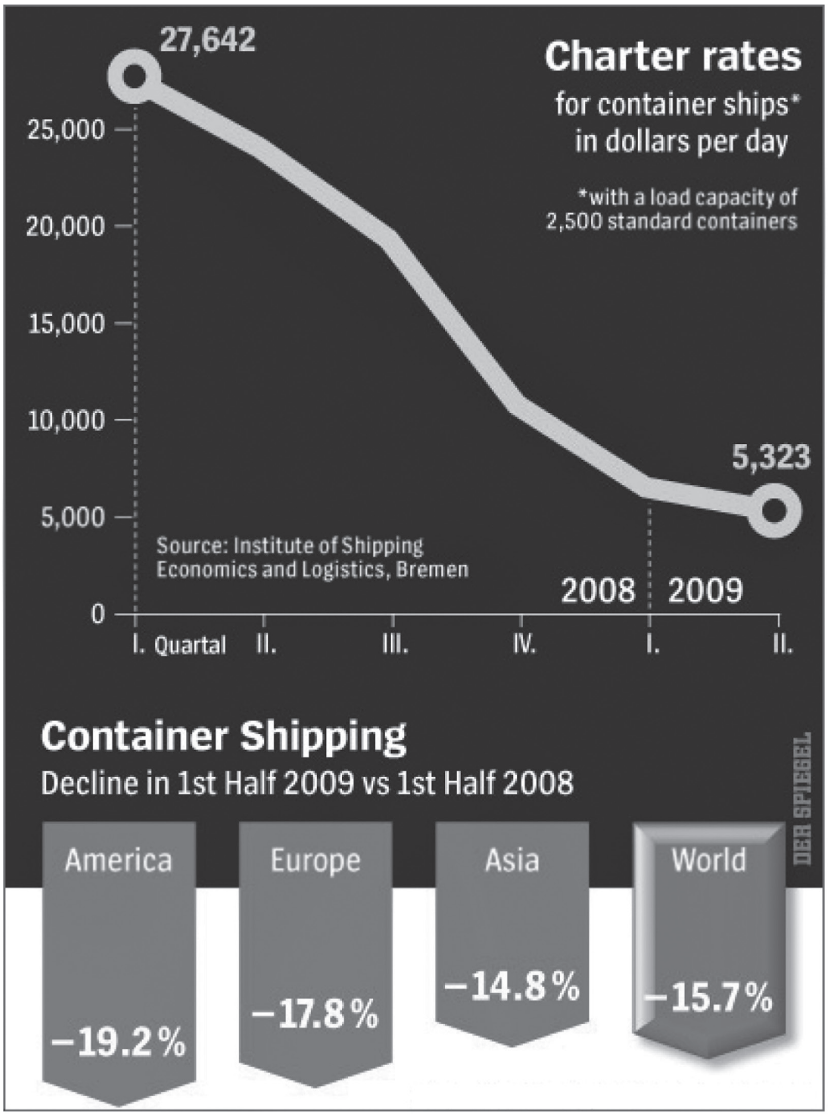
The company's failure illustrated the consequences of taking on too much debt. During a market downturn, freight receipts dwindle, making continued servicing of interest payment obligations impossible. Failure on the part of the lenders to appreciate the implications for the ability to pay, and of the cyclicality of the shipping industry, resulted in a failure to correctly evaluate the fluctuating nature of the value of the underlying security, the ships themselves. Excessive debt is referred to as 'gearing', and Tidal Marine's demise was in large part a consequence of taking on too much debt, the interest payments on which could not be serviced during a cyclical downturn in the industry.

1.3.2 Atlas Shipping

In December 2008, Danish dry bulk operator 'Atlas Shipping' filed for bankruptcy. Quoted in Lloyd's List December 18th 2008, the company's founder and chief executive, Bo Kristensen, said:

> *"It is extremely unfortunate that due to the historic drop in freight rates... the group will not be able to fulfill all its financial obligations as they fall due".*

Atlas's bankruptcy was principally a consequence of having a debt structure that could not be supported during a time of exceptionally depressed freight rates. It could also be said that any company, faced with a sustained decline in its earnings, will inevitably fail as it becomes unable to meet its debt obligations. However, innovation in the structuring of financing can at least defer this until such time as earnings and freight rates return to profitability. Figure 3 illustrates the sharply volatile nature of earnings during a typical cycle.



Source: ISL Monthly Container Port Monitor

Figure 3 The volatile nature of earnings during the shipping cycle

1.3.3 BCCI

In 1991, the 'Bank of Credit and Commerce International' (BCCI), was finally forced to close by regulators. The scandal that followed showed how the board and management had been involved in crime on an unprecedented scale, resulting in the bank's insolvency several years before the final closure was called by the Bank of England. One of the principal causes of the bank's collapse was its over-exposure to the shipping sector. Significant among these was a series of loans made to a collection of Europe-based shipping companies, known as the Gulf Group, the assets of which were controlled by a Luxembourg-based holding company, Gulf International Holdings. By the time of the bank's closure the Group was its principal debtor, owing an estimated amount of US$700 million, a sum hopelessly unprovided for in the bank's capital base. The bank itself was insolvent to the amount of US$5 billion. With such an enormous exposure to the international shipping industry, it was perhaps inevitable that BCCI would face insurmountable funding problems if its principal borrower, the Gulf Group, became unable to trade its vessels at profitable rates. The relationship between BCCI and the owners of Gulf, the Gokal Brothers, remains unclear to this day, but the capital intensive nature of shipping, combined with the bank's undercapitalisation and inability to borrow in the interbank markets, provide a perfect example of the risks that banks undertake when their loan portfolios are so heavily committed to the sector.

1.3.4 Eastwind Maritime

In the summer of 2009, the New York-based carrier 'Eastwind Maritime' filed for bankruptcy. The company was no longer able to meet its obligations on US$300 million of debt on its 55 ships, a significant part of its loans coming from weakly capitalised small banks. Aozora Bank, a Japanese bank, was to find that, as a consequence of the collapse in freight rates and the concomitant fall in asset values, the value of the 12 Eastwind ships, which it now controlled after the filing of the bankruptcy petition, substantially underpaid its outstanding loan of US$77 million loan to the company. This was a perfect example of negative equity where the outstanding loan value significantly exceeds the available asset value. Other banks caught up in the company's demise included, according to the New York Times of November 11th 2009, the UK-based Bank of Scotland and the Sweden-based Nordea Bank. The difficulties faced by these lenders appear to have originated in loan decisions made at a different phase of the shipping cycle, when freight rates were booming and vessel values were spiking upward in their wake. With a collapse of 45% in freight rates for container ships it was inevitable that vessel values would also crash, leaving many of Eastwind's creditors in negative equity territory but unable to realise their security by selling the vessels into markets where prices were below those which had prevailed when the initial loan decisions had been made. The Times article also points to a US$350 billion portfolio of dubious shipping industry loans presently held by European banks.

1.4 The Main Sources of Shipping Finance

Figure 4 illustrates the main sources of finance for the shipping industry. As will be discussed in detail in later chapters, different sources are easier or more difficult to access at different points in the shipping cycle. The 'mix' between sources, for example the balance between debt (on which interest payments are mandatory) and equity (on which the payment of dividends is discretionary), will be determined both by the condition of the market(s) in which the borrower operates its vessels and the financial fundamentals of the borrower itself. The mix is not and cannot be static; it has to be adjusted on an ongoing basis to take account of the changing trading environment and the cost of funding. For example, during periods of boom equity investors are often carried away with the moment and the excitement of a rising market, so equity-based funding instruments are relatively easy to place. However, during periods of slump investors can shy away from shipping equity, leaving capital-needy shipowners with few options, principal amongst which are disposal of assets (rarely a good idea when the second hand market is in the doldrums), or borrowing, possibly at higher rates of interest reflective of lenders' concerns about risk. These are simplistic observations but the basic premise holds true; shipowners must largely structure their capital base in line with the highly cyclical environment in which they conduct their business. To make the situation even worse, it is often the case that getting the debt-equity structure right, adjusting it to take account of anticipated cyclical movements, is more often than not a matter of instinct rather than taught skills.

Form of Finance	Principal Features	Types
EQUITY	[Usually] voting rights	Ordinary
	Rights to information concerning the investee company	Partly paid
	[As a general rule] last group to be paid on insolvency of the company, but right to participate in any surplus	Cumulative [priority to dividend payments]
	Right to remove the board [subject to provisions in the company's articles]	Convertible [the right to convert the investment into ordinary shares]
	No right to petition for administration or liquidation of the company if no distribution from profits made.	Participating [the right to a guaranteed dividend plus an additional profits-related dividend, if declared]
DEBT	Right to payment of interest	Senior debt
	Right to petition for administration or liquidation of the investee company following non-payment of interest	Junior debt
	Higher right to repayment over equity upon insolvency of company	Many forms of bonds with different interest rate and currency payments schedules
	No voting rights or right to participate in management of the company	Mezzanine finance [with both debt and equity features]
LEASE	Finance Lease	Terms of the lease will determine purchase rights on termination, and burden of cost of upkeep and maintenance of leased asset
	Operating lease	
	Ijara [Islamic lease]	

Figure 4 Sources of shipping finance

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Cycles
- risk
- earnings
- failures
- sources
- debt
- equity.

1.5 Test Questions

Having completed Chapter 1, attempt the following questions and submit your answers to your Tutor.

1. Discuss the factors that create volatility in the shipping cycle, with particular reference to the following sectors:

   The Sale and Purchase market

   The international grain markets

   The ores and coal markets.

2. You are the Chief Financial Officer of a shipping company principally engaged in the transportation of coal and ores. The company has a large fleet but several of the vessels are old and lacking in effective modern gear. In contrast, several vessels possessing the latest technical facilities and excellent fuel efficiency have been recently acquired. You are asked to write a briefing note to the Chief Executive Officer describing how an anticipated downturn in the world economy will impact upon all aspects of the company's business, and what strategies may be followed to accommodate or even take advantage of this phase of the economic cycle and the upturn that will eventually follow.

Chapter 2

The Lender's Perspective

Learning Objectives

By the end of this Chapter you should understand the basic principles of prudent lending in the shipping sector, have a practical understanding of the basic forms of security available in respect of a shipping loan, understand the legal rights, obligations, and priorities in terms of repayment in shipping mortgages and appreciate the importance of effecting assignments of insurances and earnings as security for a loan.

Contents

2.1 Basic Principles of Good Lending

In 1921, an American banker, writing a textbook for banking students, wrote of the importance of the '3 Cs' in the lending decision. These elements were Character, Capacity, and Capital.[2]

In lending to shipping companies, these three items retain their significance. Banks will routinely look to the character of the owners of a company, particularly if it is privately owned, and in this context the importance of 'lending to the name' in the shipping business cannot be overstated. Specifically, if the borrower has a good reputation in the industry, has not previously defaulted on loans and will, as far as possible, put the interests of their creditors before their own when the company experiences difficulties, then this will be a factor in favour of the making of a loan. It was largely on the basis of name and reputation that some of the early shipping dynasties, such as those of Onassis and Niarkos, were founded. If the loan is to be made to a company rather than to a private individual the same

[2] Kniffin, W.H. (1921). American banking practice-A treatise on the practical operation of a bank, intended for students, bank employees and others who would know of the conduct of a bank under recognised American practice, with which is combined the negotiable instruments law, uniform in forty-six States. New York: McGraw-Hill Book Company Inc.

principles apply, although issues of corporate governance, including board structure, the presence of non-executive directors at board level and the involvement of stakeholders in internal decision-making processes, will be a wider factor. The borrower/banker personal relationship based upon trust remains one of the defining characteristics of the shipping business today, possibly more so than in other industries because of the uniquely capital intensive nature of the business.

‘Capacity’ is the borrower’s ability to service the loan, meet regular interest repayment schedules and pay off principal either during the loan or at its conclusion. Factors taken into account in this context will include whether the borrower has the benefit of a long term time charter party, preferably with a government entity as was the case in Shikumi Sen financing provided by the Japanese government to its domestic shipping sector during the 1960s and 70s. The borrower’s ability to generate cash will also be an important consideration, whether it has vessels available to exploit volatilities in the spot market for example. A further factor will be the nature of the sector in which the borrower’s vessels are deployed. Are they affected by seasonality factors, such as harvests, and the transportation of dry commodities, such as grain, at particular times of the year? Are they dependent upon wet commodities such as oil, the demand for which is affected by the state of the wider economy? Or is the vessel dependent upon specialist trade, such as the transportation of large equipment fixed in the spot market, which is even more dependent upon demand and activity in the wider economy?

Capital relates to the company’s underlying assets and the stability of their value. A bank will usually take a mortgage over vessels when making a loan to a shipping company, giving it the power to seize and then sell the assets covered in the event of default on the loan by the borrower. However, it is usually the case that vessel values ‘chase’ shifts in freight rates. If these are declining, vessel prices in the S&P market will also follow, leaving the lender with a security of less value than was the case when the original loan was made. To provide for this eventuality lenders will often take a range of securities for the loan.

2.2 Sources of Security for Loans

2.2.1 Ship Mortgages

In its basic form, a ship mortgage is a charge by way of lien over a vessel, given to secure a loan. According to the UK Merchant Shipping Act 1988. Schedule 1, Paragraph 21,

> *“a registered ship, or a share in any such ship, may be made a security for the repayment of a loan or the discharge of any other obligation; and on production of the instrument creating any such security (referred to in this Act as a mortgage), the registrar of the ship’s port of registry shall record it in the register.”*

A typical mortgage, together with covenants on behalf of the borrower is set out in Appendix 1, kindly provided by Holman Fenwick Willan LLP, London. Registration of the mortgage is essential if the lender is to obtain priority over other lenders in the event of the borrower becoming insolvent. Registration confers a mortgagee higher priority over the following:

(a) Earlier unregistered mortgages, irrespective of knowledge of them

(b) later registered or unregistered mortgages

(c) additional advances subsequently made under a prior registered mortgage where under the agreement was that mortgage should cover present and future advances by the mortgagee.

However, a mortgagee does not have priority over the following:

(a) Any mortgage registered earlier

(b) any claims in connection with which the vessel had already been arrested at the time when the mortgage was entered into

(c) any possessory lien of a ship repairer

(d) maritime liens, whether earlier or later.

A typical registration form for a mortgage to be registered in the Bahamas is shown in Appendix 2, kindly provided by Holman Fenwick Willan LLP, London.

From the lender's perspective, although the mortgage provides a degree of security in respect of a loan, it is subject to several weaknesses. First, it is subject to earlier registrations that take priority, registration being deemed notice even if the later lender has no knowledge of it. Second, unlike other forms of security that may be the subject of a mortgage such as a building or factory, the very subject matter here, the ship, may simply disappear over the horizon, leaving the lender with the burden of trying to ascertain its new position and then determining whether the new jurisdiction in which the vessel is located recognises a court order made for the arrest of the vessel to which the mortgage relates. This can be time-consuming and a potentially fruitless endeavour. Third, the ship itself may be damaged at sea or may even sink, leaving the lender with potentially costly litigation to determine rights in the wreck or rights against a holding company that may be located in a different jurisdiction, where mortgage rights are not recognised or provide only limited priority.

Sometimes security will be provided in the form of a charge over vessels that are not yet in existence, or 'newbuildings'. In the event of default by the borrower, it will be the lender who will take delivery of the ships, as and when they are completed.

2.2.2 Legal Rights of Mortgage Holders

The following case illustrates the legal rights and duties arising under a typical ship mortgage. (Case facts reported on the website of DMC Casenotes at http://www.onlinedmc.co.uk/den_norske_bank_v__acemex.htm. Case note contributed by Ann Moore, Law Correspondent for Fairplay International Shipping Weekly).

Den Norske Bank ASA v. Acemex Management Co. Ltd (The Tropical Reefer), English Commercial Court, [2003] EWHC 326, 26th February 2003.

In December 1997, under a Loan Facility Agreement with three companies, Den Norske Bank agreed a loan of US$6m to purchase three vessels, '*Tropical Reefer', 'Blue Reefer'* and *'Sky Reefer'.* Security included mortgages on the three vessels, and a guarantee and indemnity provided by Acemex Management. The loan facility and guarantee agreements were subject to English law. The ship mortgages were governed by the law of Cyprus, where the vessels were registered.

By July 2001 the Bank was owed more than US$2m in unpaid instalments, plus interest. The three vessels had other substantial debts, and '*Spring Reefer'* and '*Blue Reefer'* were to be sold for scrap. Den Norske rejected proposals for renegotiation of the loan, or offers of partial payment, and arrested the '*Tropical Reefer'* in Panama, to realise its security under the mortgage. At the time of her arrest, the vessel was laden with a cargo of bananas, for discharge in Germany. The respondent claimed that if the vessel had been allowed to proceed to Germany without delay, before arrest, the proceeds of the subsequent Admiralty

sale would have been enough to discharge the outstanding debt. As it was, the bananas deteriorated while the '*Tropical Reefer*' was under arrest and had to be jettisoned off Panama at a cost of US$204,140. This was deducted from the sale proceeds as part of the cost of the arrest.

Den Norske asked the Commercial Court for summary judgment for US$815,277.09, the balance remaining after various repayments. The respondents argued that the Bank owed them a duty of care as to how it exercised its right of arrest, and having done so, it owed a further duty as to deciding whether or not to release the vessel. It was in breach of this duty in refusing to take steps to maximise the vessel's sale price. The Bank said no such duty existed.

Judgment

The judge followed Lord Templeman's *dicta* in *China & South Sea Bank v Tan Soon Gin* [1990] 1 AC 536, as amplified in the Privy Council case of *Downsview Nominees v First City Corporation* [1993] 3 AER 626. Lord Templeman said the courts had evolved basic equitable principles for the enforcement of mortgages and the protection of borrowers. From these flowed two rules, that

> ***"powers conferred on a mortgagee must be exercised in good faith for the purpose of obtaining repayment,"***

and that these powers may be exercised even if

> ***"the consequences may be disadvantageous to the borrower."***

Lord Templeman said the general duty of care allegedly owed by a mortgagee to the mortgagor under the common law of negligence, was inconsistent with the rights and duties arising from these equitable principles.

> ***"If a mortgagee exercises his power of sale in good faith for the purpose of protecting his security, he is not liable to the mortgagor even though he might have obtained a higher price and even though the terms might be regarded as disadvantageous to the mortgagor."***

The judge in the present case said a ship mortgagee's power of arrest was the necessary first step to enforcing his security by having the vessel sold by an Admiralty Court, and must be distinguished from the power of sale expressly granted by the terms of a mortgage. An Admiralty Court sale meant the value of the security was enhanced as the vessel was sold free of encumbrances.

A ship mortgagee would only be expected to release the vessel from arrest if he were offered security of equal value for paying off the loan.

> ***"He does not owe the mortgagor a general duty in negligence or in equity to take reasonable care in dealing with the ship... So long as the mortgagee acts in good faith for the purpose of obtaining repayment ... he can arrest the vessel notwithstanding such action might harm the interests of the mortgagor."***

The judge dismissed the respondent's argument that such a duty of care existed where re-arrest in another jurisdiction would enhance the proceeds of sale, as this would be inconsistent with Lord Templeman's analysis of the duties of a mortgagee.

The respondents had also argued that summary judgment was inappropriate because a court could not be sure that the respondent had no real prospect of establishing at trial the existence of the duty claimed. That decision would depend on the facts and circumstances of the individual case, which could not be known before trial; in addition, the authorities recognised that there were circumstances where the mortgagee had to have regard to the fact that a short delay in selling might result in a higher price.

The judge held, however, that the precedents cited (*Medforth v Blake* [2000] Ch 86; *Standard Chartered Bank* v *Walker* [1982] 1 WLR 1410; *Meftah v Lloyd's Bank* [2001] 2 AER (Comm) 741) did not establish that, in analogous circumstances, a mortgagee had any duty beyond that of good faith in arresting a vessel for debt.

The judge concluded, therefore, that the claimant owed the respondent no duty of care in law, either in the timing of the arrest or in deciding whether to release the vessel at Panama. Even if there was a duty of care, the communications between the claimant and the borrowers before the arrest showed the action was reasonable. It followed that the respondents had no real prospect of establishing at trial that the duty had been breached.

2.2.3 Ship Mortgage Indemnity

A recent innovation in ship mortgages is the ship mortgage indemnity (SMI). This provides additional insurance for the 'gap' between what the lender is willing to provide and the amount that the borrower requires. In this way, the shortfall is covered and the difference that would otherwise have been a 'deal breaker' is overcome. The indemnity does not provide additional or shortfall funds in respect of the initial loan, but instead covers the lender in the event of the borrower defaulting on the entire loan. There have been several weaknesses associated with SMI, amongst which is the reality that the indemnity is only as good or as strong as the insurance company providing it. There have been instances when the provider, the underwriter, has failed, leaving the lender with a higher degree or risk on the original loan than was acceptable given internal constraints such as lending policy criteria that prevented the entire loan from having been made in the first place. Take-up of SMI policies has been extremely patchy and, as a consequence, both lenders and underwriters have very limited experience in dealing with claims. In other words, the instrument has very limited track record although legal documentation has now reached a level of acceptable standardisation. The withdrawal of several major international underwriters from provision of the instrument did not help, increasing its cost as a consequence. The suffering of a loss by the lender is an essential prerequisite to activating rights under the policy, and first the lender must issue the borrower with a 'Letter of Demand' that is not satisfied. The policy will then indemnify the lender in respect of the 'Net Ascertained Loss', defined as the outstanding balance due to the insured, the lender, inclusive of principal and interest and the lender's reasonable external costs (such as litigation and vessel sale costs), after crediting the net proceeds of the disposal of the vessel covered by the mortgage, realisation of any additional collateral security, and any net income and the conclusion of any claim against the borrower and guarantors.

The main conditions of the policy are:

i. The lender must do all things reasonably practicable to avoid or diminish a loss to the underwriter, for example, by initiating legal action where appropriate (such as applying for the arrest of a vessel covered by the mortgage)

ii. The vessel must be returned in class

iii. After paying the lender, the insured, the underwriter has subrogation rights (can 'step into the shoes' of the insured in respect of right to pursue legal action against the borrower. The insured must lend its name to such an action)

iv. The policy is non-cancellable by the underwriter

v. Premiums are fully earned and non-reclaimable by the insured following cancellation of the policy by the insured

vi. False or fraudulent claims by the insured render the policy void, with premiums paid to date non-refundable.

2.2.4 Assignment of all Insurances

One of the principal risks faced by the lender to the shipping company is that the main source of security for the loan, the vessel itself, may be damaged or lost. To protect against this eventuality it is usual for the lender to require full assignment of the benefit of all insurances, including hull and protection and indemnity insurance, from the borrower so that should the worst case scenario materialise, the lender will receive payment from the insurance company of the full amount of the sum insured. Since the lender has a tangible and real risk in the borrower's enterprise he will have an insurable interest within the strict definition of the term, as laid down in the Marine Insurance Act 1906, section 1. Assignment of the benefit of an insurance policy is also permissible, although the lender will ensure that the underwriter is notified of the fact of the assignment and the borrower is a party to the assignment. If the shipowner does not yet have insurance, obtaining this may be made a condition precedent (a requirement that has to be met) to the making of the loan.

2.2.5 Assignment of all Earnings: The Charter Party as Security

In the main, two forms of charter party will be of interest to the lender as security. The charter party represents the earning capacity of the vessel and, as such, is a useful addition to the mortgage of the vessel since it may be the case that the lender, not wanting to force a sale of the vessel in a depressed market in which the price achieved is less than the amount outstanding on the loan (negative equity), instead prefers that the vessel remain trading to at least generate some income from which debt can be serviced, even if in part, pending recovery of the market and a strengthening of price.

The time charter party is the preferred form of security since it represents a continuous cashflow and the shipowner remains in management of the vessel, albeit at the instruction of the time charterer. In this arrangement the charterer will be notified of the assignment of earnings from the borrower to the lender, and will then be obligated to make further payment to the order of the lender, for example, into a bank account controlled by the lender. Once payment has been made the lender will take sufficient to meet the schedule of payments under the loan, and will pay to the borrower any amount over and above this sum.

An illustration of a typical general assignment of insurances and earnings is provided in Appendix 3, kindly provided by Holman Fenwick Willan LLP, London.

2.2.6 Consecutive Voyage Charter Parties

A voyage charter party is a contract to transport goods from one geographical point to another. It represents a significantly weaker form of security than a time charter party as it does not represent a stable or predictable cashflow. Charter parties are often undertaken by shipowners deploying vessels on the spot market. However, from the lender's perspective there may be value to a security in such an arrangement if there is a series of agreements to transport goods, or there is a consecutive voyage charter party. In this case, future earnings are relatively easy to predict, the cashflow being a further source of security in respect of the loan. To cover for times when the vessel is laid up for whatever reason, perhaps for repairs or frustration of a voyage, the shipowner will usually take out 'off-hire' insurance cover. If the vessel's earnings are interrupted in this way, the insurance policy should ensure sufficient funding to enable interest payments on the loan to continue to be met. Similarly, both the shipowner and lender will be concerned to avoid an increase in the vessel's costs, perhaps because of port dues, crewing costs, bunkers, which impacts upon cashflow and reduces the ability to continue interest payments. To ensure that such costs are passed on to the charterer it is usual for the shipowner to include an escalation clause in the charter party.

2.2.7 Bareboat Charter Party

In this charter party the charterer assumes responsibility for the management of the vessel hired, and meets all costs such as bunkers, crew, and port dues. Unlike a time charter party, the charterer takes delivery of the vessel and then trades it on his own account. By contrast, in a time charter party the shipowner remains in possession of the vessel, undertakes responsibility for all costs, but deploys the vessel as per the charterer's instructions. The period of hire provides a cashflow that can be assigned to the lender in the same way as under a time charter party.

2.2.8 Charge or Lien Over Shares

A lender may take a charge over the shares of the shipping company borrower directly or, alternatively, over shares that it holds in another company, perhaps a subsidiary with its own assets (this is particularly appropriate in the context of a network of one-ship companies, all the shares of which are held by a holding company). The charge may be a legal or, alternatively, an equitable assignment of the shares. For a legal assignment the lender will take possession of the share certificates, which will be transferred into its name. The register of shareholders will be amended accordingly. After the loan has been paid off in full the shares will be re-transferred to the borrower. In the case of an equitable assignment, the register of members shareholders does not alter as the shares are not formally transferred from the borrower to the lender. Instead, the share certificates are passed to the lender together with a blank transfer form and a power of attorney authorising the lender to transfer the shares into its own name. In the event of default on the loan the lender will not require the borrower's cooperation, instead it will simply transfer the shares into its own name and then sell them at the best price obtainable. Alternatively, and in the case of a private company, the lender may force a sale of the entire company. However, the danger of the lender holding such a large shareholding in the borrower company is that, for tax purposes, the company may inadvertently become a subsidiary of the lender with the balance sheet consequences that this implies. The weakness of this form of security, and why it is sometimes regarded as 'makeweight', or simply adding to more valuable security held elsewhere, (such as the vessel itself) is that the value of the shares may decline in value prior to their sale by the lender, realising much less than originally anticipated. It is also important from the borrower's point of view that it retains full voting rights, notwithstanding the transfer. This may be achieved by the borrower being accorded proxy status by the lender, entitling it to attend and vote at meetings.

2.2.9 Guarantees and Indemnities from a Parent or Holding Company

If the borrower is asset-weak, or its cashflows (and therefore its ability to service interest payments) are unpredictable, the lender may consider taking a guarantee from a parent or controlling holding company. It is important to note that guarantees are secondary liabilities; they only come into play if and when there is default in the head loan. If English law governs the guarantee then it must be in writing if it is to comply with the requirements of the governing law, the Statute of Frauds 1677, section 1 of which provides that guarantees must be in writing or they are rendered void. This is in contrast to indemnities that are primary liabilities. In essence, the party providing the indemnity indicates to the lender, 'Provide the loan to company X, and we will meet the payment obligations upon it'. Unlike guarantees, indemnities do not have to comply with the Statute of Frauds, although for practical purposes they will be in writing. Guarantees and indemnities are totally separate legal agreements from the loan itself. When taking guarantees a lender should ensure that the provider is 'good for it', or has the assets or capital to honour it if called upon to do so. Cross collateralisation within a group of companies is only effective if the wider pool of assets is strong, compensating for weakness in the borrower's balance sheet. From the provider's perspective it is usually unwise to undertake an unlimited guarantee, instead there should be a cap to the extent of liability that is mutually agreed between the provider and the lender.

A typical corporate guarantee is provided in Appendix 4, kindly provided by Holman Fenwick Willan LLP, London.

2.2.10 Value Maintenance Clauses

The danger for a lender that accepts collateral in respect of a loan, is that its value may decline significantly by the time enforcement and sale is required. The amount of the loan outstanding may exceed the value of the collateral, leaving the lender to claim as an unsecured creditor for the balance. To avoid this outcome it is often the case that a lender will insist upon the inclusion of a value maintenance provision within the terms of the loan. If the value of the collateral declines below a certain percentage of the value of the loan, at that point the borrower will be required to provide additional security to ensure that the lender's position is not weakened. In the context of such clauses it is vital that the lender understands the nature of the borrower's business and is able to obtain regular re-valuation of the assets securing the loan. Failure to do so may result in a weakening of the underlying security, which only becomes apparent when it is too late to do anything about it.

In November 2008 Dow Jones reported that Norway's DnB NOR ASA Bank and Sweden's Nordea Bank AB, two of the global shipping industry's biggest financiers, were at risk on loans that had been made to clients to expand their fleets during the immediately preceding boom years, which was to take advantage of escalating freight rates and a disequilibrium between demand for tonnage and available supply. Dow Jones noted that the London-based Baltic Dry Index, which gives an average freight rate for raw material cargo, had collapsed 94% since an all-time high at 11,793 in May 2008, and that the index was now trading at 763, its lowest level since 1985. The rate was barely sufficient to enable shipowners to cover daily operating costs and as a consequence ships were being laid up, while those being traded suffered from a lack of cargo. Two bankruptcies at this time, 'Ukraine-based Industrial Carriers' and UK-based 'Britannia Bulk Inc', added to pessimism in the S&P market, driving down the value of collateral previously provided to lenders in the form of mortgages over vessels. Dow noted that both banks responded by tightening their loan-to-value covenants, which measures loans in relation to the value of the underlying security, using breaches of these covenants as the basis for renegotiating price and loan terms, including requesting additional security or a reduction of the loan amount. Without the inclusion of such a covenant both banks would have had to sit idly by as collateral underpinning the loans steadily declined in value in parallel with similar falls in the S&P market.

A typical value maintenance clause can be found in Appendix 5 clause 12, kindly provided by Holman Fenwick Willan LLP, London.

Having evaluated the strengths and weaknesses of the various forms of security that a lender may look to take from a borrower in respect of a loan, we can now look at the forms of loan that are usually made available in the shipping industry.

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Name
- capacity
- security
- mortgages
- indemnity
- assignment
- charter party
- shares
- guarantees.

2.3 Test Questions

Having completed Chapter 2, attempt the following questions and submit your answers to your Tutor.

1. Discuss the various forms of security which may be available to a bank when making a loan to a shipowner, comparing and contrasting each in the context of the various phases of the shipping cycle.

2. Discuss the basic clauses found in a typical ship mortgage, identifying the legal rights of mortgage holders.

3. What are the functions of a ship mortgage indemnity?

Chapter 3

Equity as a Source of Finance in the Shipping Business

Learning Objectives

By the end of this Chapter you should understand the reasons why investors are traditionally wary of investing in the shares of shipping companies, understand the main reasons why shipping companies sometimes list on several stock exchanges, appreciate the implications of the Sarbanes-Oxley Act 2002 for companies wanting to list on US stock exchanges and, appreciate the different types of shares that can form part of the equity base of a company and the significance of private placements.

Contents

3.1 The Traditional Difficulty of Attracting Equity Investment into Shipping

Traditionally, there is a perception among investors that shipowners are secretive and unwilling to accept interference from shareholders in the decision-making process. Perhaps one of the main obstacles to investor enthusiasm for shipping company equity is the extent to which the share price, as a product of anticipated earnings (or dividends), fluctuates in line with freight rates. At the peak of the shipping cycle investor enthusiasm is at its strongest, with exceptional profits predicted to be made in a highly volatile market. The phenomenon of market exuberance, the precursor to asset bubbles, helps to draw in investors and niche shipping funds. However, as the cycle begins its descent into recession, equity quickly drains away as shareholders take flight and sell, to lock in profits made on the rising share price during the boom. During the cycle's nadir, the depression, vessel earnings are either negligible or non-existent, significantly reducing the prospect of dividend payout in the immediate future. The shipping company is left with a capital structure comprising a high level of debt and limited equity, but the obligation to continue servicing the former remains unaffected by the steep decline in freight rates and earnings. It is at this point that bankruptcy risk becomes a real possibility.

Investor scepticism to initial public offerings arises for different reasons. Specifically, given the single ship company structure preferred by many companies, and the registration of such companies in a range of different jurisdictions across the world for both taxation and protection of assets from arrest reasons, the entire structure of a potential issuer may often appear opaque and deliberately obfuscated or overly complex. It is difficult to evaluate the profitability or otherwise of an entire group if assets are held in many single-ship companies. Such structures also make manipulation of reported profits and losses a real possibility, particularly if intra-group transfers and dividend payments are used to ensure that profits are declared in jurisdictions where the tax burden may be minimal or non-existent. This risk has the potential to deter investors further. The secrecy traditionally associated with the industry is also a cause for concern. Finally, there is a widespread perception that the industry is much more cyclical in terms of earnings than is the case with other industrial sectors. In the absence of long term time charter parties, vessel deployment to the spot market presents a problem when calculating to any accurate degree the potential profitability of an issuer, even in the short term. As the assets, the vessels themselves, have a well-deserved reputation for extreme volatility, the value of collateral that may be available to investors, after paying off preferred creditors and senior debt holders, presents similar difficulties. In this context there is a fundamental misunderstanding between both sides, the shipowner and the investor.

To paraphrase an observation by Drury and Stokes[3]:

> *'The complaint is frequently heard that the stock market does not understand the shipping business and, therefore, rates shipping shares at an unjustifiably low level. The managements of shipping companies… claim to feel constrained in their buying and selling of ships…by the knowledge that the investment community tends not to regard ship sale profits as part of the recurring profitability of the company'.*

By contrast, potential investors complain that shipping companies fail to appreciate the importance of transparency in their dealing with stakeholders. Companies also fail to understand that investors are reluctant to see a high turnover in assets through sales in the S&P market precisely because to do so is to undermine the very security to which they will have recourse, after all superior claims have been satisfied, upon the insolvency of the company itself. Apart from other forms of security that may be available, such as cashflows from medium term charter parties, it will be the vessels themselves that provide the substantial form of security to these investors, hence their reluctance to see disposals that are not followed by fresh acquisitions, perhaps of upgraded or more modern tonnage.

This lack of understanding on both sides serves to create thin equity markets for shipping company shares and a widespread perception among the wider public that the industry is not suitable for amateur investors. To a large extent it could be argued that marketing and explanation by shipping companies contemplating an Initial Public Offering (IPO) is of equal

[3] Ship Finance: The credit crisis. Can the debt-equity balance be restored? Drury, C. and Stokes, P. A Lloyds Shipping Economist Study, 1983, at p.128.

importance to the fundamentals of cashflow projections and asset value underpinning the offering.

Shipping companies often list their shares on several stock exchanges. This may be for several reasons, including the following:

i. To gain access to highly liquid equity markets where investors may be more sophisticated in their portfolio requirements and so more interested in complex equity instruments than would be the case in, for example, smaller exchanges where trading and investor sophistication and 'appetite' is weaker (in other words, listing in deeper rather than shallow markets in terms of turnover and liquidity).

ii. To build market awareness in a different geographical location, through for example, 'road shows' given to potential overseas investors.

iii. To take advantage of less onerous listing requirements with regard to a particular financial instrument, for example, in terms of prospectus content and disclosure to potential investors.

iv. To diversify the investor base, for example, if the domestic market has been tapped already and would not be receptive to a new issue, at least in the short term.

Here are some examples of companies that have decided to list on stock exchanges outside their country of origin.

3.1.1 Some Companies Listed on the New York Stock Exchange

Diana Shipping Inc, a Greek-based global provider of shipping transportation services, listed 18th March 2005 on the NYSE via an IPO.

Greece-based Tsakos Energy Navigation Limited,

Double Hull Takers Inc (DHT Maritime Inc) of the Marshall Islands, listed 13th October 2005,

Seaspan Corporation of the Marshall Islands. listed 9th August 2005.

Greece-based Navios Maritime Holdings Inc, a seaborne shipping and logistics company, focused on the transport and transhipment of dry bulk commodities, including iron ore, coal, and grain.

3.1.2 Some Companies Listed on the Oslo Bourse

International dry bulk operator Jinhui Shipping and Transportation Limited, listed on Hong Kong Stock Exchange as well as the Oslo Bourse,

US based American Shipping Company ASA. The company owns and bareboat charters vessels for operation in the United States. The company is headquartered in Oslo, Norway, with its principal operating subsidiary in Philadelphia, Pennsylvania, United States.

Norway-based International shipping company Camillo Eitzen and Company, with activities in bulk, gas, chemical, tank, ship management and maritime services.

3.1.3 Some Companies Listed on the Tokyo Stock Exchange, and Listed on other Exchanges

Tokyo Japan-based Nippon Yusen Kabushiki Kaisha, provider of ocean, land, and air transportation services. Also listed on Frankfurt Stock Exchange, and the New York Pink OTC Market, Tokyo Japan-based Mitsui OSK Lines Ltd, owner and operator of ocean-going fleet. The company has operations in North America, Europe, Asia, Central and South America, Oceania, and Africa. Also listed on the Frankfurt Stock Exchange, the US Pink OTC Markets,

Tokyo, Japan-based Kawasaki Kisen Kaisha Ltd, container ships services provider. Also listed on the Berlin Stock Exchange, US Pink OTC Markets.

On 8th March 2006 Gulf News.com reported that 'British shipping icon' P&O's shares traded for the last time, on the previous day, on the London Stock Exchange following its acquisition by Dubai-based DP World. On March 9th the shares would be similarly delisted from the Tokyo Stock Exchange and Australian Stock Exchange.

3.2 Investor Scepticism and its Principal Causes

Equity financing within the shipping industry has a checkered history in terms of its appeal to shipowners and investors, shipping equity often being undervalued in the marketplace. Drury and Stokes have previously noted the degree to which the investor lacks understanding of the business of shipping, recognising that this problem is coupled with the immature nature of global shipping equity trading exchanges. The industry has also lacked that intangible, nebulous factor of 'excitement', simply put, or the ability to enthuse the widest investor community, creating in the process a deep and diverse investor base. From the shipowner, raising finance through equity or 'initial public offerings' is rarely viewed with enthusiasm and, in many cases, is viewed with scepticism. There are several reasons for this attitude. First, shipwners have a well-deserved reputation for secrecy in their business transactions, while equity holders have a right to significant amounts of information regarding intended use of funds, risks that a company faces and interests of the company's owners in its shares, directly and indirectly. In the case of family-owned businesses, this perceived intrusiveness regarding shareholder ownership may present a significant cause for reluctance to go down this route.

There are further issues that may negatively impact upon a shipowner's attitude. Shareholders, even if in a minority, have significant levels of legal protection. A shipowner cannot simply run the company as they wishe since, if this is to the detriment of a minority, a strategy can be challenged in court and in some cases prevented or injuncted. If a company has sold shares to the public it also has to make regular reports available regarding the company's year of trading, its losses, depreciation on assets, finance raised, and so on. For many owners this information is regarded as strictly confidential and they have a reluctance to see it come out in the public domain. If a company does undertake an initial public offering, the prospectus will have to disclose such information and there will be legal liabilities on the part of the board in respect of inaccuracies or partial disclosures. Such information will also have to be verified or certified by external agencies such as firms of accountants and lawyers; openness and transparency is not an optional extra on the part of the borrower. Public companies are expected to comply with standards of corporate governance and to respect the interests of stakeholders, including shareholders, bond holders, employees. They are also expected to have an acceptable number of non-executive directors appointed to the board, which may constitutes a substantial weakening or loosening of control of a family that has, perhaps, owned the business for a generation or more. With regard to costs of an IPO, these can often be higher in the context of shipping companies than is the case for other sectors, and will include legal, accounting and compliance with market quotation rules. This may make this form of financing more costly versus the alternatives.

3.3 The Sarbanes-Oxley Act 2002

Foreign companies have also become increasingly wary of listing on the stock exchange in the United States because of the Sarbanes-Oxley Act, passed in 2002 (or the Public Company Accounting Reform and Investor Protection Act 2002). This Act was passed in response to a series of corporate scandals that severely damaged investor confidence in the markets in the early days of the 21st century, companies such as Enron, WorldCom, and Tyco. These scandals involved companies that collapsed owing investors billions of dollars, principally as a consequence of fraud and false accounting on a large scale. The aims of the Act were threefold. First, to punish those who deliberately deceived investors through fraud or manipulation or fabrication of accounting information placed in the public domain. Second, to extend and reinforce the obligations of the CEO and board when making financial information available to shareholders. Third, to bring about a cultural change within the accounting profession concerning its obligation to avoid being used as a ‘useful tool’, or facilitator, of schemes intended by the board to defraud its investors. In other words, the principal intention was to make the profession more proactive in its policing obligations, strengthening the reliability of financial information coming into the public domain in the process.

The legislation applies to public companies, including the management and board (principally but not exclusively, the chief executive officer and finance officer), as well as the accounting firms that facilitate fraud through deliberate or careless practices. The legislation does not apply to privately held companies, although investors, lenders and other stakeholders also have a raft of other statutory and common law protections in this context as well. The Act imposes significant criminal sanctions and penalties for securities fraud involving, amongst other activities, the fabrication, alteration or destruction of documents relevant to a federal investigation, or any scheme intended to defraud shareholders. In section 302 of the Act internal governance and reporting guidelines stipulate how financial information is to be provided to the public. Signing officers of the company must acknowledge their accountability and responsibility in respect of the accuracy and reliability of this information, and, in this way, provide a basis for legal culpability (and punishment) in the context of subsequent legal action should the information prove to be untrue.

Section 404 requires a company’s management, together with an external auditor, to provide accurate information in the form of an ‘internal control report’ regarding the efficacy of the company’s internal auditing and reporting controls. This section has resulted in a significant increase in companies’ compliance costs and administrative effort, since it is not merely a matter for internal debate and also places responsibilities (and legal risk) upon an independent third party, the auditor.

Paradoxically, the Act does not give shareholders the right to bring legal action in the event of non-compliance. Instead there has to be an investigation, by the Securities and Exchange Commission and the Justice Department, as to whether or not a breach has occurred and to them bring legal action under the Act itself. However, the fact that there has been an investigation and a finding has been made against a company may be used as a substantial element within any subsequent claim against the company for damages by aggrieved investors. In the absence of such a finding, as was the case prior to Sarbanes-Oxley, it would be for investors to satisfy a court that there had been carelessness or deliberate manipulation of financial information by the defendant company.

3.4 Types of Equity

The decision by a shipowner to make a share issue is often not an easy one. If the company has been controlled by family interests for many years, then to invite in 'outsiders' can present a culture shock. Specifically, external shareholders can demand information regarding sensitive matters such as future strategy, anticipated disposals or acquisitions and cashflow projections, and have legal rights to inspect documentation previously kept secret. Good corporate governance requires that such external stakeholders have representation at meetings and at board level, but such intrusiveness does not always sit well in an industry renowned for its opaqueness in terms of ownership and its traditional preference for utilising one-ship companies registered across several jurisdictions. There are also wider compliance issues; stock exchanges require truthfulness and accuracy in the reporting of financial information, including the provision of profits warnings to stakeholders and the disclosure of directors' dealings in the company's shares.

3.4.1 Ordinary Shares

Ordinary shares or equity are the most common form of shares held in the UK and the US. This form of investment does not give the holder the right to any return and, if the company has not made a profit during a financial year, it may elect not to make any dividend payment to shareholders. In contrast to payments of interest to bond holders, which is mandatory, payments of dividends to shareholders are entirely within the company's discretion. Of course, if the company fails to make a payment shareholders may decide to sell their holdings, resulting in a decline in the share price as supply exceeds demand and a decline in the value of the company as a consequence. If this happens, lenders to the company who have taken shares as security for loans may demand that additional security is provided by the company to maintain security at a certain percentage of the loan. The company will also decline in value as its share price falls, making it a takeover target. For these reasons a company would be ill-advised to ignore its shareholders' requirements for reasonably regular and predictable returns on their investments. Most shares also give voting rights to owners on a wider range of company matters, including changes to the company's internal constitution and the appointment and removal of its directors. However, in some limited cases a company will elect to issue shares without voting rights attached. It is also the case that shareholders have a wide range of protections at law, and this extends, with certain restrictions and caveats, to the rights of minority shareholders.

3.4.2 Partly Paid Shares

Shares may be issued 'partly paid', meaning that shareholders are only obliged to make part of the payment now, the rest in the future when called upon to do so by the company. The advantage for the holders is that they receive the full dividend, should the company decide to declare one, and not a proportional reduction to reflect the amount outstanding on their holding. They also have exactly the same voting rights as shareholders who have paid in full, and do not need to find the full sum to pay for their share allocation 'in one go'. The disadvantage for shareholders in this position is that, should the company fail or pass into liquidation before they have paid the amount due, they will still have to contribute the outstanding sum to the liquidator. In other words, they would have to pay money into a company that has become bankrupt since the entire amount on their shares is the extent of their liability to creditors.

3.4.3 Rights Issues

Sometimes a company will make a rights issue, or issue of new shares, to existing shareholders, pro rata to their existing shareholdings in the company. The price at which the new shares are offered is invariably at a discount to the prevailing market price. In this way a company will raise fresh capital, but giving existing shareholders the 'right of first refusal' before the shares are offered in the wider marketplace. (There may be a provision in the company's articles that new issues must first be offered to existing shareholders, these being pre-emption rights, although they are often left out from the articles or deleted later by resolution). The rights issue may be taken up in full by existing shareholders, rejected, or accepted in part. If all new shares are not taken up, the balance may be offered in the open market.

If the shareholder takes up the rights issue his existing percentage shareholding is not diluted. The downside of this is that his exposure in the event of the company failing in the future is similarly increased. But, if the shareholder renounces his rights his holding will be diluted. Each right has a value, this being the difference between the subscription price at which it is offered to existing shareholders and the ex-rights price (the price to which the share is expected to fall once the new shares are issued into the market). Before the end of the offer period in which shareholders must make up their minds whether to accept or reject in whole or in part, the rights can be sold to other investors, earning the shareholder compensation for the dilution if they are sold at a premium. These are called nil paid dealings.

The following observation has been made regarding the pricing of rights issues[4]:

> *'In making a rights issue the main decision to be taken by the company is the price at which the issue should be made and its timing. The shares will normally have to be offered at a price equal to or below the market price since otherwise shareholders will prefer to buy shares in the market. The shareholders have to be given some period in which to decide whether or not to subscribe to the issue. There is a risk that the market price of the shares will fall during this period; thus if the company wants to be sure of getting its money it must either offer the new shares at a price so far below the current market price that the risk of shareholders not taking up their rights is negligible, or the issue must be underwritten (at a price closer to the current market price).'*

3.4.4 Cumulative Participating Preference Shares

Preferred stock is paid a guaranteed dividend that has priority over dividend payments to ordinary shareholders, who cannot be paid unless and until the preference shareholders have been paid first. In a cumulative issue dividends that have not been paid and are in arrears are built up, and the entire amount must be paid before any dividends to ordinary shareholders. However, if a preferred issue is non-cumulative and the company misses a dividend payment, this is not cumulated for later payment to shareholders. Holders of preferred stock may or may not have voting rights. There are four different types of preferred stock: cumulative preferred, non cumulative, participating and convertible.

3.4.5 Convertible Preferred Stock

Holders of preferred stock can convert their holdings into common stock. The investor gains because he receives a guaranteed dividend combined with the prospect of a further gain should the underlying stock increase in price. Preference shares are convertible at a premium to the ordinary share price and the investor's compensation is a higher dividend than for the ordinary share.

3.4.6 Participating Preferred Stock

Shareholders receive a certain guaranteed dividend plus an additional dividend based on a pre-specified percentage of either net income or the dividend paid to the ordinary shareholders, assuming there is such a payment.

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[4] Finance for Managers. Volume 5. The equity market. Morgan Grenfell and Co. Ltd, in association with the British Institute of Management and the Institute of Chartered Accountants in England and Wales. Gee and Co. (Publishers) Ltd, 1985.

3.5 Private Placements

A private placement is an offering that is made to a small number of selected investors, that does not need to comply with the more arduous and detailed rules relating to initial public offerings. In the United Kingdom the formal rules regarding provision of information in a prospectus to investors do not apply, while in the United States the placement does not have to be registered with the Securities and Exchange Commission (although they are covered by the relevant legislation regarding investor protection from misleading information and fraud, the Securities Act 1933). Investors in private placements tend to be highly sophisticated with in-depth understanding of the market in which the company looking to raise funds in this way is active. These would include, for example, pension funds, ship funds, insurance companies, and hedge funds. There are many advantages of pursuing this route instead of an IPO. First, it presents an opportunity to take on, as investors, institutions with specialist knowledge of the sector, and to benefit from their expertise. Second, information furnished to the investors is not issued in the public domain so the company's statement to investors is kept confidential. Third, the costs (such as legal, accounting, and printing of materials), and formal compliance obligation in terms of issuing a detailed prospectus, do not apply to the same degree as is the case with an IPO (although investors will still require practical information regarding future anticipated profit performance, the purpose for which the funds will be used, rate of return on the investment, etc). Prior to making a private placement it will be vital to ensure there are no pre-emption rights accruing to existing shareholders. These are provided in the company's articles and may entitle existing shareholders to the right of first refusal on all new issues prior to them being offered outside the company. If a placement is made in breach of such rights the placement may be challenged and set aside if it has already taken place, or injuncted or prevented if still at the planning stage. However, pre-emption rights may have been excluded from the articles, in which case this issue will not arise.

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Scepticism
- exchanges
- Sarbanes-Oxley
- shares
- pricing
- private placements.

3.6 Test Questions

Having completed Chapter 3, attempt the following questions and submit your answers to your Tutor.

1. Discuss the various historical reasons for investor scepticism regarding shipping equity. To what extent is investor behaviour affected by the cyclical nature of the shipping business?

2. You are the Chief Financial Officer of a shipping company operating through a number of subsidiaries registered in territories including Cyprus, Panama, Gibraltar, and the Cayman Islands. The company is looking to raise finance and is considering doing so in the form of equity. You are asked to write a briefing note to the Chief Executive Officer describing the various options available, and the potential advantages and disadvantages of listing on several stock exchanges, including those of the United Kingdom and the United States.

3. Critically compare and contrast the suitability or otherwise of the various forms of share issues that may be available to the company.

Chapter 4

Debt Financing and the Bond Markets

Learning Objectives

By the end of this Chapter you should understand the structure of different types of bonds traded in the capital markets, appreciate the purpose of sinking funds, be aware of the structure of convertible bonds and their implications for shipping finance and fully understand the driving factors behind issuance of convertibles in case studies provided.

Contents

4.1 Types of Bonds

In its simplest form a bond is a debt instrument issued for more than one year's duration made with the intention of raising capital for a company. Bond holders have a right to receive payment of interest (or the coupon), which is in contrast to shareholders who receive dividends at the discretion of the issuer. However, the rate of interest payable to bond holders will not reflect the increasing profitability of the borrower, again in contrast to shareholders who should, all things being equal, participate through rising dividend receipts. Bond holders do not own the company while shareholders are the owners with voting rights (although some shares are issued without voting rights). Bond holders have greater priority than shareholders if the borrower experiences financial distress resulting in liquidation and a distribution of its assets.

There are probably a hundred and one different forms of bond, of which the following are just a few illustrations.

i. Plain 'vanilla' bonds. This is the simplest form of debt instrument and provides the starting point for innovation in most other complex financial instruments. It provides a fixed maturity date when repayment of principal (the amount borrowed) is due, and a stipulated, certain, rate of interest or coupon. This type of bond has a known, predictable cashflow.

ii. Dual currency bonds. These are fixed income financial instruments that pay a coupon in a base currency (usually the currency preferred by the investor), and the principal upon maturity in a non-base currency (usually the currency of the issuer).

iii. Heaven and Hell bonds. These are fundamentally dual currency bonds but with the difference that principal repayment is linked to the change in the spot exchange rate from issuance to maturity.

iv. Zero coupon bonds. These are bonds that do not pay a rate of interest during their lives but trade at a deep discount, providing a profit when the bonds redeem at face value on maturity (face value is the amount paid to the holder on maturity, sometimes known as par value).

v. Bunny bonds. Bunny bonds are fixed rate bonds that give the holder the option to receive payments either in cash or more bonds, combined with the original issue (bonds with the same coupon and maturity as the original issue). The investor will usually exercise the reinvestment option if interest rates fall, eliminating reinvestment risk (the risk of having to reinvest coupons at a lower interest rate). If interest rates rise, the investor will usually elect to take coupons in cash in the usual way.

vi. Stepped coupon bonds. These are bonds with coupons that change to new rates, which are set out at the time of the bond's issue, on pre-specified dates. In other words, the coupon or interest rate 'steps up' to new levels at pre-set dates that are indicated at the time the bond is issued.

4.2 Sinking Funds

A sinking fund is a fund into which a company makes regular payments over time, usually the lifetime of a bond, to retire a bond issue or preferred stock or to lessen the impact or need to obtain funding on the maturity of a bond and the calling for payment of a balloon payment. Investors tend to prefer bonds or debentures backed up by sinking funds because, by definition, they reduce the risk of default upon maturity since a cash sum will have been put aside precisely to provide for this. Kaen[5] has commented;

> *'The periodic redemption of the debt is believed to provide some evidence of a firm's solvency. It also eliminates or reduces the need to make an unusually large payment to bond holders at the maturity of the debt, which the firm may or may not be able to do. Accordingly, it is generally believed that a sinking fund provision reduces the default risk associated with a bond issue, making the required rate of return on the bonds lower than it would be in the absence of the provision'.*

4.3 Convertible Bonds

4.3.1 Convertible Bonds: A Definition[6]

> *'A convertible bond is a hybrid financial instrument that incorporates features of a bond (fixed income security) and an equity claim (usually common stock). In most instances the convertible can be exchanged, at the holder's option, for the common shares of the corporation issuing the convertible. The conversion value, or stock value, is the market value of the common shares for which the convertible can be exchanged. The bond value or floor price is the market value of an equivalent bond that does not include a conversion feature. The market price of a convertible will be the conversion value or the bond value, whichever is higher, plus a premium'.*

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[5] Kaen, F. R. Corporate Finance: Concepts and Policies. Blackwell Business Books, 1995, at p. 567.

[6] An estimate of convertible bond premiums. Jennings, E. H. Journal of Financial and Quantitative Analysis 1974, Vol. 9, pp. 33-56, at p. 33.

Equity convertibles combine a debt instrument, similar to a bond, with the right of conversion into the common stock or equity of the issuer or other company owned or controlled by the issuer. In the US domestic market it is accepted practice to set the coupon (interest rate payable) at a premium over the dividend yield, expressed as dividends paid divided by share price, of the common stock into which the bonds are convertible. This is done to induce investors to place their money into the convertible bonds rather than the underlying equity. Coupons on convertibles are usually less than those on non-convertible or plain ‘vanilla’ bonds because of the additional value of the conversion component. The attraction to the investor is the mix of risk and return, ie it provides the steady income associated with the bond (interest payments being mandatory) with the possible capital gain associated with a share. For the issuer/borrower, the finance is usually cheaper as the interest rate will be less due to the conversion attraction. Issuing activity in convertibles is traditionally at its highest when stock markets are bullish or overly optimistic. However, convertibles may present problems, for example, when the stock market in general or the price of the share into which conversion is anticipated on purchase in particular fall below the conversion price. In this worst case scenario the convertible will never be converted because the share price at which conversion is permitted may never be reached.

4.3.2 Implications of Conversion for a Shipping Company

In the context of the shipping business it is unwise for a company to decide upon a debt-equity mix and then regard this as static or unchangeable. The industry is fundamentally cyclical, comprising periods of ‘booms and busts’, during which investor sentiment changes according to the profit prospects of the borrower or share issuer. Investor attitude towards a company’s debt-equity mix will fluctuate as a lagging response to the position within the cycle at which the company is, for example, attempting to raise fresh equity or secure new debt refinancing. During market upturns, when freight rates are rising and tonnage supply does not meet increasing demand, prices of shares in shipping companies tend to rise as investors look to cash in on booming profits through anticipated high dividend payouts.
In previous decades, particularly the 1960s, ships came to be regarded as ‘floating real estate’, and, as such, gave a substantial and stable underpinning of a companies’ value on the stock markets. However, as the cycle moves into recession and then depression, this perception no longer holds true as ship values in the S&P market gradually drift downwards and into possible freefall. At this time the debt-equity mix becomes of considerable importance to investors. If there is a high level of debt in the company’s capital structure, how will it continue to be able to sustain interest payments? And if it fails to do so, will this result in an emergency workout strategy with creditors or, even worse, liquidation of the company? However, if the capital structure consists of a substantial equity element, at first sight this would appear to be a plus in favour of the company. If profits are declining or even non-existent, then the company can scale back its dividend payouts or even suspend them altogether, at least until the market moves back into equilibrium and profits start to recover. The paradox is that at this point share prices in shipping companies tend to ‘chase the freight market downwards’, becoming of limited appeal to investors. The ability to make a new issue, an initial public offering (IPO), evaporates as investors move into shares in other sectors.

From a lender’s perspective the principal question will be whether or not the company will continue to be able to maintain interest payments on its outstanding loans. If not, what will be the value obtainable from the sale of collateral, inevitably the vessels owned by the company? From the investor/shareholder’s perspective the concern will be; how quickly the company will return to profitability and restore dividend payments at a reasonable and competitive level vis a vis other industrial sectors? There will also be the fear that, should the company face liquidation, shareholders will be the lowest ranking in terms of repayment on insolvency, ranking below other stakeholders in the company, such as secured and unsecured debt holders, costs of the liquidator and unpaid taxes. Conversely, during a boom when share prices are rising steeply and there is general market exuberance in shipping stocks, investors will try to increase their holdings, making purchases and driving share prices up even further. This is the behaviour typically associated with the start of a ‘bubble’ during which market sentiment becomes out of kilter with underlying market realities. Convertible bonds represent an attempt by issuers to ‘hedge their bets’, to raise capital in the form of debt but with the possibility of this converting into equity should markets and share prices move in a particular direction. From the investor’s viewpoint such instruments represent an opportunity to ‘have one’s cake and eat it too’, or to hold an investment that gives the certainty of income in the form of mandatory interest payments whatever the earnings level of the borrower, with the prospect of converting this into equity and cashing in on rising profits through a switch to dividend payments which, given the point on the shipping cycle at which the bond is issued, will be higher than alternative fixed interest payments when the instrument is maintained in its unconverted debt form.

4.3.3 Conversion Rights in the Context of the Shipping Cycle

Convertible bonds give the holder the right, but not the obligation, to convert from a debt instrument into equity if and when the share price to which it is referenced reaches a certain level. This is known as a put option. Once converted, the instrument cannot then be returned back to its prior form at a later date; the decision to convert is final and irrevocable. However, it is sometimes the case, but less usual, that the issuer is provided with the right to force conversion if the share price hits a pre-specified level. This is called a call option. This may be activated when, for example, although the share price has reached the trigger level investors are, for whatever reason, refusing to switch, leaving the company with a burdensome debt component within its capital that is greater than it would otherwise want. Ingersoll[7] observes;

> *‘Voluntary conversion of a convertible bond will occur only if the current yield on the stock exceeds the current yield on the bond’.*

If, for example, the shipowner is of the view that the peak of the shipping cycle in the trade in which its vessels are trading is about to be reached, it may want to expand the equity within its structure in anticipation of future declines in earnings that may make it increasingly difficult to sustain mandatory interest payments to debt holders. At the nadir of the cycle a high proportion of debt in the capital structure may become unsustainable. If refinancing at lower interest rates (or no or deferred interest) is not possible, then insolvency becomes increasingly likely. Hence the need to expand the equity component at a time when the market is perhaps still unduly optimistic, lagging in its response to problems on the horizon and the imminent downswing in the cycle. Forced conversion will increase the equity component in the company’s capital structure, freeing up future debt-raising capacity by reducing gearing (the level of indebtedness), enabling the borrower to raise new debt at lower interest rates through refinancing.

4.3.4 Timing of Issue of Convertibles

During a cyclical downturn, a recession or depression, investor appetite for shares in shipping companies will generally be low. At this time, debt issues may also receive a lukewarm reception. In the absence of a long term time charter party or government support, a company may be unable to give assurance of its ability to meet interest payments on debt in the short term, deploying its vessels principally in the spot market with all the problems that this entails.

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[7] A contingent-claims valuation of convertible securities. Ingersoll, J.E. Jr. Journal of Financial Economics 1977, Vol. 4, pp. 289-322, at p. 317.

Alexander, Stover and Kuhnau[8] observe:

> *'Rates of return of convertibles issued in hot issue months tend to rise to large premiums in the first month and remain undiminished relative to the market in later months. Rates of return on cold month convertible issues are small or negative in the first month and subsequently rebound to a premium of smaller magnitude than hot issues. An issuer would receive the highest price possible for his new debentures by offering at a price that minimises the difference between the after market price and offer price. Therefore an issuer should seek to avoid hot issue months in which rates of return on new securities rise to large premiums. Since hot issue markets for convertible debentures are predicable, a strategy of avoiding hot markets and issuing in cold markets may be feasible.*
>
> *'Hot months' are defined as a period when new issues exhibit larger than average rates of return relative to the entire market. If a shipping company's share price is depressed when freight rates are falling and the market in recession, it may be that it will have to offer an attractive return to investors to encourage them to take up a convertible issue. This option may be preferable if for example an issue of straight debt is more expensive: the presence of an option to convert into equity in the future may reduce the rate of interest payable on the convertible vis a vis a straight debt offering, particularly if investors are of the view that the share price has almost reached bottom and will begin to rise again in the near future. Of course, the deciding factor will be where the exercise price is struck; pitching it too high in practical terms puts off the date when it may become exercisable and consequently will be of limited interest to investors. But if instead the exercise price may arise in the near future following a gentle recovery in the underlying stock, then the issue may be taken up in its entirety by investors keen to cash in on an anticipated rising market. Instead the best approach is probably to issue in a 'cold' month, when the share price is high and the rate of return which needs to be offered as an incentive to investors is lower. Such a point in the shipping cycle may be when freight rates are high and market enthusiasm for shipping stocks generally strong. Such timing makes sense: if freight rates and earnings are about to fall as the cycle starts to move into a downward direction, it is then that the company may wish to reduce the level of debt in its capital structure, replacing it with equity payment on which, in the form of dividends, will be discretionary instead of mandatory, as is the case with debt'.*

4.3.5 Attractions of Convertible Issues

From a marketing point of view, the longer the maturity of a convertible the better, from the investor's perspective, because the conversion privilege is worth more the longer it lasts. For this reason issuers can extend the maturities of their convertibles out to a longer date than is the case with a plain 'vanilla' bond.

From the issuer's perspective, the issue of a convertible has the following main attractions:

i. A lower coupon will be payable than on a comparable plain 'vanilla' bond.

ii. The bond usually has a longer maturity than a plain 'vanilla' bond.

iii. The fact that convertibles can be sold at a premium over the underlying equity, and then forced to convert when a trigger price is reached, means that fewer shares need to be sold and less dilution need result than from a normal offering of shares.

iv. Some convertible issuers feel a challenge to be able to force conversion within a reasonable period of time, notwithstanding the preference of the holders to retain it as a debt instrument. Failure to convert might imply a company's inability to live up to its own profitability expectations. The existence of an unconverted or busted

[8] Market timing strategies in convertible debt financing. Alexander, G.J., Stover, R.D., and Kuhnau, D.B. Journal of Finance, Vol. 34, No. 1., pp. 143-155 at p. 151.

convertible sometimes makes the issue of new convertibles or even straight debt or equity that much more difficult.

From the investor's perspective, convertibles have the following implications:

i. Convertibles offer a combination of advantages: the certainty of a bond, with the right to participate in the appreciation of the company's equity in the future.

ii. Euro-convertibles are available in bearer form so that anonymity of beneficial ownership is preserved. Interest is also paid free of withholding tax (tax deducted at source in the country of the issuer).

iii. Convertibles have risks in common with other volatile securities. Although they provide a bond value in their unconverted form, this is often far below that of comparable plain 'vanilla' bonds because of the lower coupon or interest rate they offer. If the issuer's share price falls, its convertible securities also usually decline, usually more steeply.

iv. Some convertibles permit forced conversion by the issuer if and when the share price reaches a certain level. This may result in undesired portfolio consequences for institutional investors as the discretionary dividend payment component increases relative to the guaranteed cashflow accruing to straight debt.

4.3.6 Case Study Illustrations of Convertible Issues

Pacific Basin Shipping Limited

On December 5th 2007 Pacific Basin Shipping Limited, one of the world's leading dry bulk shipping companies, announced that it had entered into an agreement to issue convertible bonds to raise approximately US$390 million to fund its existing capital commitments and finance possible acquisitions. The bonds would mature in 2013. The company's CEO, Mr. Richard Hext, described the terms of the issue and the circumstances which made this form of financing more suitable, given market conditions, than alternatives (for example, a straight debt issue). Hext stated;

> ***"The dry bulk shipping market continues to be very strong with, consequently, a favourable reception from the investor community to the convertible bond issue which we announced on Monday. Today we have been able to increase the size of the convertible bond from US$350 million to a total of US$290 million, on the basis of a bond coupon of 3.3% and restricted conversion terms. Currently, these terms give bondholders the right to convert to equity at HK$19.28 per share but, for most of the next three years, conversion can only be effected once the daily closing price of our shares has exceeded HK23.14 for five consecutive trading days. The proceeds of the bond will fund our existing committed capital expenditure and further development of our Company"***

The interesting aspects of the issue is that it shows how terms on a convertible bond can be tighter (or less generous to investors) when the market is booming; the CEO specifically indicates that the strength of the bulk shipping market had been a deciding factor in going ahead with the issue. The conversion price was also subject to restrictions. To counter the risk of temporary 'blips' in speculation-originated price spikes in the share price, the convertible issue specified that the trigger price had to persist for five trading days. In other words, the share price increase had to be for a genuine investor optimism-led reason rather than a temporary aberration. The restriction indicates a desire on the part of the company to retain the issue in debt form for a reasonable time into the issue, possibly because of the dilution of shares that conversion might risk.

Golden Ocean Group Limited.

In late 2009, Norwegian bulk shipping company Golden Ocean Group Limited, controlled by John Fredriksen, announced that the company would issue US$100 million in principal amount of convertible bonds with a five year tenor. The senior unsecured bonds would be convertible into common shares of the Company. The bonds were expected to have an annual coupon in the range of 4.375%-4.875% payable semi-annually in arrear, and have a conversion premium of 27.5%-32.5% over the volume weighted average price of the shares on the Oslo Stock Exchange (converted into US$) at the time of the pricing. The convertible bonds would be issued and redeemed at 100% of their principal amount and would, unless previously redeemed, converted or purchased and cancelled, mature in December 2014. The proceeds from the convertible bond offering were to be used for financing the existing ship building programme, to improve the Company's ability to react to market opportunities, and for general corporate purposes. (Details provided on the website www.Bluepulz.com, 8th December 2009).

STX Pan Ocean Limited

In November 2009, the Board of Directors of STX Pan Ocean Limited announced that the Company had successfully launched a five-year convertible bond, issued to raise US$200 million, due 2014. The issue provided STX Pan Ocean with long term financing, enabling it to lengthen its debt maturity profile on attractive financing terms. The convertible bonds provided a coupon of 4.5% per annum and had an initial conversion price of KRW 14,125, representing a 25% premium to the reference share pricing at the launch of the offering. The Company intended to use the net proceeds from the offering for general corporate purposes and to fund part of the purchase price of newly built vessels. The bonds are traded on the Singapore Stock Exchange. STX Pan Ocean Co. Ltd is the leader in the Korean market in the dry bulk sector in terms of dead weight tonnage as of September 2009, and was ranked in the Top 10 globally in terms of vessels owned in its dry bulk fleet. The Group transports dry bulk cargo such as iron ore, coal, grain, steel products, sugar, cement, and logs worldwide, discharging most of its cargo in Asia. (STX Pan Ocean Co. Ltd News Release, November 2009).

4.4 Mezzanine Financing

Mezzanine finance has been defined as follows[9]:

> *'Mezzanine finance' is one of those exotic terms that do not have much meaning on their own and need some explanation. A parallel to retail shop architecture, where the term mezzanine originates, may be useful. The mezzanine (finance) fills the space between the ground floor (equity in financial terms) and the first floor (senior debt). The airier the space between the ground and first floors (the greater the difference between the value of hard assets and the market value of the business) the larger the size and importance of the mezzanine.*
>
> *There is another aspect that gives mezzanine finance that 'in between' look. To the senior lenders, mezzanine finance will look like more equity. To the ordinary equity investors, mezzanine finance will look like more debt'.*

[9] Mezzanine financing. Imm, M.H. The Treasurer, October 1986, pp. 21-25, at p. 21.

Mezzanine can typically be converted into equity by the investor if, but only if, the debt is not repaid by the date specified in the original funding arrangement. The debt usually offers a higher interest rate, principally because there is little or no underlying security to which the investor can have recourse, other than equity in the issuer. However, it is less risky than unsecured straight, or plain 'vanilla', debt since there still remains the option to convert into equity if there is default in repayment. Mezzanine is treated like equity in a company's balance sheet. Mezzanine is ranked behind secured debt (for example, held by banks or finance houses), but ahead of equity in terms of repayment priority following insolvency of the issuer.

The equity element offers to holders the possibility of participating in the future profitability of the project being financed, assuming that repayment on the mezzanine has not been made prematurely as is within the right of the borrower. Imm has identified some of the principal protective covenants usually included in mezzanine financing. These include a prohibition against the payment of dividends in the early years of the arrangement, maintenance of asset security cover and a bar on the sale of significant assets. Mezzanine lenders may also require fixed and floating charges over assets, which will rank behind similar charges given to holders of senior debt. If a company agrees to these terms it should result in the overall cost of the mezzanine, although a higher than average up-front fee may be payable in respect of a shipping company given the cyclicality of the nature of its business and earnings. This form of finance is appropriate for medium size shipping companies with strong records of profit growth and stable anticipated cashflows.

Mezzanine finance often has an 'equity kicker' attached, such as equity warrants.

Stopford has explained that mezzanine finance, despite the availability of equity kickers, has not been widely used in shipping and is not easy to place with investors. This is surprising given that it can be obtained relatively quickly and with less due diligence on the part of the lender than is the case with traditional financing. It also usually offers relatively generous returns, but offers no or limited collateral on the part of the borrower, and is subordinated to debt of senior lenders such as banks and venture capital companies.[10]

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Bonds
- sinking funds
- convertibles
- conversion
- cycle
- timing
- mezzanine.

4.5 Test Questions

Having completed Chapter 4, attempt the following questions and submit your answers to your Tutor.

1. With reference to the types of bonds studied, consider their relevance and suitability at different phases of the shipping cycle (for example, when freight rates are high or low, when interest rates are high or low, when S&P prices are high or low).

[10] Martin Stopford, Maritime Economics, 3rd edition, 2009. Routledge.

2. What are the functions of a sinking fund?

3. Discuss the advantages and disadvantages to a shipping company of issuing convertible debt. At which points of the shipping cycle would you anticipate investors to be more or less likely to convert their convertible bonds from debt into equity? At which point would you anticipate a shipowner to be more or less likely to force conversion of convertible debt, assuming that it has this right under the terms of the issue?

Chapter 5

Types of Loans

Learning Objectives

By the end of this Chapter you should understand the sometimes conflicting objectives of borrowers and lenders in the shipping industry, fully appreciate the different structures of loans utilised in the shipping industry and the rationale for each, be capable of constructing a typical syndicated loan structure and have a detailed knowledge of the principal methods by which interest rate and currency risk in the shipping sector can be minimised or hedged.

Contents

5.1 Loan Objectives of the Principal Parties to a Ship Loan

In terms of describing a simple conflict of objectives between a lender and prospective borrower, the following observations could be made. The lender may be interested principally in minimising risk while, at the same time, ensuring a satisfactory rate of return on its loan. At the same time, a prudent and realistic lender will not want to place a repayment burden upon the borrower that could, in the event of a severe economic downturn, result in its failure as a business. If interest payments are deferred until some future date, perhaps in the form of an inflated lump sum payable at the end of the loan, this in itself represents a risk. The borrower may be unable to make the final payment or may even fail before then, but during the loan period the lender may have received little or nothing, banking upon receipt of a generous final payment in recognition of its having foregone regular payments throughout the loan’s life. In contrast, the borrower may want to reduce the amount of security it makes available to the lender as security in the form of charges over assets, which usually means a severe restriction on the use of those assets. For example, shipowners often look to sales of vessels as a source of revenue of equal importance to trading receipts. Some shipowners will be content, during a cyclical downturn, to cover their costs and not necessarily generate profits in the short term if there is the prospect of selling assets at a high price in the S&P market when freight rates start to recover. In this context, the ceding of control over assets in the form of a charge given to a lender may sometimes be baulked at. Shipowners value the flexibility to make disposals as and when they wish, and without the delay, which inevitably results if the lender's permission has to be sought first. If payment of interest can be deferred until some future date, reducing the burden on freight earnings in the early stages, then so much the better. The shipowner will hope that, when the time comes to meet rolled back interest payments added to principal, a cyclical upturn in the S&P market will result in a windfall profit. Such a windfall will then enable the final 'exit' payment to be met, assuming that it cannot be made from cashflow from trading of the vessels accumulated for this purpose. It is against this backdrop of potentially conflicting objectives that the terms of a loan will be structured.

5.2 Types of Loans

5.2.1 Plain 'Vanilla' Loans

The starting point for consideration of types of loans in the shipping business is the plain 'vanilla' loan. This loan comprises a principal and a schedule of repayments made up of either interest alone, or interest and principal. The loan agreement will be set out in a document detailing the amount being borrowed, the term of the loan, covenants on the part of the borrower and the events that constitute breach. The interest rate will either be fixed at a certain percentage or, more likely, floating. The benchmark over which the rate will float will usually be the London Interbank Offered Rate or 'LIBOR' (the rate at which banks lend to each other). Occasionally, the benchmark will fixed above an index more appropriate to the environment in which the borrower trades, for example, the Baltic Dry Index in the case of a borrower involved in the shipment of grain. Such a reference point makes sense. If the freight rate in that sector declines, for example because of a poor harvest and reduced demand for tonnage on particular trade routes, then the borrower's earnings will also probably decline, making it increasingly difficult to sustain interest payments if the loan is LIBOR referenced. As a consequence of a perceived riskiness above that of other sectors, shipping companies traditionally pay a higher spread over LIBOR, usually in the range of 50 to 200 basis points (one hundredth of one percent). The majority of loans are term loans, repaid according to a pre-agreed schedule, usually at three or six month intervals. An up front or facility fee will be payable to the bank on signing of the loan agreement, to cover its costs including credit, approval, and documentation (particularly legal drafting costs and review) procedures.

5.2.2 Moratorium Loans

Volk[11] has identified one of the principal goals of the shipowner in determining its financing strategy during a cyclical downturn:

> *'In order to reduce the burden of capital repayment obligations, shipowners should try to acquire the vessels at low or at comparatively low market prices. However, during recession periods the revenues obtainable will not be sufficient to repay the loans. Only few shipowners will be in the position to stand the losses arising in the initial investment period. Especially during recession periods moratoriums are the key to shipowners, enabling them to acquire vessels at low market prices without the subsequent repayment burden. Later on, when the shipping market hopefully has improved, the repayment obligation may start, without heavily straining the shipowner but with the additional advantage to dispose of cheap, newly built and efficient vessels, whereas competitors just may start to order new buildings, presumably at higher market prices and possibly getting the vessel delivered when the boom is over'.*

A moratorium loan does not require commencement of repayment for an initial period of up to two years, during which time a newbuilding can be completed or a distressed shipowner

[11] Volk, B. Investment in Recession. Institute of Shipping Economics, Bremen, 1984, at p. 29.

can trade its vessels in a depressed market at break even. As such, these loans are found in refinancing during a workout, lenders being cognisant of the fact that should they foreclose on the company, take control of its vessels and sell them, the amounts raised would fail to pay off the amount outstanding on existing loans. However, they may also be used by a shipowner to finance the purchase of ships during a depression when values are exceptionally low and so opportunities to build up or expand a fleet are better than at any other time during the typical shipping cycle. The lender may be prepared to 'take a hit' or a loss during this period of the loan, but instead may aim to recoup this later when the interest rate on the loan becomes payable, possibly in the third year, at a rate marginally higher than that prevailing on similar loans at that time. Both sides benefit; the shipowner has a 'breathing space' during a depression when earnings are low or non-existent, the lender benefits if foreclosure and sale of assets at an undervalue is avoided.

As an alternative to an interest-free period on a loan, a lender may instead settle for an initial rate that is significantly less than that prevailing in the wider market. Provided this rate coincides with the cost of its own borrowing, then effectively it will not be incurring a loss but, similarly, will not be making a profit (the opportunity cost of not using the funds in a different project). At the end of this subsidised period, of perhaps two years, the rate payable can be stepped up, and again at regular intervals until, by the end of the loan, the interest rate has risen above that prevailing in the wider market. Such a stepped interest rate schedule is appropriate at a time when earnings are depressed but there is the prospect for a return to profitability within the foreseeable future.

5.2.3 Bullet Repayment Loans

In a bullet loan only interest is paid throughout the loan's life, the entire principal being paid on maturity. Refinancing is usually required to pay the entire bullet repayment amount and may either be obtained from a vessel sale or, alternatively, a fresh loan. This form of finance is best suited for a depressed market in which vessel earnings are stretched, but an upturn is anticipated to coincide with the date of termination of the loan when both earnings and asset values in the S&P market will be buoyant. From the lender's perspective the risk is that the borrower will be unable to make the bullet payment, asset values have remained depressed, and the lender is, therefore, unwilling to make a renewed commitment to the borrower in the form of a roll-over loan. From the borrower's perspective the risk is that it will lack the cash to make the payment and will be forced into selling a vessel that it would otherwise have preferred to have retained.

5.2.4 Balloon Repayment Loans

A balloon repayment is the payment of a one-off sum at the end of a loan period, compensating for lower interest rate payments received by the lender during the currency of the loan. The arrangement may be appropriate if, for example, it is anticipated that the lender will sell the vessel financed at the end the loan, releasing sufficient funds to meet this additional payment. From the lender's perspective the risk is that the asset sale does not raise the cash anticipated at the commencement of the loan, leaving the borrower unable to meet the balloon payment notwithstanding the fact that it has met all (lower) interest payments according to the loan schedule. It is invariably difficult to estimate with any degree of precision the residual value of a vessel.

Residual value insurance provides a way of assuring the amount receivable when the need to make a balloon payment arises. In essence, the insured (the lender or more likely the shipowner) is indemnified against a loss that may occur when the proceeds of sale of a vessel are substantially less than the insured residual value at a particular time, for example, when a balloon payment becomes due and it was anticipated at the commencement of the loan that the vessel would be disposed of to satisfy this. The vessel must have been maintained in Class and the decline in value not attributable to poor maintenance but, instead, to a general decline in market conditions as indicated in the S&P market. Most plain 'vanilla' loans are structured on the assumption that full payment is made prematurely, for example, a loan for twelve years with capital payments and interest scheduled around an assumption of settlement in full in year ten with the making of a balloon payment. In year ten the borrower has the option of either paying of the remainder of the loan in full with a one-off balloon payment or, alternatively, seeking refinancing for the remaining period of the loan. It has been observed that when the repayment schedule on a loan extends beyond 14 years lenders may be reluctant to accept the level of residual value risk, principally because of the difficulty in estimating market price trends of the asset so far into the future. Residual value insurance, according to structured finance specialists, London Special Risks Ltd[12], can fill the gap between the balloon payment the borrower will be required to make at the break point in the loan, and the asset risk (or market volatility exposure) the lender is prepared to accept so far out into the future.

London Special Risks observes that the type of insurance can be placed in respect of most types of commercial vessels less than 10 years of age at commencement of the policy and less than 20 years of age at termination date. Vessel types include container vessels up to 9,000 TEUs, LNG carriers, LPG carriers, VLCCs, suezmaxes, product carriers, PCCs and bulk carriers. The insurance can be arranged for up to 15 years, with sums insured of more than US$100 million with a single underwriter. Premium rates vary from 2% to 7.5% of the amount of the residual value insured, determined in large part by the duration of the loan and the location of the balloon payment break point within it. The claim is based on the insured residual value less the fair market value, less any repair costs if applicable.

A similar result can be achieved using a ship mortgage indemnity. This type of risk underwriting indemnifies a lender against financial loss in the event of failure by a borrower to repay a loan and the subsequent inability of the bank to recover their debt following sale of the security, the vessel. This may result when, for example, a workout solution has either failed or has been rejected during negotiations, and a consequent asset sale into a depressed S&P market has to be made. The underwriter's contractual relationship is with the bank and not the shipowner; the shipowner acquires no rights under the terms of the policy.

5.2.5 Back/Front Ended Loans

Under these arrangements, payments of the principal are either higher at the beginning of the loan (front ended) or at the end (back ended). Front ended loans tend to be more popular with borrowers when freight rates are high, making their ability to pay off larger portions of the loan or principal greater. As a result, interest payments tend to taper downwards because of the earlier payoff of the principal upon which the rate is calculated. Back ended loans are appropriate when the borrower's ability to pay off the principal is limited, perhaps because of a prevailing environment of low freight rates or a need on the part of the borrower to deploy vessels on the spot market due to an absence of time charter party fixtures. As a consequence, principal reduction is slower and the interest payable throughout the loan more consistent, reducing at a lower rate than is the case with front ended loans.

5.2.6 Revolving Credit Facility Loans

Under this arrangement amounts already repaid can be re-borrowed. The chief advantage of this structure is that the terms of a new loan do not have to be renegotiated every time the borrower has a fresh need for cash. An added benefit is that, although the borrower will be required to pay a facility fee in respect of the arrangement, interest does not start to run unless and until there is a draw down of cash by the borrower. In this sense the borrower

[12] Residual value insurance for commercial shipping vessels. London Special Risks at www.londonspecialrisks.com.

is not paying for loan capital that it does not need; interest is only incurred if and when capital is needed. The arrangement represents 'liquidity on tap', which the borrower can call upon when needed without the uncertainty of new terms on a renegotiated loan. Such arrangements are usually for between 2 to 5 years' duration, and the bank provider is paid a commitment fee in respect of the undrawn down amount.

In April 2006, Greece based owner and operator of products tankers and container vessels, Aries Maritime Transport Limited (renamed NewLead Holdings Limited as of December 2009), agreed a US$360 million fully revolving credit facility of 5 years' duration in which the Bank of Scotland and Nordea Bank Finland acted as the joint lead arrangers, and fully underwrote the facility, while also arranging a syndicate of other ship finance banks. Aries used the facility to replace an existing US$140 million term loan facility and a US$150 million revolving credit facility. After paying off the term loan and revolving credit facility, Aries was left with an undrawn commitment under the new facility of US$75 million. This undrawn amount was to be used to take advantage of later opportunities for modern tonnage acquisitions. Regarding the pricing of the new facility, at the time of drawing down the remainder of the facility it was anticipated that the company would pay one eighth of a percentage point less in margin than it had been paying under its existing facility. One of the other advantages, apart from the obvious cost saving, was that interest did not start to run unless and until funds had been drawn down, which would not have been the case if the company had simply taken a plain 'vanilla' loan for use at some later undetermined time.

A variant of the revolving credit facility is the note issuance facility. This is an agreement by a syndicate of banks to buy short and/or medium term notes from a borrower in the event that it is not able to sell these in the Eurocurrency market (the Eurocurrency market is the money market in which currency held in banks, outside of the country where it is legal tender is borrowed and lent by banks in Europe. For example, a Japanese company borrowing US dollars from a bank in France is using the Eurocurrency market).This provides an assurance to a debt securities issuer since it knows it will be able to raise the fund it requires, notwithstanding that the issue cannot be placed with investors. The facility is only a contingent liability from the banks' perspective; only if the underwriting bank is requested to make funds available to the borrower will it acquire an asset (the notes), which will require an entry to be made in the balance sheet and an appropriate capital adjustment to be made to recognise this new risk.

5.3 Hedging Risk

Two of the principal forms of risk, apart from fuel volatility risk, are interest rate risk and currency exchange rate volatility.

5.3.1 Interest Rate Swaps

An interest rate swap may be used by a company that wants to switch its interest rate obligations from fixed to floating, or vice versa. For example, this may be used if a company has made a bond issue under which it has to pay a floating rate of interest to bond holders, but anticipates that rates will start to increase in the near-term, increasing its interest rate burden. Under an interest rate swap it can effectively switch this burden into a fixed rate obligation. Conversely, a company may have a fixed rate obligation to its bond holders but expects interest rates to start to fall, placing it at a competitive disadvantage to its rivals that have declining payments to make. An interest rate swap can be used by the

company to switch from a fixed rate to a floating rate, taking advantage of the decline. In the overwhelming majority of swaps, the reference 'benchmark' will be the interbank offered rate of LIBOR, but other benchmarks more relevant to the circumstances of the borrower may be used, such as SIBOR, (Singapore Interbank offered rate), or HIBOR (Hong Kong Interbank offered rate). The interest rates are calculated on a hypothetical or notional sum, parties making periodic payments to each other or, as is usually the case, one party making a net payment to the other after netting of the payment obligations against each other. The result of the exchange is that each party obtains the type of interest rate it wants, fixed or variable (floating), on acceptable terms, governed by a standard contractual document.
A typical structure of an interest rate swap is shown in Figure 5.

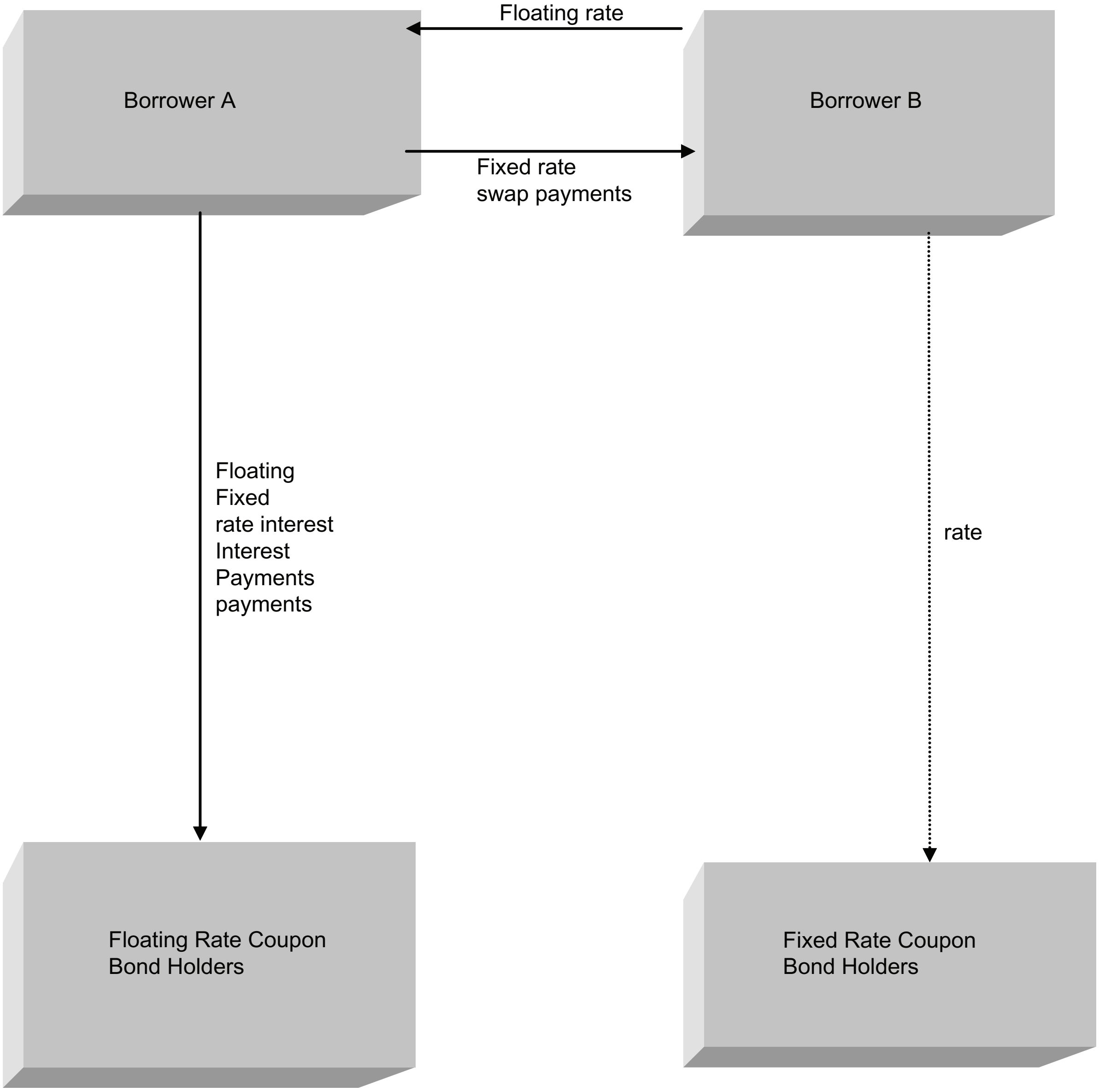

Figure 5 An interest rate swap

It may be the case that companies are happy to deal with each other directly, as shown in Figure 5, effectively entering into an agreement to service each other's debts. However, in most cases a bank will act as an intermediary, effectively 'standing in between' both parties, receiving fixed interest payments from one party and passing these through to the other, and doing likewise with floating interest payments received from the opposite counterparty in the swap. A swap with a bank as intermediary is shown in Figure 6.

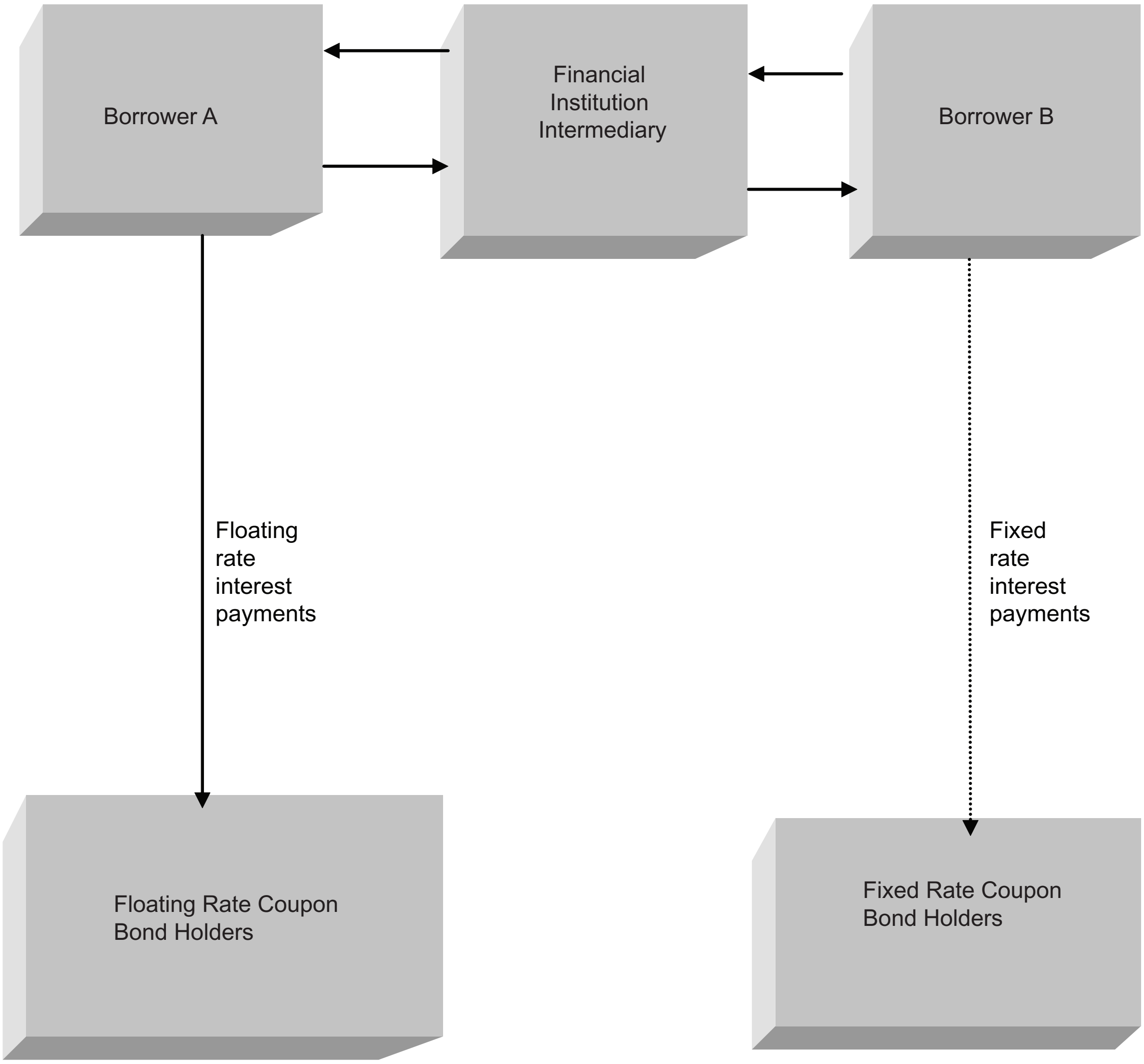

Figure 6 An intermediated interest rate swap

There are several reasons why a bank may be used as an intermediary, notwithstanding the reality that the cost of the entire transaction will be increased by the fee that will be payable by each side of the swap to the bank in payment for its service, and the risk it will assume under the two arrangements. First, the presence or intermediation of the bank strengthens the transaction since, unless the parties have strong credit ratings, there will be a risk that one will default, effectively terminating the swap and leaving the other party obligated to re-assume its payment commitments upon its original borrowings. Both parties benefit from the bank's stronger creditworthiness in that there is less likelihood that it will default on its payment obligations as intermediary. The interposition of the intermediary insulates each party from the other and, in so doing and in return for a fee, the bank guarantees that each borrower will receive the swap payment due from the other. Second, it is rarely the case that one party's swap needs or outstanding debt obligations, for example on an outstanding bond issue, exactly match those of the counterparty. The bank is able to tailor a swap to meet a counterparty's needs without the need for exact matching. If there is a shortfall between the two parties on either side of the swap, the bank will 'warehouse' this, waiting until a new counterparty comes along wanting a swap for the balance. Third, the bank is able to 're-swap' its commitments under either side of the swap, breaking down or redistributing the risk to a wider group of stakeholders to an extent not possible when parties deal with each other directly.

Some additional characteristics of an interest rate swap.

i. The transaction amount is referred to as the notional amount since it is not a sum that is exchanged between the counterparties. Neither party obtains the liquidity or funding upon which the interest payments are calculated.

ii. Lenders to each counterparty, for example investors in bonds issued, are not parties to the swap nor do they obtain legal rights or obligations under it. The swap only affects the coupon flows in terms of which party is effectively servicing them.

iii. The swap transaction is totally separate from, and independent of, the underlying debts previously taken on by both parties. If one party defaults on the swap this does not constitute a ground for withholding payment on the underlying debt. In most if not all cases, the original lenders or bond holders are not even aware that a swap has taken place, nor is there any reason why they should be.

5.3.2 Currency Swaps

A currency swap is used to hedge future exchange rate risk by locking into rates fixed or agreed at the commencement of the arrangement. As in the case of an interest rate swap, a bank or other financial institution acts as an intermediary in the transaction. The two or more parties on either side of the swap do not have any legal relationship with each other or even know each other's identities. Under the swap the counterparties do not lend currencies to each other, but sell them to each other with a concomitant agreement to reverse the exchange of currencies at a fixed date in the future. The amount to be swapped is established in one currency and the prevailing spot exchange rate is used to establish the amount in the other currency. Currency swaps involve interest payments that take the form of a periodical (usually annual) payment by the counterparty in the lower interest rate country to the counterparty in the higher interest rate country. The interest cost is negotiable but generally approximates to the interest rate differential between the countries. Rates can be either fixed or floating. All currency swaps involve the buying and selling of different currency cashflows in the future.

> *'By entering into a currency swap agreement an institution can switch an asset or a liability from one currency to another. The swap transaction can be done from a fixed interest basis into a floating rate basis in the other currency, or from a floating rate basis into a fixed rate basis in the other currency.*
>
> *The currencies are swapped initially through a normal spot foreign exchange transaction so that each of the counterparties have full availability of the currencies they are seeking. Throughout the life of the two obligations, each of the counterparties pay the other's interest obligations in accordance with the swap agreement. At maturity the currencies are swapped back to the original currencies through a forward foreign exchange transaction, usually effected at the initial spot exchange rate'.*[13]

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Loans
- moratorium
- bullet
- balloon
- revolving
- swaps.

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[13] Currency and Interest Rate Hedging. Andersen, T. J. New York Institute of Finance, Prentice Hall, 1987, at p. 235-236.

5.4 Test Questions

Having completed Chapter 5, attempt the following questions and submit your answers to your Tutor.

1. You are the Chief Financial Officer of a shipping company which has a high level of equity in its capital structure and is now looking to rebalance this by raising debt. You are asked to write a briefing note to the Chief Executive Officer describing the various types of loan which may be available from the banks, and the relative potential advantages and disadvantages of each at the various phases of the shipping cycle.

2. Describe the principal methods by which a shipping company may be able to hedge the interest rate or currency risk on its loans.

Chapter 6

Syndicated Loans

Learning Objectives

By the end of this Chapter you should understand the principal reasons why companies obtain finance via a syndication of banks rather than through a single loan from a single provider, and critically appreciate the functions and duties of all parties to a syndicated loan.

Contents

6.1 Syndicated loans: A Definition

A syndicated loan is a loan made to a single borrower, financed by a syndicate of banks. These types of loan are typical where the amount to be financed is too great a sum or risk to be undertaken by a single bank alone. The risk is distributed or shared between those banks participating in the syndicate, their own risk often in part assumed by underwriters participating in the arrangement. The deal is arranged by a lead manager who is given the mandate, usually after a competitive tender process, by the borrower. The arrangement will usually be entered into, by the lead manager, on a ‘best efforts’ basis, meaning that if the total amount required by the borrower cannot be raised from investors, the borrower will have to settle for a lesser amount. Providers of the funds will ultimately be institutional investors such as pension funds or hedge funds, or other banks that simply take up a slice of the larger loan.

6.2 A Typical Syndicated Loan Structure

The standard traditional syndicated loan usually follows the three tier method, where underwriters have a separate subordinate role to the management group. In the alternative two tier method, introduced by American banks, the managers are legally part of the underwriting group and are appointed by the underwriters to take decisions on their behalf. Figure 7 illustrates a typical three tier syndicated loan arrangement.

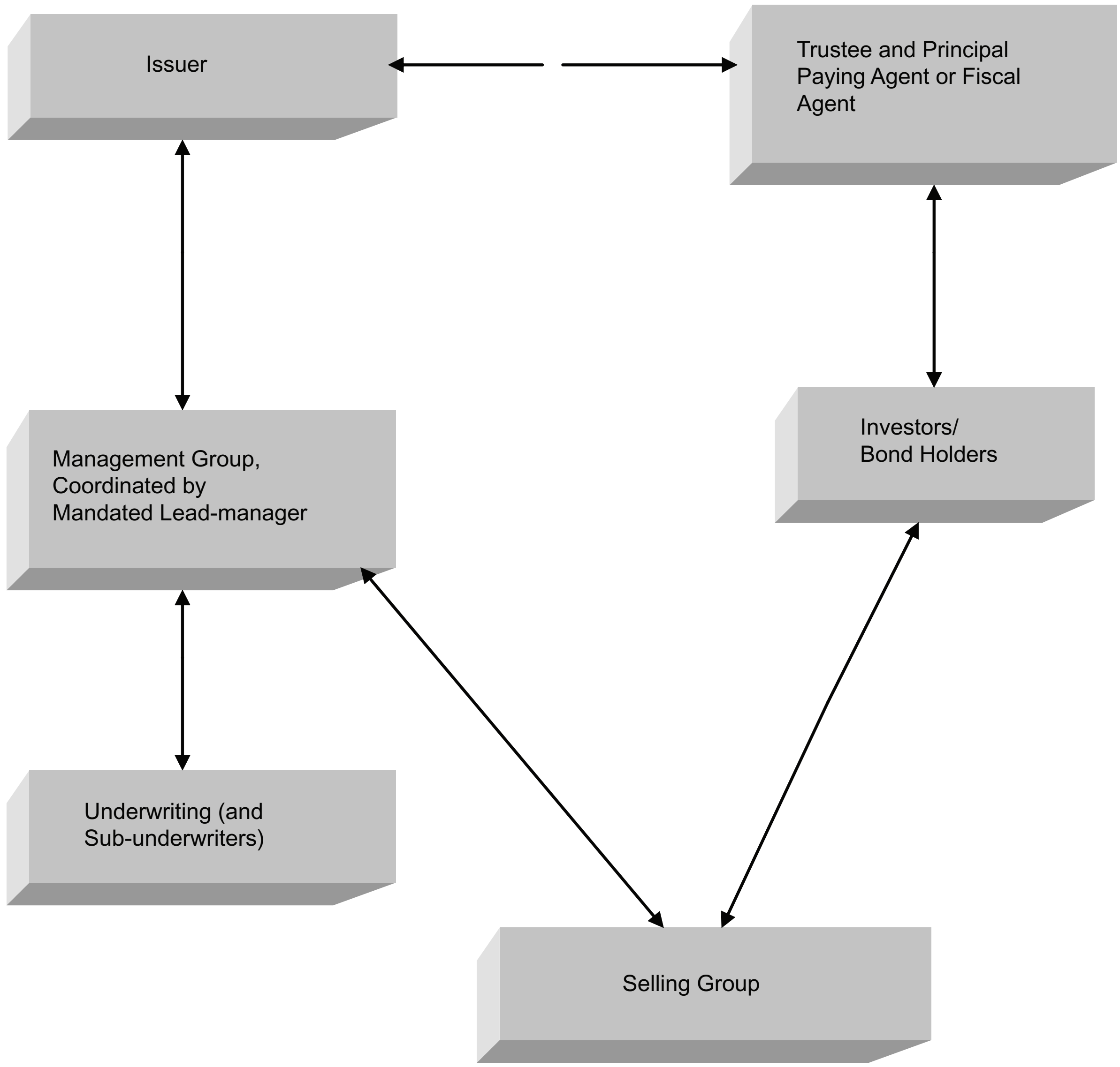


Figure 7 UK/European three-tier syndication framework

The role of the trustee is to represent and protect the interests of investors. It will be empowered to negotiate with the borrower regarding deviations from the terms of a bond issue, for example, if the funds raised are not used for the purpose initially indicated. In the event of minor breaches of the issue, such as failure to pay interest on the due date, the trustee may waive these on behalf of investors if they are due to (for example) a temporary procedural irregularity that will be quickly rectified by the borrower. In the event of significant and insurmountable breaches it will be the trustee that will initiate legal action, on behalf of investors, to recover their money if there has been a default or fundamental covenants have been broken, avoiding the prospect of multiplicity of litigation by individual investors acting on their own behalf. A fiscal agent, in contrast, is principally a mechanical appointment dealing with administration of a bond issue, and has power to negotiate on behalf of investors or to waive minor breaches. The functions of the fiscal agent include receiving interest payments from the borrower and distributing these through agents to investors, and publishing notices in the media in the event of optional redemption rights arising in favour of investors (the ability to require that the borrower/issuer take back and pay for the bonds issued, prematurely). In Figure 7 it can be seen how the management group sells the bonds directly to the selling group, the transaction usually being conducted by the lead manager on behalf of the management group. The selling group members then sell the bonds to investors such as pension funds and hedge funds, the securities laws of the country in which the sale takes place governing the nature of the information to be provided in the issue prospectus and the legal liabilities of all participants in the syndication. Members of the selling group will receive a commission or concession fee for securities placed with investors. Occasionally, members of the management group will also participate in the selling group. The management group agrees to buy the securities issued at an agreed upon price and to resell them at a public offering price, the difference or spread representing the management group's profit on the deal.

In March 27th, 2009 http://shipchartering.blogspot.com reported: 'Syndicated loans grind to a halt'. In that month the syndicated loans markets in shipping had collapsed. In the whole of the year there were 4 syndicated deals, compared with 268 deals completed during 2008. There were several reasons for this collapse in the market, but bank nationalisations after the credit crunch combined with extreme funding gaps in the banks themselves meant that little investment was available for the shipowning community. The cost of finance had risen in a short time from a usual 50 basis points spread over LIBOR to 200 points or more, reflecting banks' weakened balance sheets and steeply declining asset values, including falls of up to 70% in the bulk carrier market within six months. Banks were now prepared to finance only 50% of vessel value, compared with up to 80% during 2008. Even then finance would only be made available on the back of secure chartering contracts against the ship. Shipping companies were now looking to private equity as a new funding source.

In March 2006 Sharjah-based FAL Oil Co, one of the largest cargo traders of fuel oil, gas oil, and jet kerosene, announced that it had taken a syndicated loan of US$90 million for expansion of its shipping fleet. Cash raised was to be used to purchase six new ships to expand the company's existing fleet of 21 vessels. The lead manager was BNP Paribas (Suisse) S.A. Geneva, other participating banks including Gulf International Bank Bahrain, First Gulf Bank, Union National Bank, Emirates Bank International and Commercial Bank of Dubai. Competition among banks to participate in the deal meant that FAL was able to achieve favourable terms.

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Management group
- trustee
- three tier
- selling group
- lead manager.

6.3 Test Questions

Having completed Chapter 6, attempt the following questions and submit your answers to your Tutor.

1. Describe the roles of the principal parties to a syndicated loan agreement.

2. Why would a shipping company look to raise finance via a syndicate of banks rather than through a single lender?

3. Which factors would a shipping company borrower take into account when deciding between several investment banks as to which is to be awarded the mandate to lead-manage a syndicated loan issue?

Chapter 7

Securitisation

Learning Objectives

By the end of this Chapter you should understand in detail the pre-requisites for securitisation, be able to construct a securitisation structure while appreciating the functions and duties of all participants, be fully aware of the procedural steps in a securitisation and be aware of the potential benefits of the securitisation technique to emerging economies.

Contents

7.1 Definition of Securitisation

Gardener and Revell[14] define securitisation as follows:

> *'An institution 'securitises' a portfolio, or part of it, when the respective assets are packaged in an acceptable form and sold as a security in the open market: a 'closed market credit' is transmuted effectively into an 'open market credit', a security. This form of securitisation may be seen as one response to an excess demand for loans faced by an institution'.*

> *'Securitisation and the associated innovation process are really concerned with developing new instruments in which the product elements inherent in a position can be decomposed, or unbundled, and passed on separately to parties whose portfolio preferences match those specific characteristics. In effect, the product elements that make up a final transaction are unbundled and repackaged as marketable products. In this sense, securitisation is a process that can 'mutate' the risk exposures inherent in a traditional, closed-market banking transaction'.*

In simple terms, securitisation is the consolidation, or 'repackaging', of a series of homogenous cashflows accruing from a number of sources, the transferring of those cashflows to a third party, and the issuance by that party of securities collateralised by those cashflows.

[14] Securitisation: History, Forms and Risks. Gardener, EPM and Revell, J, Research monographs in Banking and Finance. Institute of European Finance, University College of North Wales, Bangor, at p.27 and 63.

Smallman and Selby[15] have identified the advantages of securitisation as follows.

> *'Securitisation lowers the cost of funds by isolating risk. With asset-backed securities, investors buy a specific set of receivables with a known amount of risk. This is far safer than investors lending to a company which can then, at its discretion, fund existing assets or purchase riskier ones'.*

A typical securitisation structure is provided in Figure 8.

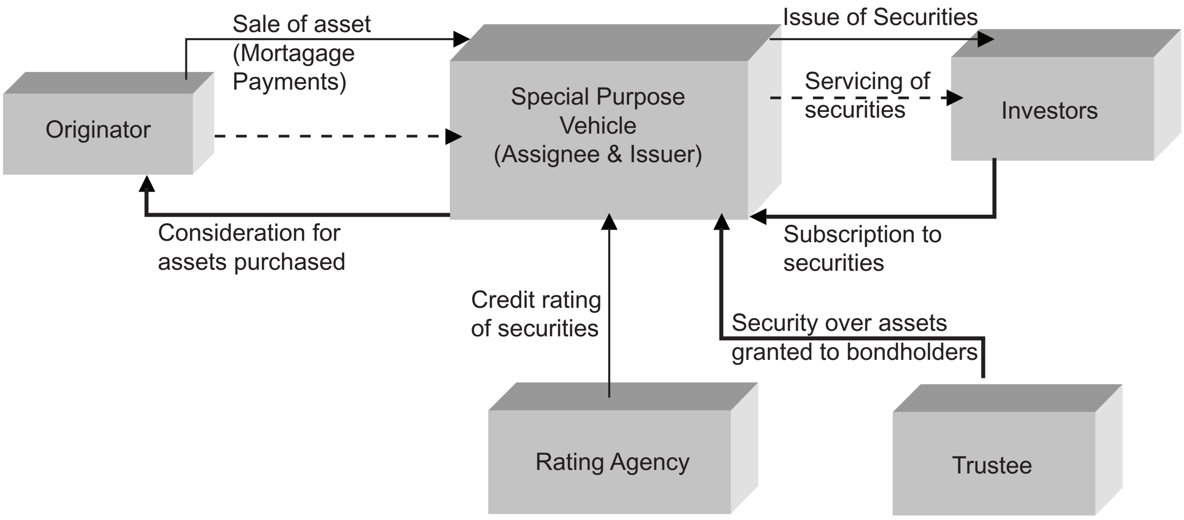


Figure 8 A securitisation structure

Cashflows are homogenous in the sense that they are derived from the same source, for example, mortgage receipts, rentals from car hire, credit card receivables, mobile telephone contract payments, and, in the case of shipping, freight receivables under a time charter party or series of voyage charter parties. Securitisation does not permit 'mixing' of cashflows from entirely different sources. For example, freight receivables cannot be securitised alongside car rental payments. The securities often take the form of floating rate notes where the interest payments fluctuate in line with a recognised benchmark such as the LIBOR rate. The bonds may be privately placed or, alternatively, traded on a recognised exchange.

7.2 Structuring of a Securitisation

The structuring of a securitisation involves the setting up by the 'originator' or the receiver of the payments of a special purpose vehicle, or 'SPV'. This is a separate company, usually incorporated offshore as a way of ensuring that interest payments made on the bonds are made gross, without deduction of tax at source (withholding tax). The SPV must be a genuinely and legally separate entity from the originator. One of the principal purposes of securitisation is to remove cashflows and the risk accruing to them from the originator and the investors who purchase the bonds issued by the SPV.

[15] Asset-backed securitisation. Smallman, JD and Selby, MJP in Securitisation, by Bonsall, DC Published by Butterworths, 1989, at p. 243.

Wood and Lowes[16] have observed:

> *'As a properly structured asset carve out, a securitisation programme should be recorded as a sale for financial accounting purposes. This reflects an investor's reliance on the specific assets, not the general obligation of the originator seller, as repayment source. The resulting direct impact on the balance sheet is to liquefy an asset. A future financial flow is converted to cash'.*

The SPV is usually a thinly capitalised entity (holding little or no cash or assets) the sole purpose of which is to issue bonds under the securitisation. If the professional advisors' deem it necessary to the issue, who are usually the banks arranging the deal, to bolster the SPV and provide it with creditworthiness, such as to provide assurance to investors that if there is default in payment on the bonds they will have some limited measure of recourse, it may be that the originator will collateralise the SPV with a partial guarantee. If this is the case then the residual risk must be brought back into the originator's balance sheet. However, to all intents and purposes, after the securitisation the originator becomes simply a collector of cashflows, or 'conduit', passing these on to the SPV and assuming no responsibility towards the investors. It is the cashflows that are collateralising the issue, hence the catchall definition for such issues as 'asset backed securities'. In effect the issuer is raising finance now against cashflows that will be received over the future. The more stable those cashflows and the more reliable the sources from which they derive, the lower the rate of interest that will be payable on the securities issued. If the SPV is collateralised, for example, by a partial guarantee that if there is a default the originator will step in to fill the gap (almost in an underwriting capacity), then this should also reduce the interest rate payable. However, it is important that investors have no formal right of legal recourse against the originator, true separation between the SPV and the originator is a fundamental feature of a securitisation structure. True separation also means that investors are protected against possible future claims by creditors against the originator, if this happens the creditors will have no legal recourse against the rights to the cashflows now legally owned by the SPV. In this regard the SPV is said to be 'bankruptcy remote' from the originator.

7.3 Procedural Steps in a Securitisation

7.3.1 Market Testing and Comparison with Alternative Methods of Funding

During the recent credit crunch, one of the principal causes of banks' difficulties was the presence of asset backed securities in their balance sheets. Specifically, mortgage payments originating in the United States had been repackaged but the riskiness had been underestimated by the investors, the banks and the ratings agencies. There had been an implicit assumption that the core assets underpinning the securitised issues, properties against which the mortgages were secured, would continue to increase in value on the back of what turned out to be a classic property bubble, and that home owners would continue to be able to service their interest payments on mortgages, interest rates being at historically low levels. Both assumptions proved incorrect. Property prices declined steeply and, as global economic recession took hold, home owners lost their jobs and started defaulting on their mortgages. As properties were repossessed and sold by lenders, supply of properties quickly exceeded demand, leading to a global property crash. Banks that had invested in mortgage backed securities (which in many cases they had created in an effort to remove the risk from their balance sheets) now found that they were unable to sell these, the market having collapsed. These became known as 'toxic assets', with values that continued to fall, generating substantial unrealised losses for the banks that held them.

[16] The Treasurer, October 1989, at p. 27.

Today it is fair to say that there is scepticism for asset-backed securities, particularly when the cashflows are derived from unusual sources or sources not understood by either financial institutions or investors. For example, one famous international rock star securitised future receivables from his back catalogue of recordings, the so-called 'Bowie Bond'. It may be difficult for such a unique cashflow to be securitised in the near future in the wake of the credit crunch. It will be for originators to explain the nature of the cashflows to be securitised, identify the risks, and obtain a suitable credit rating from the ratings agencies. This will be achieved through, for example, marketing 'roadshows' by the originator at which the cashflows and the structure will be explained. It will also depend on the utmost transparency, if there is opaqueness regarding risk then the issue will not be well-received or may even not be taken up by investors.

With regard to alternative methods of financing, it may be that the originator will simply factor these future cashflows. In essence, this will mean selling them to a factor, usually for a substantial discount. The factoring may be on a recourse or non recourse basis. With regard to the former, if any of the payments are not made to the factor then it may, in turn, claim against the seller for the shortfall. In contrast, non-recourse factoring means that if there is default the factor has no legal redress against the seller; it has assumed the responsibility and full risk associated with those future cashflows. For this reason factoring on a non-recourse basis will result in a larger discount on the debt being demanded by the factor, in compensation for the greater degree of risk it will be assuming under the arrangement.

A second alternative will be for the borrower to simply take out a loan secured against those cashflows. If this route is taken it is likely that additional security, such as a guarantee by the borrower, will also be required by the lender.

7.3.2 Pooling of Assets to be Securitised, and Transfer to the SPV

The originator will formally assign the rights to the cashflows to be assigned to the SPV. A technical legal point is that there must be a legal right on the part of the originator to transfer these cashflows to a third party. Occasionally a contract will provide that only the parties to the original contract, the originator and the payers of the cashflows, can sue or be sued on the agreement, or take benefit from them. If this is the case then a transfer of the rights to the cashflows will constitute a breach of contract, enabling the payers to challenge the assignment to the SPV. Benefits of policies of insurance or value maintenance provisions will also be assigned to the SPV and the providers of the policies, the underwriters, notified. The originator will collateralise the SPV, for example by providing it with cash or a partial guarantee, at this stage. The originator will also appoint an independent trustee to the issue, tasked with the responsibility of representing and protecting investors' interests and initiating legal action in the event of breaches of the terms or covenants of the issue by the SPV.

7.3.3 Issuance of Securities by the SPV

The SPV issues the securities, either through a public issue or via a private placement. Different classes or 'tranches' of securities may be issued, lower or subordinate tranches having less security or claim to assets and, because they are more risky, carrying higher rates of interest. The SPV will issue the different tranches over an extended time period. Investors will pay for the securities, the cash being paid on, by the SPV, to the originator in payment for the rights to the cashflows assigned. Although the assets will have been assigned to the SPV, it will remain the responsibility of the originator, as conduit, to collect in and pay on the future cashflows to the SPV. If there is a future default by the payers it will be the originator's responsibility to take enforcement measures.

7.3.4 Collateralisation

In terms of collateralisation of the SPVs used in a shipping finance transaction, there are three potential sources of security. First, there is the value of the vessels that are being bought with the finance. This value will fluctuate over time and, during a falling S&P market, may fall significantly in value below that originally anticipated by investors. Second, there is the cashflow arising from charterparties. Such homogenous and predictable income, if there is a long term charter party in place, provides the typical subject-matter of any securitisation structure. Third, it may be possible to cross-collateralise by reference to assets or cashflows arising in other parts of the borrower's fleet, or within other companies that it controls (for example, in the case of a series of one-ship companies).

In February 2006 CMA-CGM, the world's third largest container company, raised US$499 million to finance 12 new panamax ships to be operated by them. The deal, the Vega Container Vessel 2006-1 corporate asset-backed securitisation (CABS), drew upon the asset backed securities market, the syndicated loan market, and the corporate bond market. Under the CABS structure, Vega Container Vessel 2006-1 plc (a special purpose vehicle incorporated in Ireland) issued $253.7 million of senior notes in the capital markets. These were securities giving holders priority over other claims in the event of the company's insolvency. The issue was wrapped (simply put, underwritten) by XL Capital Assurance, and achieved a AAA rating from Standard and Poor's and Aaa from Moody's on the basis of the exceptionally low level of risk to investors in the issue. A liquidity facility was crucial in this regard, Vega would be able to continue servicing interest on the senior notes for a period not exceeding 36 months in the event of the vessels being repossessed, remarketed and sold after a default under the bareboat charters (a bareboat charter being an arrangement for the hire of a vessel in which no crew or other provisions are included, these being provided by the charterer). There was also an unrated tranche within the structure, of a $283.3 million syndicated bank loan made by leading shipping banks. Within the mezzanine structure there was an equity tranche of subordinated notes to be purchased by CMA-CGM, using the proceeds of a $283 million corporate bond issued simultaneously with completion of the CABS.

Vega used the funds to make 12 loans to separate special purpose vehicles incorporated in Ireland. These companies would then purchase 4 × 1,700 teu vessels from Hyundai, 2 × 4,400 teu vessels from Hanjin, and 6 × 5,100 vessels from Hyundai during a delivery period of 3 years. The vessels were placed on bareboat charter to CMA-CGM for use on its global network.

7.4 Securitisation and Emerging Economies

An IMF Report[17] explained the principal reasons that stand in the way of the restoration of voluntary market financing (access to the global capital markets without reliance on risk quasi-underwriting by supranational agencies such as the IMF or World Bank) by developing countries:

> *'The success of developing country borrowers in regaining access to international capital markets is related to their ability to address investor concerns about the risk*

[17] Private Market Financing for Developing Countries. World Economic and Financial Surveys. Published by the International Monetary Fund, December 1991, at pp. 19-20.

of default (counterparty credit risk) and the risk that foreign exchange will not be available to meet debt-servicing obligations (country transfer risk). Credit terms are also affected by the extent to which lenders are confident that, if necessary, they will be able to trade debt instruments without unduly affecting the price before maturity (liquidity risk)'.

The importance of developing a national shipping line in a developing economy context must be considered 'in the round'; There will be compelling arguments both in favour and against such a strategy.

Hansen[18] states;

'Sound investments in shipping are likely to result in some net savings of foreign exchange. The relative savings will be greatest where, at least after an initial build-up period, the country can utilise domestic rather than foreign shipping resources, e.g., crews, management and overhead, insurance, communications, vessel repairs, spare parts and supplies, and possibly even the ships themselves. The net foreign exchange savings may be relatively greater from the more labour-intensive types of vessels and from the use of second-hand vessels….'

Securitisation presents a useful technique for developing countries to develop their shipping industries since it may help in assuage the concerns of international investors in several ways. First, if the special purpose vehicle is incorporated outside the jurisdiction of the country, as is usually the case in most securitisations but for predominantly tax-driven considerations, the political or corruption risks sometimes associated with developing countries can be addressed. If the SPV is controlled and administered by an independent trustee, for example an international bank of high standing, and any collateralisation of the SPV, principally in the form of vessels, is owned by the SPV itself rather than the state shipping line, then investors should be more confident regarding their legal rights should there be default in loan repayments. For example, the law governing investors' rights will be set out in the jurisdiction clause governing the structure, usually English law or the law of the United States, making it easier for court judgments to be obtained and enforcement measures such as arrest of a vessel initiated. Investors will not be obliged to rely upon domestic legal systems that may involve substantial delay and a restricted range of remedies that it may not be practical to enforce. Second, cashflows in the form of future freight receipts will accumulate in an account in the SPV's name held with an international bank. Payments on loans will be made to lenders by the SPV and the remainder in the account then paid on to the state shipping company. In this way the risk of interference with payments between earning and passing on to lenders or investors is minimised. This outcome has been called the 'piercing of the sovereign ceiling' since it enables companies to borrow in the international markets at rates of interest lower than those obtainable by their own governments. However, it has been alleged by critics that in the context of emerging economies securitisation can amount to a mortgaging of a country's future earnings in favour of foreign investors, who in turn may acquire ownership of domestic assets and, as such, should be opposed as a method of raising capital in international markets. Third, it will be easier for the general maintenance of the fleet to be ensured if ownership is vested in the SPV with oversight by the trustee, rather than might be the case if the fleet is instead owned and maintained by a domestic shipping company within a developing country. In this context it can be seen that financial engineering, or the creation of complex financing techniques, can be utilised for the benefits of borrowers not just in a developed economy context, but also in a developing economy with all the economic and social improvements that flow from this.

[18] Developing Countries and International Shipping. Hansen. Published by the World Bank, 1981. Staff Working Paper No. 502.

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Repackaging
- homogenous cashflows
- asset-backed
- structure
- procedure
- collateralisation
- emerging economies.

7.5 Test Questions

Having completed Chapter 7 attempt the following questions and submit your answers to your Tutor.

1. Identify the main components of a securitisation structure.

2. What are the main requirements which a cashflow must possess before it can be securitised?

3. Why is it necessary to set up a special purpose vehicle as an interposed party between investors and the originator-shipping company?

4. Identify and discuss the main requirements for success of a securitisation by a shipping company (you may include marketing considerations).

Chapter 8

KS and KG Financing

Learning Objectives

By the end of this Chapter you should understand the impact of government policy upon shipping finance, be fully aware of the historical background to and structure of German KG shipping finance, be able to critically evaluate the strengths and weaknesses of KG shipping finance and be fully aware of the structure of Norwegian KS shipping finance.

Contents

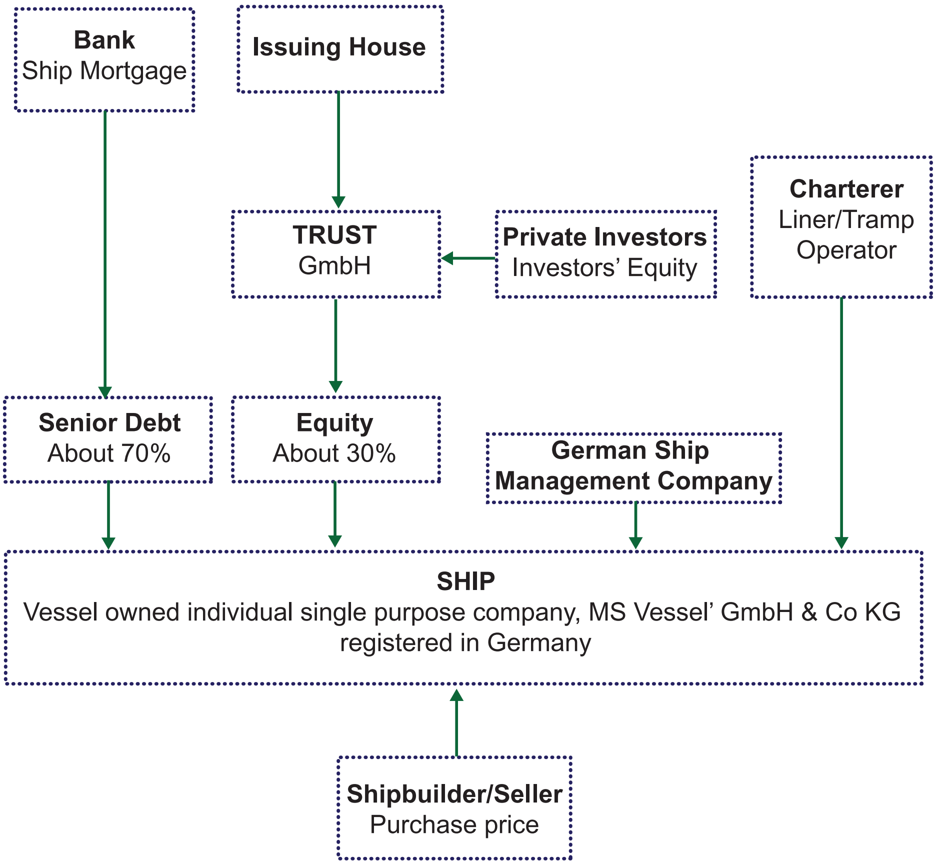
8.1 The German KG Approach to Ship Financing

Governments have traditionally taken different approaches to their shipbuilding industries, some believing that market mechanisms are the best way to ensure that demand and supply for newbuildings is kept within a sensible equilibrium, others taking a more interventionist approach. The former policy may be broadly characterised as ‘laissez faire’, believing that subsidies merely postpone the day when inefficiencies in the domestic industry collide with reality, leading to widespread job losses as the sector ‘downsizes’ to compete with yards in other countries where low labour costs, coupled with high tech investment, ensure greater market penetration. The latter approach, in which the state takes responsibility for protecting its domestic shipbuilding capacity, perhaps for employment maintenance purposes of for wider strategic reasons such as the reluctance to end up in a position of over reliance upon overseas carriers, manifests itself in several broad instruments of political/social policy. First, direct subsidies may be provided, either to yards themselves or further upstream, perhaps by subsidising energy costs or preference in terms of awards of government contracts. Both approaches risk challenge by foreign competitors as being in contravention of the basic tenets of the global system, as established under the former General Agreement on Trade and Tariffs and, latterly, under the rules of the World Trade Organisation.

8.1.1 A Typical KG Structure

A ‘middle way’ policy was adopted in the domestic shipping sector by German governments in the 1990s, resulting in German shipping finance banks accounting for 60% of international ship finance by the early years of the 21st century. This system is known as the Kommanditgesellschaft, or the ‘KG’ model, based upon the German limited partnership structure that had been around for nearly a 100 years. Originally, in the early 1970s, the policy was aimed at simply attracting equity into domestic real estate and infrastructure project financing via single purpose, single asset companies. Later, in the 1990s, the

German government provided even greater tax incentives to shareholders who invested in the shipping sector. Under the system a KG has one general partner and several limited partners, comprising private investors who take shares (and therefore limit their liability to the extent of those shareholdings) in a fund established to invest in new or second hand tonnage and, in this way, participate in the profitability of the shipping sector. Individuals who alone would not be able or willing to invest in the sector, pool their resources with other investors, creating a fund that can invest in single ship companies. Risk is shared between the investors but is not unlimited, as would be the case of a true partnership; liability begins and ends with the extent of the shares held. The shareholders' liability on their equity is augmented with the equity of the GmbH, with a minimum of EUR 25,000. Each investor shares profits and losses in the venture in proportion to its equity stake. The general partner will be a limited company, or 'Gesellschaft mit beschrankter Haftung' or 'GmbH'. A 'closed shipping fund' will raise the amount of equity capital required to finance a single high-investment carrier; when the amount has been raised the fund will close and new participants will not generally be admitted. A typical KG structure is provided in Figure 9.



Source: Von Oldershausen, 2005

Figure 9 Typical structure of a KG deal

The total proportion of equity available in a typical KG is around 30% of the vessel cost, with the remaining 70% provided by a bank through a loan secured with a ship mortgage. Income generated from deployment of the vessel, either (preferably) on a long term time charter party or on the spot market, will be used over time to pay off both the shareholders in respect of their interests, and the bank loan. At that point the fund will own the vessel outright. During this paying down period, shareholders will also participate in the profits of the vessel through dividend payments, and will also share in the gain, if any, accruing to the fund on the disposal of the vessel. The KG will be liquidated once the vessel has been sold. Subject to certain qualifying conditions, the tax advantages to be gained by investors in KG closed shipping funds are considerable, and there has been an enormous flow of shareholder funds into the sector throughout the past two decades. The principal qualifying conditions for a KG fund are:

- The vessel must be in compliance with international classification standards
- all types of vessels qualify, including bulkers, tankers, and gas carriers
- the vessel must be on time charter only
- management of the company must be based in Germany.

8.1.2 Advantages of KG Ship Finance

The United Kingdom law firm, Watson, Farley and Williams, set out the tax advantages to investors in KG shipping funds in a briefing note, issued in January 2009:

> *'The main attractions of the German KG model with respect to shipping funds are the benefits available under the German tonnage tax regime. Under the tonnage tax regime, enterprises and individuals with seagoing vessels have the opportunity to be taxed on the basis of a deemed profit related to the ships tonnage instead of the actual operating results. The basis for the calculation of the deemed profit is an amount per net ton of the ships in operation. According to the German tonnage tax system the profit earned is fixed at a certain amount and is much lower than the average profit calculated on the basis of the regular rules of determination of the taxable profit. All profits including capital gains as well as losses from the shipping business are covered by this lump-sum profit. The lump-sum profit is the tax basis for trade tax and income tax of all investors. Effectively the lump-sum allows a nearly tax free income from shipping business for the investors'.*

On November 13th 2009, Bloomberg.com reported that the KG shipping finance sector had crashed. The item's author, Kyunghee Park, explained how ER Capital Holding GmbH & Cie KG, the largest operator of German closed-end shipping funds, had reported that plunging freight rates and industry losses would probably cause a second sector-wide drop in investments during 2010.

Bloomberg quoted ER's Chairman, Erck Rickmers;

> ***"The market has completely crashed this year…. Investors don't like uncertainties and there are too many uncertainties".***

The global recession had reduced trade demand, coinciding with excess shipping capacity flooding the market, depressing freight rates and vessel prices. Newbuildings ordered during the previous boom were also now being delivered into a falling market, exacerbating difficulties even further. Rickmers anticipated that investors would eventually return to the KG market, possibly in 2011, but slowly and with caution. The Bloomberg article and observations by the Chairman of ER Capital Holdings are useful illustrations of the consequences of a mismatch between government policies in the form, in the context of KG financing, of tax incentives given to investors in the industry. Shipping is at its heart a cyclical business, tax regimes that deliberately seek to affect investor behaviour do so at their peril if tax planning is elevated above consideration of market fundamentals, the inevitable processes of boom, recession and depression, and the unintended consequence of oversupply of tonnage into falling markets.

8.2 The Norwegian KS System of Ship Finance

8.2.1 Structure of KS Financing

A significant proportion of the equity contributed by the limited partners is in the form of uncalled capital, usually comprising a maximum of 25% of the total investment. At least 40% of this uncalled capital upon the establishment of the KS, or within a maximum of two years following this date, with at least 20% paid up front. Lenders are able to treat this uncalled capital as an additional form of security in respect of loans. Following its setting up, the KS will then purchase a vessel (the structure works on the basis of one-vessel ownership, as is the case with the German KG equivalent), and either bareboats or charters it to a shipping company for a period of up to a usual maximum of 10 years or more, usually a shorter charter. Purchase money for the vessel is provided by the shareholders and a bank loan, the latter secured by a mortgage of the vessel, assignment of freight earnings and insurances.

In March 2005 Asia's leading offshore support and marine services provider, Ezra Holdings Limited, concluded a US$78.05 million sale and leaseback agreement on 4 anchor handling, towing and supply (AHTS) vessels with Mount Faber KS, a Norwegian limited partnership 50% owned by NFC Shipping Fund V LLC. The 4 vessels, comprising 1 × 12,240 brake horsepower (bhp) AHTS, 1 × 8,000 bhp AHTS and 2 × 14,000 bhp AHTS, were delivered throughout 2005 and 2006. Mount Faber KS purchased the AHTS vessels upon their completion.

Under the agreement, after the purchase Mount Faber KS leased the vessels to Ezra's wholly-owned subsidiary, Emas Offshore Pte Ltd, on a bareboat charter basis.

Mount Faber KS is a Norwegian Limited Partnership established solely for the purpose of the transaction. It was 50% owned at inception by NFC Shipping Fund V LLC, with the other 50% owned by 4 Norwegian investors. NFC Shipping Fund V LLC is wholly owned by Navigation Finance Corporation (NFC), a joint venture of DVB Bank and Northern Navigation International. NFC is a private equity provider to t
e maritime industry. DVB Bank AG, based in Frankfurt/Main, is an international advisory bank and finance house that specialises in the global transport market. Northern Navigation Group was set up in 1991 and is controlled by the Lorentzen family. It has offices in Oslo, Norway, and Greenwich, Connecticut, USA, and participates in shipowning and finance activities.

8.3 Similarities Between KG and KS Financing

In many ways the Kommanditselskap, or KS, system of ship financing in Norway is similar to the limited partnership arrangement applied in Germany under the KG system. The KS system is founded upon a limited partnership but the exception to the KG system is that it applies to older second hand tonnage, while the German system is more restrictive in this regard, preferring to focus upon new tonnage and newbuildings. Again, KS focuses upon one ship companies and a relationship between one general partner and several limited partners, the liability of whom is restricted to their shareholdings in the venture. Both the general and limited partners may be corporate entities or private investors lacking legal personality. The liability of the limited partners is restricted to the amount they have contributed. If this has been partly paid or is uncalled, then should the venture fail they will be obliged to make up the shortfall on their contribution (pay off the amount outstanding), but will not be required to go beyond this in a form of unlimited liability, which is found in the traditional partnership arrangement. The general partner, however, has joint liability in respect of the KS. If one or more of the limited partners defaults, or becomes bankrupt, or fails to discharge its obligation for some other reason, that proportion of the risk underwritten accrues to the general partner. In this regard the general partner has unlimited liability towards creditors of the KS in a manner recognisable in the traditional partnership arrangement. However, since most investors will be unwilling to assume such an open-ended liability, general partners are usually single purpose companies. According to Stokes (1997), KS ship financing reached its peak in the late 1980s, energised by a landmark Norwegian court ruling that stipulated that KS partnerships would not be taxed as corporate entities but, instead, at the level applicable to the individual partners. The KS sector was to boom on the basis of this preferential treatment, but fell back in popularity in the early 1990s following a series of tax reforms in Norway that significantly eroded the competitiveness of these arrangements in terms of depreciation of assets and the ability to defer tax obligations in the context of capital gains.

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Project financing
- tax incentives
- partnership
- time charterparty
- advantages
- legal personality.

8.4 Test Questions

Having completed Chapter 8, attempt the following questions and submit your answers to your Tutor.

1. Describe the basic features of the German KG approach to shipping finance.

2. Discuss the basic features of the Norwegian KS system of shipping finance.

3. To what extent are the two forms of financing you described above compatible with the free market mechanisms which usually govern the raising of shipping finance in the global capital markets?

Chapter 9

Importance of the Debt-Equity Structure in Shipping Finance

Learning Objectives

By the end of the Chapter you should understand the historical background to the formation of the Basel Committee, appreciate the components of the Basel capital adequacy ratio and its relevance for shipping finance, be capable of critically evaluating capital financing theory and understand in detail the relevance of a flexible debt-equity structure for a shipping company.

Contents

9.1 The Lender's Perspective

9.1.1 The Basel Committee

The Basel Committee on Bank Supervision was established by the central bank governors of the 'Group of Ten' countries at the end of 1974. The Committee meets four times a year. It was set up in response to a series of bank failures, including Bankhaus Herstatt in Germany and Franklin National Bank in the United States, which illustrated beyond doubt the global nature of banking and the need to protect stakeholders such as depositors and shareholders in a global context. It was no longer sufficient for regulators to look to protect their own domestic constituency. When a bank failed in one country it invariably had negative implications and consequences for stakeholders in a wide range of other countries, including international banks that may have lent to that bank. Today, the Committee's members come from a wide range of countries including Argentina, Australia, Belgium, Brazil, China, France, Germany, Saudi Arabia, Spain, Sweden, Turkey and the United Kingdom. The paradox is that, although the Committee is the pre-eminent setter of standards for bank regulation, its recommendations have no legal force and it has no policing power to investigate or ensure that individual countries are complying with its standards. Those standards are also a 'minimum'; they can be exceeded by more stringent requirements imposed by regulators upon their own domestic banking sectors if considered necessary to strengthen the stability of the system. The Committee recommends broad supervisory standards, guidelines and statements of best practice, with the intention that individual regulatory authorities will implement these through their own codes of conduct or statutory rules. The principal goal of the Committee is to achieve convergence or harmonisation of bank regulation at the domestic level between member countries, such that the opportunities for banks to engage in international regulatory arbitrage diminish over time (arbitrage is the ability of banks to exploit inconsistencies in the international regulatory system, for example, establishing subsidiaries in countries where the disclosure rules or capital adequacy guidelines are weaker than in other countries).

In 1988, the Committee introduced a capital measurement system called the Basel Capital Accord. The system comprised a credit risk measurement framework with a minimum capital standard of 8%, to be implemented by the end of 1992. The framework has found its way into the regulatory frameworks of most member countries but has also been widely accepted by non-members as the predominant international set of minimum regulatory requirements. In June 1999, the Committee extended its regulatory recommendations in its proposal for a Capital Adequacy Framework. This consisted of three pillars: minimum capital requirements based upon and taking further the elements set out in the 1988 Accord, supervisory review of institutions' internal risk assessment systems, and disclosure to strengthen market discipline or effective oversight by stakeholders as a complement to the role of supervisors. In June 2004, a further tighter revised framework that provided a template for national legal provision by members was issued by the committee.

9.1.2 The Significance of the Capital Adequacy Ratio

The capital adequacy ratio is the ratio of a bank's capital to its risk. It is the key to a bank's ability to withstand shocks, such as major defaults on loans or a wider economic crisis, that might result in a bank run. If a bank is undercapitalised relative to the risks that it holds in its balance sheet, there is a danger that it will be unable to meet its own costs, and will become insolvent. One of the worst illustrations of a banking crisis was that which occurred during the Depression in the United States during the 1930s. During the space of a couple of years over 10,000 banks failed across the United States, one of the principal causes being the extent to which so many of them were hopelessly undercapitalised. For example, in some states it was possible for a bank to gain a licence with US$2 million in capital, an amount that made it highly likely to fail with a series of small defaults or insolvencies among its borrowers. The problem in the United States was also exacerbated by the prohibition on national banking; banks could only conduct business on a state by state basis, resulting in a proliferation of highly undercapitalised 'unit' banks.

During the recent 'credit crunch', banks around the world failed for a similar reason, an inadequacy of capital relative to the degree of risk that they had assumed in their lending, and an inability to raise fresh capital through borrowing in the interbank market, share issues, or increases in the amounts placed in savings by depositors. In the case of the UK bank Northern Rock, the bank was funding its lending through a combination of approximately 25% from its depositors and the remaining 75% from borrowing in the interbank market. When the interbank market effectively dried up in terms of the availability of credit, the Northern Rock became unable to fund itself and eventually ended up in government ownership.

9.1.3 The Basel Capital Adequacy Ratio

Capital adequacy can be expressed as:

CAR = Capital/Risk.

The Basel Committee divides capital into three levels or 'tiers'. Tier 1 is the bank's core capital and comprises equity capital, retained profits, subtracting accumulated losses (in other words, the amount available for payment out to shareholders in the form of dividends but which instead has been retained and not paid out by the company) and disclosed reserves. Equity is important because it represents capital that cannot be returned at the option of the holder. In English law it is not possible for a company to repay shareholders' funds precisely because it is the extent of their liability to creditors (in other words, it is the 'cushion' available to creditors in the event of the company becoming insolvent). Tier 2 capital is secondary capital comprising items that include undisclosed reserves, revaluation reserves (where a bank revalues an asset which it holds, such as freehold premises, and includes this increase in its accounts), general loss reserves (where the bank is aware that it has incurred losses but is not yet able to precisely ascertain or measure the nature or extent of those losses), subordinated term debt (debt that is not redeemable-it cannot be called upon to be repaid- for a set (usually long) term and ranks lower than (it will only be paid out after) ordinary depositors of the bank) and hybrid instruments (instruments that have characteristics of both debt and equity, but are akin to equity where the holder may take a loss on the face value without triggering a liquidation of the bank). Undisclosed reserves may be defined as the unpublished or hidden reserves of a bank that may not appear on the balance sheet but are, nonetheless, real assets. These are not common, but are accepted by some regulators where a bank has made a profit but this has not appeared in normal retained profits or in general reserves. Most regulators regard this item as distortive of the bank's financial data as presented to the public, and in many cases it is not permitted.

Tier 3 capital is capital held by banks to meet part of their market risk, commodities risk and foreign currency risk. Essentially, this is short term subordinated debt. To qualify as tier 3 capital, assets must be limited to 250% of a bank's tier 1 capital, be unsecured, subordinated and fully paid up, and have a minimum maturity of two years. It must not be repayable before the agreed repayment date unless the supervisory authority agrees, and must be subject to a lock-in clause stipulating that neither interest nor principal may be paid (even at maturity) if such payment means that the bank falls below its minimum capital requirement. Tier 3 capital must be capable of becoming part of a financial institution's permanent capital, available to absorb losses in the event of insolvency.

The capital adequacy ratio is one of the central planks of the Basel Capital Accord of 1988. The minimum ratio of regulatory capital to risk-weighted assets is set at 8% (the core regulatory capital element should be at least 8%). However, it is important to appreciate that these ratios represent the essential minimum necessary, according to the Basel Committee, to ensure stability of the international banking system and its ability to withstand short-term shocks.

In the context of the global shipping industry, it is probably fair to assume that the Basel II approach to risk weighting of banks' capital bases will be either neutral in the case of large companies with sound internal governance systems, or negative for medium to smaller size companies. The reasons for this assumption are threefold. First, and as seen earlier, shipping has been traditionally perceived by investors as a highly volatile industry, subject to sharp peaks and troughs at either end of the economic cycle. This perception is evidenced in the lower ratings attributed to shipping companies, by international ratings agencies such as Standard and Poor's and Moody's, when compared to similar sized companies active in other industrial sectors. Accordingly, banks will, *ceteris paribus*, be required to allocate greater capital towards shipping loans in their portfolios, this being reflected in the greater interest margins demanded on loans to the companies themselves. Second, risk on loans is further increased by the mobile nature of the industry. Ships are, by definition, moveable assets and for this reason a bank looking to enforce a security provision in a loan may find that the asset has been moved beyond the reach of its domestic legal process. This risk is heightened by the use of 'one ship company' structures which mean, usually, that a vessel held in one subsidiary company cannot be arrested in respect of an outstanding loan to a vessel held by another subsidiary within the same group (subject to legal caveats and reservations). Third, a lack of transparency on the part of dealings by medium to smaller size companies usually results in risk being 'overestimated' by banks, negatively impacting upon the capital adequacy ratio as stipulated by Basel and determined by banks' own internal risk evaluation models. A higher rate of interest payable by all but the very largest and most transparent of global shipping companies would appear to be an unavoidable consequence of this risk evaluation process.

9.2 The Shipping Company Borrower's Perspective

The debt-equity ratio for a shipping company is a vital consideration, even if determined in a sometimes 'rough and ready' way. The process is often driven not by the issue of precise balancing, but instead by the owner being forced to obtain finance from those sources which are willing to provide it rather than from those from which it would have preferred to have taken it. In simple terms, beggars cannot be choosers. The consequences of an imbalance can be fatal. For example, a company that has significant levels of debt in its capital structure may find itself unable to meet interest payment obligations in the event of a downturn in freight earnings. Default, in turn, results in liquidation. However, a company with significant equity in its structure may find that shareholders 'clamour' for ever-greater amounts of information about the company's activities and future plans. Such voices cannot be ignored when raised at, for example, annual general meetings. For family-owned businesses the risk of a hostile takeover by an unwelcome shareholder may also present a reason against raising finance through the equity route. Although dividend payments are discretionary in contrast to interest payments on debt, which are obligatory, it is also a simple truth that a company that ignores its shareholders usually experiences a sharp decline in its share price as a consequence. If shares have been given as partial collateral to other lenders, a decline will often trigger value maintenance provisions in loan agreements, meaning that further security will have to be offered up to make good this decline. It is against these realities that the more academic nature of the capital financing debate must be considered.

9.2.1 A Brief Overview of Capital Financing Theory

In their groundbreaking work on the capital structure of companies, Modigliani and Miller derived two propositions, known also as the capital structure irrelevance theory. The theory states that, in the absence of taxes and bankruptcy costs, and in an efficient market, a company's value is unaffected by how it is financed, whether this be by equity alone, a mix of debt and equity, or entirely debt (or completely leveraged).

In any consideration of the optimal mix of debt and equity in a company's balance sheet, the starting point must be the Modigliani-Miller (MM) theorem, sometimes known as the capital irrelevance theorem. This theorem provides that, in the absence of bankruptcy costs, taxes, and asymmetric information (firms and investors can borrow or lend at the same rate), and in an efficient market, the value of a firm is unaffected by how it is financed. In other words, it does not matter whether a company finances its activities entirely by debt (requiring mandatory servicing through interest payments) or entirely through equity (discretionary payments to shareholders in the form of dividends). Dividend policy is also irrelevant; the company may make payments as high as it wishes, subject to legal constraints, or make none at all. It is entirely irrelevant.

Modigliani[19] defined the theorem as follows:

> *'… with well-functioning markets (and neutral taxes) and rational investors, who can 'undo' the corporate financial structure by holding positive or negative amounts of*

[19] Modigliani, F. (1980). Introduction. In A. Abel (ed.), *The Collected Papers of Franco Modigliani,* volume 3, pp. xi-xix. Cambridge, Massachusetts: MIT Press.

debt, the market value of the firm – debt plus equity – depends only on the income stream generated by its assets. It follows, in particular, that the value of the firm should not be affected by the share of debt in its financial structure or by what will be done with the returns – paid out as dividends or reinvested (profitably)'.

9.2.2 The Components of the MM Theory

The theorem has four principal components, evolved from several academic papers:

i. Under certain conditions, a firm's debt-equity ratio does not affect its market value
ii. A firm's leverage (simply put, its level of debt) has no effect on its weighted average cost of capital
iii. A firm's market value is independent of its dividend policy
iv. Equity-holders are indifferent about the firm's financial policy.

Miller[20] explained the intuition for the Theorem with a simple analogy.

"Think of the firm as a gigantic tub of whole milk. The farmer can sell the whole milk as it is. Or he can separate out the cream, and sell it at a considerably higher price than the whole milk would bring."

"The Modigliani-Miller proposition says that if there were no costs of separation, (and, of course, no government dairy support program), the cream plus the skim milk would bring the same price as the whole milk."

Anne P. Villamil[21] of the University of Illinois has proposed the following interpretation of this analogy;

'The essence of the theorem in its most simple sense is that increasing the amount of debt (cream) lowers the value of outstanding equity (skim milk): selling off safe cash flows to debt-holders leaves the firm with more lower valued equity, keeping the total value of the firm unchanged. Put differently, any gain from using more of what might seem to be cheaper debt is offset by the higher cost of now riskier equity. Hence, given a fixed amount of total capital, the allocation of capital between debt and equity is irrelevant because the weighted average of the two costs of capital to the firm is the same for all possible combinations of the two'.

9.2.3 Criticisms of the MM Theory

The Modigliani-Miller propositions have been considered in numerous academic papers, and a number of observations and criticisms made. These have included the following.

i. If the approach is taken that levels of debt are irrelevant and it does not matter if a company does not make any use of equity, this can be used to justify unsustainably high financial leverage, or gearing. As debt increases so does the bankruptcy risk or the prospect of the company becoming unable to service its interest payments. In the context of highly cyclical industries such a capital structure makes the possibility of bankruptcy even more likely during economic downturns.

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[20] Miller, M. H. (1991). *Financial Innovations and Market Volatility*, Cambridge, Massachusetts: Blackwell Publishers.
[21] Anne P. Villamil, The New Palgrave Dictionary of Economics.

Merton H. Miller, in his testimony in the case of the US bank, Glendale Federal Bank's lawsuit against the U.S. Government, December 1997, put it succinctly:

> *'I have a simple explanation [for the first Modigliani-Miller proposition]. It's after the ball game, and the pizza man comes up to Yogi Berra and he says, 'Yogi, how do you want me to cut this pizza, into quarters?' Yogi says, 'No, cut it into eight pieces, I'm feeling hungry tonight.' Now when I tell that story the usual reaction is, 'And you mean to say that they gave you a [Nobel] prize for that?'"*

ii. The propositions are unrealistic in practice. Companies are subject to taxation in most trading scenarios, and yet the propositions are made on the assumption of no taxes. They also assume that there are no costs involved in raising debt. This is another assumption not applicable in practice, where investment banks can apply substantial fees for their efforts in raising finance on behalf of corporate clients. There is also an assumption that markets are efficient and knowledge or information are transmitted within them with minimal effort or resistance. This is rarely the case; insider dealing legislation is premised almost entirely upon an assumption that some players in the markets have information that is not available in the public domain and, as such, can be exploited for personal gain.

iii. The proposition that the debt element within a company's capital structure is irrelevant has been challenged in the context of leveraged buyouts, or LBOs. In an LBO an investor, usually a private equity firm, raises a significant amount of debt to purchase equity in a company, usually opposed by its existing owners, in which case it is a hostile takeover. The investor raises capital in part on the security of the assets and future cashflow of the company to be acquired and, in this sense, is raised on a non-recourse basis in that providers of the capital cannot turn to the assets of the investor for repayment of their loans in the event of default in interest payments by the acquired company. In this way the investor only needs to provide a small proportion of the debt required, the remainder is raised on the security of the target's assets. The use of debt to finance the acquisition, rather than equity, increases the financial return to the equity investor or acquirer. Since payments on the debt are usually fixed any increase in share value, which invariably follows after corporate restructuring, disposals of assets, and reduction of management overheads have been achieved, pass through to the investor in the form of increased dividend payout. The tax shield of debt raised to finance the takeover also increases the value of the company. A tax shield is the reduction in tax that arises when an allowable relief is taken in respect of interest payments made upon debt. In contrast, distributions to shareholders in the form of dividends are taxed (while interest payments to debt are not). The greater the amount of debt taken on, the greater the interest payments, the greater the capitalised value of cash flowing to debt than would be the case of cashflow passing to shareholders in the form of dividends. Cashflows of a company are increased because of the increase in the allowable relief in respect of interest payments made on debt, hence increasing the value of the company in the process. The savings of such shielded cashflow then pass through to shareholders in the form of increased dividends. In both these scenarios the MM propositions do not appear to hold true; taking on more debt has both increased the value of the company and the cashflows passing through to shareholders. In this regard the debt-equity ratio is not irrelevant.

9.3 Shipping Finance and the Debt-Equity Mix

The debt-equity structure within a shipping company cannot be regarded as static, it has to change and adapt according to the position in the shipping cycle in which the company is trading. Specifically, the cycle may affect finance-raising considerations in the following ways.

i. When the shipping cycle is at its zenith and the industry is experiencing a boom, it is usually the case that tonnage demand exceeds tonnage supply. Shipowners are able to maximise their vessels' earning capacity, either deploying them in lucrative voyage charter parties or in the spot market. Freight earnings increase, enabling the company to service debt which, if the wider economy is also prospering, will be at lower interest rates. At this time demand for vessels in the S&P market will also increase, driving up prices as spare capacity becomes increasingly difficult to obtain. In this scenario one of the principal forms of security available to lenders to shipping companies, the ships, experience a spike in their value. (Historically shipowners have regarded profits made on ship disposals as of equal importance to freight earned from the trading of vessels). Banks are willing to make loans against such security, and usually at low interest rates. Shipowners should be aware that such loans invariably contain value maintenance clauses; the borrower will have to provide additional security should the vessel value decline. But in an exuberant market the implication of such clauses for the future are often overlooked. Debt is relatively cheap at this time so the company will raise debt at this point. If debt is being raised at this point in the cycle, it should be at a fixed rate if at all possible.

ii. When the shipping cycle is at its nadir, freight rates will be low or even non-existent, resulting in laying up of tonnage. Asset values will also fall, the greatest evidence being declines in the S&P market. Newbuildings ordered at the peak of the cycle will be delivered, exacerbating the problem of oversupply of tonnage into the market, depressing second-hand tonnage further. Share prices will be depressed and investor appetite for equity weak. As a general principle, share prices follow freight rates downwards, with a lagging effect. Banks will be wary of making loans given that asset values will be low. At this point alternative sources of security, such as guarantees given by wealthy shipowning individuals, will be required or charges will be made over other assets such as property or shares. Assignment of insurances and cashflows taken at the peak of the cycle will be of increasing importance to lenders.

iii. At the nadir of the cycle earnings will be low and vessel deployment limited. In this scenario the company may be reluctant to take on debt at high rates, and may in any event find loans difficult to come by. Besides, in such an environment companies will not be raising additional capital for, for example, making purchases in the second-hand market or placing orders for newbuildings. Debt may be required principally to meet running costs and to keep the company 'afloat', or to meet its existing payments on expensive floating rate debt raised at a different point of the cycle when debt was cheap relative to other forms of funding such as equity. At this point a deep discount bond with a stepped coupon, or even no coupon, may be appropriate. A sinking fund may also be useful; as freight rates improve as the industry begins to recover, improved freight earnings should enable bonds to be redeemed, leaving less to be found by the borrower at maturity. Sales of vessels on maturity may be feasible in order to meet any balloon payment. If timing is correct, when the bond issue matures and the payment has to be made, the cycle should be approaching its next peak when asset prices are strong, placing less stress on the borrower's finances to meet the balloon.

Alderton[22] identifies this opportunity to provide for a balloon payment at a time when vessel values are at their peak as follows;

'Ultimately nearly all important decisions in sea transport operations depend on the ability to judge the future trend in the freight rates. A ship may appreciate in value three or four times in a few weeks on a rising market and depreciate perhaps even quicker on a falling market. It has been said that more money can be made out of buying and selling ships at the right time than by operating them successfully'.

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Basel Committee
- capital adequacy
- tiers
- risk
- Modigliani Miller
- criticisms
- debt-equity
- mix.

9.4 Test Questions

Having completed Chapter 9, attempt the following questions and submit your answers to your Tutor.

1. You are the Chief Financial Officer of a shipping company which has a high level of debt in its capital structure relative to equity. You are asked to write a briefing note to the Chief Executive Officer describing the potential consequences of this imbalance, and how banks may respond to it if the company seeks further funding in the future (you should also consider the implications of such lending for the banks in terms of impact upon their own balance sheets).

2. 'The overall size of a cake is not affected by the number of slices into which it may be cut'. Discuss this observation in the context of the Modigliani-Miller irrelevance hypothesis.

[22] Sea Transport. Operation and Economics. Alderton, P.M. Thomas Reed Publications Ltd, 1984 at p. 90.

Chapter 10

Islamic Finance

Learning Objectives

By the end of this Chapter you should understand in detail the drivers of Islamic finance, and appreciate the structures of the principal Islamic financial instruments and how they accommodate the fundamental principles.

Contents

During the past decade, Islamic finance has become of increasing relevance and importance as an alternative source of finance both in project financing in general and shipping finance in particular. Estimates indicate a growth rate in the sector of at least 15% per annum during the past 5 years, reflecting a flow of funds into Shariah compliant instruments from both sovereign (or state-owned) investment institutions, mainly located in the Middle East, and private owners of capital looking for savings and investment opportunities that comply with their own religious requirements.

One of the most significant players in the provision of Islamic products in the context of shipping finance is Fortis Bank. In November 2009, Fortis Bank signed a joint venture agreement with Qatar’s leading investment bank, QInvest Bank, in which each committed US$50 million to the QInvest-Fortis Bank Nederland Shipping Fund, making it the world’s first Sharia’a-compliant fund.

10.1 General Principles

There are a number of principles underlying Islamic finance, but among them the most important are the following:

i. The payment or receipt of interest or ‘riba’, is prohibited. The prohibition is against excessive interest or usury. There are conflicting positions between several Muslim countries as to what constitutes unacceptable interest. In some, simple interest is acceptable but not compound, while in others, for example Turkey, interest has been acceptable if its purpose is to counteract the effects of inflation. In some countries interest in any form is unacceptable. There are several reasons for this prohibition but perhaps the most widely accepted is that payment of interest involves oppression or exploitation of the debtor by the creditor, and also results in the accretion of wealth to those who already possess wealth but without it necessarily being used for a socially productive purpose. For this reason fixed interest loans or bonds paying a fixed coupon are not acceptable in an Islamic context.

ii. Speculative activity is not permitted. For example, it is not possible to speculate on differences between prices in different markets (the essence of arbitrage), nor is it possible to sell something before legal ownership or full possession has first passed to the seller. It is for this reason that short selling of financial instruments (selling them before actually taking possession of them) is prohibited in most Islamic countries. In this context gambling is also prohibited or 'gharar'.

iii. There must be a genuine sharing of risk in a venture between the provider of capital and the entrepreneur. One of the principal forms of business between the two groups is a quasi-joint venture arrangement.

iv. Certain activities are prohibited, such as businesses involving gambling or alcohol. Gambling involves excessive risk-taking or 'maisir' for no socially beneficial purpose. These activities are 'haraam', or 'forbidden'.

v. Socially and economically productive use of capital, and charitable giving, are of fundamental importance in the decision whether or not to finance an activity.

10.2 Financial Instruments Compliant with Islamic Financing Principles

There are a number of innovative financial instruments that have been developed in recent years, amongst which are the following.

10.2.1 Mudharabah

This is one of the most widely used methods of financing and effectively constitutes a form of joint venture between the provider of capital or the investor (the 'rabb-ul-mal'), and the borrower or entrepreneur (the 'mudarib'). Profits generated from the project are shared between the parties in accordance with a pre-agreed profit-sharing ratio. In its basic form the loss to capital accrues to the investor, and there is no recourse to the entrepreneur in respect of this unless the mudarib has been negligent, guilty of misconduct, or been in violation of the terms of the agreement. Management of the investment is the sole prerogative of the mudarib. Also, no security can be taken in the form of, for example, a personal guarantee or charge over assets. The loss to the entrepreneur arises from the expenditure of time and effort on the project and this is not reimbursed to the entrepreneur by the investor. In 'musharaka' financing, profits are allocated between the parties according to a pre-agreed ratio, as is the case with mudharabah financing, but with the distinction that losses are shared between the parties in accordance with the equity participation in the venture.

10.2.2 Murabaha or 'Cost-Plus' Financing

Under this arrangement the investor, usually a bank, acquires an asset from a seller on behalf of the client or entrepreneur. Possession and legal ownership passes to the investor whereupon it is then sold to the entrepreneur at an increased price or mark-up to reflect the acquisition costs to the investor and the lost alternative investment opportunities arising from having acquired the asset. The investor can add to the price to reflect the risk that the entrepreneur will not go ahead with the purchase, and for having capital tied up in the asset until the second sale goes ahead. The danger with this form of finance in terms of compliance with the Shariah prohibition of 'riba' is that these added costs can be used as an indirect way of charging interest. However, the basic distinguishing feature compared with non-Islamic finance is that, under murabaha, risk continues to rest with the lender and security cannot be taken over the assets of the entrepreneur. If the client refuses to go ahead with the purchase from the bank or investor, a compelled purchase cannot be ordered by a Shariah court; the investor will have to retain the asset unless, and until such time as, it can be disposed of at a later date, perhaps at a loss. However, the reputational damage to the entrepreneur will be considerable, and the prospect of finding future providers of murabaha financing significantly reduced.

10.2.3 Ijara

Ijara is the Islamic form of leasing in which the use of an asset is provided to the lessee for a fixed period and at a pre-agreed price, but not the legal ownership of that asset, which remains vested in the lessor. At the end of the lease the lessee does not have the right to purchase the asset because, according to Shariah principles, this would be to taint the contract with uncertainty. However, under a variant of 'ijara', 'ijara wa iktina', or hire purchase contract, the lessee commits to buy the asset at the end of the lease at a price agreed at the outset, the payments of rentals constituting the principal part of that price. Rental payments only commence after delivery of the asset or equipment to the lessee, and cannot commence earlier. In an Islamic lease the risk of damage or deterioration of the asset rests solely with the lessor or investor/banker; it cannot be shared or allocated to the lessee, as is the case with a conventional lease. As a general rule the lessor is not allowed to insure the risk of destruction of the asset under the lease. Also, penalty payments for late payment under the lease, if linked to the passage of time (for example, payment of 'x' per week or month of default) is not permitted. Assignment of the cashflow arising from the lease by the lessor is not permissible; the payment stream is an asset and property right that is not severable from the underlying asset itself so cannot be assigned without assigning the 'tree' as well as the 'fruit'.

10.2.4 Sukuk

Sukuk is the equivalent of a bond although, unlike its non-Islamic counterpart, it does not generate a fixed rate of interest. By analogy, Sukuk can be compared to securitisation since future cashflows are shared between the issuer and the investors. Such cashflows can be generated from, among other sources, an asset (Sukuk al Ijara), or a business (Sukuk Al Musharaka), the bonds being traded upon both Middle East exchanges but also those in Western Europe, including the London and Luxembourg Stock Exchanges. Underpinning the structure is a binding promise on behalf of the issuer to repurchase the assets generating the cashflow on maturity of the Sukuk bonds. Meanwhile, cashflows derived from the project, for example the trading of a purchased vessel, will be shared with investors or holders of the Sukuk bonds.

On 20th June 2005, Mushtak Parker of 'Arab News' reported through the Middle East's Leading English language daily's website on a US$26 million 'Al Safeena' Ijara Sukuk for Saudi Arabian oil and petrochemical Aramco. The deal was structured, arranged and co-underwritten by the London-based ABC International Bank Islamic Asset Management and combined Islamic equity with conventional debt for the same asset. The asset financed was a VLCC, the 'Venus Glory', owned by Pacific Star (PacStar) International Holding Corporation, in turn owned by Saudi Aramco. The VLCC was chartered on a bareback (bareboat) charter basis through a number of intermediate and sub-charter arrangements to Vela International Marine Ltd, also a wholly-owned subsidiary of Saudi Aramco. The eventual structure approved by ABCIB's Shariah adviser, provided for the transfer of the vessels 'usufruct' to investors in the Sukuk, allowing the legal title in the Venus Glory to remain with PacStar. (Usufruct means that a party has the legal right to use and derive profit from an asset legal ownership or title in which belongs to another). The charter revenues received from the underlying lessee, Vela International Marine, were completely rent-based and were therefore free of riba and acceptable for a Sukuk issue. The Al Safeena Sukuk issuance was listed in Jersey, subject to oversight and approval by the Jersey Financial Services Commission.

Michael G. Alexiou, Managing Partner of Athens-based Alexiou and Co, reported in ArabianSupplyChain.com, September 29th, 2008 that the Al Safeena deal was followed by Qatar Global Sukuk, valued at US$700 million, illustrating the extent to which the technique has gained appeal to investors within a relatively short period of time.

Key Words

Reflect upon and contextualise the following words taken from this Chapter:

- Principles
- speculative
- socially productive
- Mudharabah
- Murabaha
- Ijara
- Sukuk.

10.3 Test Questions

Having completed Chapter 10, attempt the following questions and submit your answers to your Tutor.

1. Identify the main principles underlying Islamic finance.

2. To what extent are the principles you described above compatible with non-Islamic finance in the context of the international shipping business?

3. Briefly identify the main characteristics of Murabaha, Ijara, and Sukuk.

APPENDICES

Appendix 1

LIBERIAN MORTGAGE FOR BILATERAL LOAN (BORROWER AS OWNER)

Draft 00.00.00

DATED 201[●]

[●]
as Owner

and

[●]
as Lender

FIRST PREFERRED LIBERIAN MORTGAGE

in respect of m.v. "[●]"

holman fenwick willan hfw

INDEX

THIS FIRST PREFERRED MORTGAGE is made on 201 [●]

BY

(1) [●], a [company] incorporated in [●] [with company registration number [●]] whose registered office is at [●] (the "**Owner**")

IN FAVOUR OF

(2) **[●],** a [bank] incorporated in [●] acting through its branch at [●] (the "**Lender**").

WHEREAS

(A) The Owner [is registered in Liberia as a foreign maritime entity and][1] is the sole and (save as provided in this Mortgage) unencumbered legal and beneficial owner of the whole of the motor vessel "[●]" (being the Vessel as defined below) registered in the ownership of the Owner under the laws and flag of the Republic of Liberia at the port of Monrovia with official number [●] and IMO number [●] and the following approximate dimensions and tonnages:

Gross Tonnage:	[●]	tons
Net Tonnage:	[●]	tons
Length:	[●]	metres
Breadth:	[●]	metres
Depth:	[●]	metres

all as more particularly described in the Certificate of Registry granted to her by the Commissioner of Maritime Affairs of the Republic of Liberia.

(B) By a loan agreement dated [●] 201 [●] (the "**Agreement**") made between (1) the Owner as borrower and (2) the Lender as lender (a copy of which is annexed hereto as Exhibit A), the Lender has agreed to make available to the Owner a loan of [$][€][●].

(C) The Owner has agreed to execute this First Preferred Mortgage as security for the repayment of the said loan, and the payment of interest thereon and of all other moneys from time to time due or owing from the Owner to the Lender under or pursuant to the Agreement, and has duly authorised the execution and delivery of this First Preferred Mortgage under and pursuant to Chapter 3 of Title 21 of the Liberian Code of Laws of 1956 as amended.

NOW THIS MORTGAGE WITNESSES as follows:

1 **DEFINITIONS AND INTERPRETATION**

1.1 **Definitions**

Words and expressions defined in the Agreement shall, unless otherwise expressly provided herein or the context otherwise requires, have the same meanings when used in this Mortgage, including the Recitals. In addition, in this Mortgage:

"Classification Society" means [●] or such other classification society which is a member of the International Association of Classification Societies as may from time to time be approved in writing by the Lender;

[1] This wording is required if the Owner is incorporated outside Liberia.

“ISM Code” means The International Management Code for the Safe Operation of Ships and for Pollution Prevention as adopted by the International Maritime Organisation as Resolutions A.741(18) and A.913(22) (as amended, supplemented or replaced from time to time);

“ISPS Code” means The International Ship and Port Facility Security Code as adopted by the International Maritime Organisation (as amended, supplemented or replaced from time to time);

“Major Casualty” means any casualty to the Vessel or incident (other than a Total Loss) in respect of which the claim or the aggregate of the claims against all insurers, before adjustment for any relevant franchise or deductible, exceeds [$][€][●];

“Mortgaged Property” means all of the Owner’s right, title and interest, both present and future, in and to the Vessel, the [Charter Rights[2], the] Earnings, the Insurances and all Requisition Compensation;

“Receiver” has the meaning given to it in the [General Assignment] [Insurance Assignment]; and

“Vessel” means the whole of the motor vessel referred to in Recital A together with all her engines, machinery, boats, tackle, outfit, fuels, spares, consumable and other stores, belongings and appurtenances, whether on board or ashore, including any which may in the future be put on board or may in the future be intended to be used for her if on shore.

1.2 **General interpretation**

In this Mortgage:

1.2.1 unless the context otherwise requires, words in the singular include the plural and vice versa;

1.2.2 references to any document include the same as varied, supplemented or replaced from time to time;

1.2.3 references to any enactment include re-enactments, amendments and extensions thereof;

1.2.4 references to any person include that person’s successors and permitted assigns:

1.2.5 clause headings are for convenience of reference only and are not to be taken into account in construction;

1.2.6 unless otherwise specified, references to Clauses, Recitals and Exhibits are to Clauses of and the Recitals and Exhibit to this Mortgage.

1.3 **Insurance expressions**

In Clause 5:

1.3.1 **“excess risks”** means the proportion of claims not recoverable in respect of general average and salvage, or under the ordinary running down clause, as a result of the value at which a vessel is assessed for the purpose of such claims exceeding her insured value;

1.3.2 **“protection and indemnity risks”** means the usual risks (including oil pollution and freight demurrage and defence cover) covered by a protection and indemnity association, being a member of the International Group of Protection and Indemnity Associations, including the

[2] Only include if assignment of charter specifically required by term sheet

proportion not otherwise recoverable in case of collision under the ordinary running down clause; and

1.3.3 **"war risks"** includes the risk of mines and all risks excluded from the Institute Time-Clauses Hulls (1/11/95) by clauses 24, 25 and 26 thereof and from the International Hull Clauses (1/11/02) by clauses 29, 30 and 31 thereof.

1.4 **Agreement to prevail**

This Mortgage shall be read together with the other Security Documents and, in the case of any conflict between this Mortgage and the Agreement, the latter shall prevail.

2 COVENANT TO PAY AND PERFORM

The Owner agrees to pay each part of the Outstanding Indebtedness to the Lender and to perform all its other obligations under the Security Documents as and when the same shall be due for payment or performance, provided that every payment which the Owner makes in accordance with the Agreement shall pro tanto satisfy its payment obligations under this Clause.

3 CHARGING CLAUSE

3.1 **Mortgage**

As security for the payment of the Outstanding Indebtedness and the performance of and compliance with all the terms, conditions and obligations of the Obligors contained in the Security Documents, the Owner has granted, conveyed and mortgaged and does by these presents grant, convey and mortgage unto the Lender, its successors and assigns the whole of the Vessel (which the Owner hereby warrants at the date hereof to be free from any other mortgage, charge or encumbrance whatsoever), to have and to hold the same unto the Lender, its successors and assigns forever upon the terms herein set forth for the enforcement of the payment of the Outstanding Indebtedness and to secure the performance and compliance with the terms, conditions and obligations contained in this Mortgage and the other Security Documents.

Provided only and the condition of these presents is such that if the Owner, its successors and assigns shall pay or cause to be paid to the Lender, its successors or assigns the Outstanding Indebtedness as and when the same shall become due and payable in accordance with the terms of this Mortgage and the other Security Documents and shall perform and comply with the terms, conditions and obligations in this Mortgage and the other Security Documents contained expressed or implied to be performed or complied with by and on the part of the Owner then these presents and the rights hereunder shall cease, determine and be void, otherwise to be and remain in full force and effect.

3.2 **Property covered**

It is not intended that this Mortgage shall cover, and this Mortgage shall not cover, property other than the Vessel as the term "Vessel" is used in Sub-division 1 of Section 106 of Chapter 3 of the Title 21 of the Liberian Code of Laws of 1956 as amended.

3.3 **No waiver of preferred status**

Notwithstanding anything to the contrary herein, it is not intended that any provision of this Mortgage shall waive the preferred status of this Mortgage, and if any provision or part thereof herein shall be construed as waiving the preferred status of this Mortgage then such provision shall to such extent be void and of no effect.

4 CONTINUING SECURITY

4.1 Continuing security; mortgage not affected by other security

The security created by this Mortgage:

4.1.1 is and shall at all times be a continuing security for the payment of the full amount of the Outstanding Indebtedness from time to time;

4.1.2 shall not be satisfied by any intermediate payment or satisfaction of any part of the Outstanding Indebtedness;

4.1.3 shall be in addition to and shall not merge with or be prejudiced or affected by any other security for the Outstanding Indebtedness which may have been, or may at any time hereafter be, given to the Lender by the Owner or any other person.

4.2 Right to consolidate

The Lender shall be entitled to consolidate this Mortgage with any other security held by the Lender for any other indebtedness or obligation of the Owner.

5 VESSEL UNDERTAKINGS – INSURANCE

5.1 Duration of undertakings

The Owner undertakes to the Lender to comply with the undertakings contained in this Clause 5 in respect of the Vessel at all times until the end of the Security Period.

5.2 Obligatory Insurances

The Owner undertakes:

5.2.1 to effect and maintain sufficient insurances on and over the Vessel in respect of (a) hull, machinery and equipment, marine, war and terrorism risks (including excess risks), (b) protection and indemnity risks (including pollution risks), [(c) loss of hire] and [(c)][(d)] such other risks for which insurance would be maintained by a prudent owner for a vessel of a similar type, size, age and flag, and otherwise in accordance with the provisions of the Security Documents;

5.2.2 to effect such insurances in such amounts in Dollars and upon such terms as shall from time to time be approved in writing by the Lender, but in any event for not less than:

(a) in the case of hull, machinery and equipment, marine, war and terrorism risks and excess risks, on an agreed value basis for whichever is the greater of (i) the market value of the Vessel and (ii) [120][3]% of the amount of the Loan[, provided however that the amount of hull and machinery cover excluding any total loss cover shall be equal to at least 80% of the market value of the Vessel];

(b) in the case of protection and indemnity risks (including pollution risks), for the full value and tonnage of the Vessel, for an unlimited amount, if available, and otherwise for the maximum amount obtainable in the market from time to time, including from the protection and indemnity association in which the Vessel is from time to time entered;

[3] Check term sheet.

(c) [in the case of loss of hire, for such periods of cover, for such excess periods and for such amounts as the Lender, acting reasonably, may from time to time require or approve;]

5.2.3 to effect the Insurances through such brokers (the "**approved insurance brokers**") and with such insurance companies, underwriters, war risks and protection and indemnity associations as shall from time to time be approved in writing by the Lender, and, if so required by the Lender (but without, as between the Lender and the Owner, liability on the part of the Lender for premiums or calls), with the Lender named as co assured;

5.2.4 to notify the Lender, at least [7] days before the relevant policies or contracts expire, of the relevant brokers and/or insurance companies, underwriters, war risks and protection and indemnity associations through and with whom the Insurances are to be renewed and of the terms and conditions of renewal;

5.2.5 to renew the Insurances, having first obtained the Lender's approval in writing of the relevant brokers and/or insurance companies, underwriters, war risks and protection and indemnity associations through and with whom the Insurances are to be renewed and of the terms and conditions of renewal, at least [3] days before the relevant policies or contracts expire, and to procure that the approved insurance brokers, and any such war risks and protection and indemnity associations with which the Insurances are effected, shall promptly confirm in writing to the Lender such renewal, on the approved terms and conditions, as and when the same occurs;

5.2.6 punctually to pay all premiums, calls, contributions or other sums in respect of the Insurances and to produce all relevant receipts when so required by the Lender;

5.2.7 to arrange for the execution of such guarantees as may from time to time be required by any protection and indemnity or war risks association for or for the continuance of the Vessel's entry;

5.2.8 to procure that notice of assignment to the Lender signed by the Owner is duly endorsed upon all slips, cover notes, policies, certificates of entry or other instruments of insurance issued or to be issued in connection with the Insurances, together with a loss payable clause, in each case in such form as may be required by the Lender;

5.2.9 to procure that all such instruments of insurance referred to in Clause 5.2.8 as are effected through the approved insurance brokers shall be deposited with the approved insurance brokers, and that such brokers shall furnish the Lender with pro forma copies and a letter or letters of undertaking in such form as the Lender may reasonably require having regard to the then current market practice;

5.2.10 to procure that the protection and indemnity and/or war risks associations in which the Vessel is entered shall furnish the Lender with a certified copy of the certificate of entry for the Vessel and a letter or letters of undertaking in such form as may be required by the Lender together with a certified copy of each certificate of financial responsibility for pollution by oil or other substances issued by such protection and indemnity and/or war risks associations in relation to the Vessel;

5.2.11 without prejudice to the generality of Clauses 5.2.9 and 5.2.10, if any of the Insurances form part of a fleet cover, to procure that the approved insurance brokers and (as the case may be) associations so approved shall undertake to the Lender that they shall neither set off against any claim in respect of the Vessel any premiums or calls due in respect of other Vessel or in respect of other insurances nor cancel any of the Insurances by reason of non payment of premiums or calls due in respect of other Vessel or in respect of other insurances;

5.2.12 to comply with all the requirements from time to time applicable to the Insurances, and not to make, do, consent or agree to any act or omission which would or might render any such instrument of insurance invalid, void, voidable or unenforceable or subject to any material exclusion or qualification or which would render any sum payable under them repayable in whole or in part;

5.2.13 not to employ the Vessel, or suffer the Vessel to be employed, otherwise than in conformity with the terms of the said instruments of insurance (including any express or implied warranties they contain), without first obtaining the insurers' consent to such other employment and complying with such requirements as to extra premium or otherwise as the insurers may prescribe, or arranging for additional insurances;

5.2.14 to apply all such sums receivable in respect of the Insurances as are paid to the Owner in accordance with the Security Documents for the purpose of making good the loss and fully repairing all damage in respect of which those sums have been received;

5.2.15 not to alter any of the terms of any of the instruments of insurance referred to in Clause 5.2.8 if, as a result of such alteration, they will cease to comply with the requirements of this Clause 5;

5.2.16 not without the prior written consent of the Lender to settle, compromise or abandon any claim under the Insurances in respect of the Vessel for a Total Loss or a Major Casualty;

5.2.17 to do all things necessary and provide the Lender with all relevant documents, evidence and information as the Lender may require to enable the Lender to collect or recover any moneys in respect of the Insurances which are payable to the Lender pursuant to the Security Documents;

5.2.18 to provide the Lender, at the time of the relevant communication, with copies of all communications of a material nature between the Owner and the approved insurance brokers or (as the case may be) approved associations relating to the Insurances of the Vessel including, without limitation:

(a) any material condition, qualification or exclusion applicable to those Insurances;

(b) any actual or potential suspension of any of those Insurances;

(c) payment of premiums and calls and performance by the Owner of its other material obligations in respect of those Insurances;

5.2.19 to make or procure that the managers of the Vessel shall make such quarterly voyage declarations as may be required from time to time in accordance with the Insurances, especially in order to maintain cover for trading in and to the United States of America and the Exclusive Economic Zone (as defined in the United States of America Oil Pollution Act 1990) and shall on request supply the Lender with copies thereof.

5.3 **MII and MAP Cover**

The Owner undertakes to pay to the Lender on demand all premiums and other amounts payable by the Lender in effecting and maintaining on behalf of the Lender a mortgagee's interest insurance policy and a mortgagee's interest additional perils (pollution) policy in respect of the Vessel (in an amount equal to [110]% of the amount of the Loan outstanding from time to time and otherwise to be on such terms and conditions and to be placed through such brokers and with such insurers and underwriters as the Lender may require).

5.4 **Consultation with insurance advisers**

The Lender shall be entitled, at any time and from time to time, to consult insurance advisers on any matter relating to the Insurances of the Vessel (including, without limitation, the terms, amounts and quality of the Insurances and the status of any insurance claims), and the Owner shall procure that there is delivered to such advisers any and all such information concerning the Vessel and her Insurances as the Lender may require. The costs and expenses of any such insurance advisers shall be for the account of the Owner and shall be payable on demand.

5.5 **Modification of Insurances**

If, in the opinion of the Lender, by reason of a significant change in circumstances after the date of this Mortgage (such changes in circumstances to include, without limitation, changes in the availability or cost of insurance coverage or in generally accepted industry practice) the Insurances do not provide the Lender with good and adequate security, the Lender may from time to time notify the Owner of any proposed modification of the requirements of the Security Documents relating to Insurances which the Lender may consider appropriate in the circumstances. Such modification may (without limitation) require the Owner to place, or procure the placing of, further and additional insurances and/or to amend or procure the amendment of the existing Insurances, whether through the existing brokers or otherwise. Any such modification shall take effect as an amendment to the Security Documents on and from the date on which it is notified in writing to the Owner and shall bind the Owner accordingly.

6 **VESSEL UNDERTAKINGS – OPERATION AND MAINTENANCE**

6.1 **Duration of undertakings**

The Owner undertakes to the Lender to comply with the undertakings contained in this Clause 6 in respect of the Vessel at all times until the end of the Security Period.

6.2 **Ownership and registration**

The Owner undertakes:

6.2.1 to keep the Vessel registered under the laws and flag of the Republic of Liberia and not to do or suffer to be done anything by which that registration may be forfeited or imperilled;

6.2.2 [to maintain its qualification as a foreign maritime entity and:][4]

6.2.3 not to change the name or port of registration of the Vessel without the prior written consent of the Lender;

6.2.4 unless the Loan is prepaid in full in accordance with Clause [5.3.1] of the Agreement upon the completion of that sale, not to sell or agree to sell the Vessel or any share in the Vessel without the prior written consent of the Lender).

6.3 **Classification, repair and surveys**

The Owner undertakes:

6.3.1 to procure that the Vessel is kept in a good and seaworthy state of repair, so as to maintain the highest class with the Classification Society free of overdue recommendations and conditions, and so as to comply with the provisions of all laws and all other regulations and requirements (statutory or otherwise) from time to time applicable to vessels registered at ports in the

[4] This wording is required if the Owner is incorporated outside Liberia.

Republic of Liberia and to vessels trading to any jurisdiction to which the Vessel may, subject to the provisions of this Mortgage, trade from time to time;

6.3.2 to procure that the Vessel is submitted regularly to such periodical or other surveys as may be required for classification and regulatory purposes and, if so required by the Lender, to procure that the Lender is supplied with copies of all survey reports and class and other certificates issued in this respect;

6.3.3 to procure that all repairs to or replacement of any damaged, worn or lost parts or equipment shall be effected in accordance with the rules and requirements of the Classification Society in such manner (both as regards workmanship and quality of materials) as not to diminish the value of the Vessel;

6.3.4 not to remove any material part of the Vessel, or any item of equipment installed on it unless the part or item so removed is promptly replaced by a suitable part or item which is in the same condition as or better condition than the part or item removed, is free from any Encumbrance (other than a Permitted Encumbrance) or any right in favour of any person other than the Lender and becomes on installation on the Vessel the property of the Owner and subject to the security constituted by the relevant Security Document(s) provided that the Owner may install and remove equipment owned by a third party if the equipment can be removed without any risk of damage to the Vessel;

6.3.5 except as required by law or by the Classification Society, not without the prior written consent of the Lender, to cause or permit to be made any substantial change in the structure, type or performance characteristics of the Vessel.

6.4 **Management**

The Owner undertakes:

6.4.1 to procure that at all times the Vessel is managed only by the Manager on the terms of the Management Agreement;

6.4.2 not, without the prior written consent of the Lender [(which shall not be unreasonably withheld or delayed)], to amend the Management Agreement[5] in respect of the Vessel in any material respect or to terminate or suffer the termination of any such appointment or to appoint or suffer the appointment of any other managers for the Vessel; and

6.4.3 to procure that on or before the Drawdown Date [of the final Advance[6]] (or, if later, the date of its appointment) the Manager executes and delivers to the Lender a Manager's Undertaking.

6.5 **Employment**

The Owner undertakes:

6.5.1 not to employ the Vessel, or suffer her employment:

(a) in any trade or business which is forbidden by the law of the Republic of Liberia or of any country to which the Vessel may sail, or which is otherwise illicit;

(b) in carrying illicit or prohibited goods, or in any manner whatsoever which may render her liable to condemnation in a Prize Court or to destruction, seizure or confiscation;

[5] Note that this wording will need to be modified if the Manager is appointed by a Charterer.
[6] Use this wording if the loan is a pre- and post-delivery loan with the final Advance on delivery.

(c) in the event of hostilities in any part of the world (whether war be declared or not), in carrying any contraband goods, nor to enter or trade to any zone which is declared a war zone by the Vessel's war risks insurers unless the Lender has given its consent thereto in writing and the Owner has effected, at its own expense, such special insurance cover as the Lender may require;

6.5.2 fully to perform its own obligations under each Charter and Charter Guarantee in respect of the Vessel and not to amend any such Charter or Charter Guarantee in any [material] respect (other than for amendments which are favourable to the Owner) without the consent of the Lender[, which shall not be unreasonably withheld];

6.5.3 not, without the prior written consent of the Lender (and then only subject to such terms as the Lender may impose):

(a) to lay up the Vessel;

(b) to let or employ the Vessel on demise charter;

(c) to let the Vessel on any time or consecutive voyage charter for a term which exceeds, or which by virtue of any optional extensions might exceed, [6][12] months' duration;

(d) to employ the Vessel on terms by which more than [2] months' hire (or the equivalent) is payable in advance;

(e) to employ the Vessel otherwise than on bona fide arm's length terms or below such rate as the Owner can reasonably show to be the market rate prevailing at the time when the Vessel is fixed;

(f) to enter into any agreement or arrangement for the sharing of any Earnings of the Vessel;

6.5.4 [to procure that the Vessel shall have predominantly international trading patterns and that its Earnings shall be denominated in [Dollars][Euro];]

6.5.5 not to employ or permit any member of the Vessel's crew to be employed in breach of the International Transport Worker's Federation (ITF) rules and regulations.

6.6 **Inspection; access to records**

The Owner undertakes to procure that the Lender or any representative of the Lender is permitted:

6.6.1 to board its Vessel at all reasonable times for the purpose of inspecting her condition or satisfying itself as to proposed or executed repairs, and to afford all proper facilities for such inspections;

6.6.2 at any time without prior notice to the Owner, to obtain information about the Vessel and her condition from the Classification Society and the relevant regulatory authorities, to have access to the records of the Vessel maintained by the Classification Society and such authorities and otherwise to communicate direct with each of them as if the Lender were the owner of the Vessel (for which purpose the Owner shall issue such authorisations and instructions to, and use its best endeavours to obtain such acknowledgments and undertakings from, such bodies, each in such terms as the Lender may require).

6.7 **Information**

The Owner undertakes:

6.7.1 promptly to furnish the Lender, when so required by it in writing, with a copy of the classification certificate issued by the Classification Society for the Vessel, all such information regarding the Vessel, her employment, position and engagements, particulars of all towages and salvages and copies of all charters and other contracts for her employment or otherwise howsoever concerning her and all such material information as shall be or ought to be supplied to the insurers of the Vessel;

6.7.2 to notify the Lender immediately upon its becoming aware of:

(a) any accident to the Vessel or incident which is or is likely to be a Major Casualty;

(b) any occurrence resulting in the Vessel becoming or being likely to become a Total Loss;

(c) any requirement or recommendation made by any insurer or the Classification Society, or by any competent authority, in respect of the Vessel which is not complied with within any time limit imposed by that insurer, Classification Society or authority;

(d) any arrest of the Vessel, or the exercise or purported exercise of any lien on the Vessel or her Earnings or any requisition of the Vessel for hire;

(e) any non-scheduled dry-docking of the Vessel;

(f) any allegation of non-compliance with the ISM Code or the ISPS Code against the Owner or the Approved Managers or otherwise in connection with the Vessel;

(g) any other matter, event or incident, actual or threatened, the effect of which will or may lead to the ISM Code or the ISPS Code not being complied with by the Owner or the Manager or otherwise in connection with the Vessel.

6.8 **Discharge of debts; avoidance of liens**

The Owner undertakes:

6.8.1 promptly to pay and discharge or secure all debts, damages and liabilities whatsoever which the Owner shall have been called upon to pay, discharge or secure and which have given, or may give, rise to maritime or possessory liens on or claims enforceable against the Vessel, and in the event of arrest of the Vessel pursuant to legal process, or in the event of her detention in exercise or purported exercise of any such lien, to procure the release of the Vessel from such arrest or detention promptly upon receiving notice of the same by providing bail or otherwise as the circumstances may require;

6.8.2 to procure that all tolls, dues and other outgoings whatsoever in respect of the Vessel are promptly paid, and upon request by the Lender, to furnish satisfactory evidence that the wages and allotments, and the insurance and pension contributions in respect of the Master and crew, are being regularly paid, that all deductions from crew's wages on account of tax and/or social security contributions have been properly made and accounted for to the relevant authorities and that the Master has no claim for disbursements other than those incurred by him in the ordinary course of trading on the voyage then in progress;

6.8.3 not without the previous consent in writing of the Lenders (and then only subject to such terms as the Lenders may impose) to create or suffer the creation of an Encumbrance (other than a Permitted Encumbrance) over or in respect of the Vessel or any share in the Vessel;

6.8.4 not without the previous consent in writing of the Lender to put or suffer the Vessel to be put into the possession of any person for the purpose of work being done upon her in an amount exceeding or likely to exceed [$][€][●] (or the equivalent in any other currency) unless either the cost of that work is fully recoverable under the Insurances or that person has first given to the Lender in terms satisfactory to the Lender a written undertaking not to exercise any lien on the Vessel or her Earnings for the cost of that work or otherwise.

6.9 **Perfection of Mortgage**

The Owner undertakes:

6.9.1 to place, and at all times and places to retain, a properly certified copy of this Mortgage on board the Vessel with her papers, and to cause such certified copy and such papers to be exhibited to any and all persons having business with the Vessel which might give rise to any lien on it other than liens for crew's wages and salvage and to any representative of the Lender and keep prominently displayed in the chart room and in the Master's cabin of the Vessel a framed notice in plain type, reading as follows (or in such other form as the Lender may reasonably require):

"**NOTICE OF MORTGAGE**

This Vessel is subject to a First Preferred Mortgage in favour of [●] under authority of Title 21 of the Liberian Code of Laws of 1956 as amended. Under the terms of the said First Preferred Mortgage neither the Owner, any charterer, the Master of this Vessel nor any other person, has any right, power or authority to create, incur or permit to be imposed upon this Vessel any lien whatsoever other than for crew's wages and salvage";

6.9.2 to cause this Mortgage to be recorded promptly with the office of the Maritime Administrator of the Republic of Liberia as prescribed by Title 21 of the Liberian Code of Laws of 1956 as amended and otherwise to comply with and satisfy all the requirements and formalities established by the said act and any other pertinent legislation of the Republic of Liberia to perfect this Mortgage as a valid and enforceable first preferred lien upon the Vessel and promptly to furnish to the Lender from time to time on written demand evidence to its satisfaction with respect to the Owner's compliance with the provisions of this sub-clause.

6.10 **Environmental undertakings**

The Owner undertakes:

6.10.1 to notify the Lender immediately upon its becoming aware of the occurrence of:

(a) any Environmental Claim against the Owner, the Vessel, any other Obligor or any other Relevant Ship; or

(b) any Environmental Incident which may give rise to any Environmental Claim;

which, in either case, could or might materially affect the interests of the Lender, and to keep the Lender advised in writing on such regular basis and in such detail as the Lender shall require of the nature of that Environmental Claim or Environmental Incident and the Owner's proposed and actual response thereto;

6.10.2 to comply with and procure that all Environmental Affiliates comply with all Environmental Laws including, without limitation, requirements relating to manning and establishment of financial responsibility, and to obtain and comply with, and procure that all Environmental Affiliates obtain and comply with, all Environmental Approvals;

6.10.3 to ensure that the Vessel is, at all times, equipped and accredited with any required trading documentation and/or authorisations necessary to legitimise the entry of the Vessel into the waters of any relevant jurisdiction. Such trading documentation and authorisations shall include, amongst other things, valid certification under the International Convention on Civil Liability for Oil Pollution Damage (as amended) and the International Convention on Civil Liability for Bunker Oil Pollution Damage, a valid US Coast Guard certificate of financial responsibility (water pollution), a valid certificate from any US state that requires a state equivalent of a certificate of financial responsibility, a vessel classification certificate and any other credentials as might be, or may come to be, required. Copies of such trading documentation and/or authorisations shall be made available to the Lender as and when requested.

6.11 **ISM Code and ISPS Code**

The Owner undertakes to comply, and procure compliance by the Manager and any other operator of the Vessel, with:

6.11.1 all provisions of the ISM Code including, without limitation, obtaining and maintaining in force at all times a valid Document of Compliance in relation to the company responsible for the Vessel's compliance with the ISM Code under paragraph 1.1.2 of the ISM Code and a valid Safety Management Certificate in respect of the Vessel as required by the ISM Code; and

6.11.2 all provisions of the ISPS Code including, without limitation, obtaining and maintaining in force a valid International Ship Security Certificate in respect of the Vessel as required by the ISPS Code, and ensuring that the Vessel's security system and its associated security equipment comply with the applicable requirements of Part A of the ISPS Code and of Chapter XI-2 of the Safety of Life at Sea Convention (SOLAS), and that an approved ship security plan is in place,

and to procure that certified copies of all such certificates and other documents are provided promptly on demand to the Lender.

7 THE LENDER'S POWERS

7.1 The Lender shall, without prejudice to its other rights and powers under this Mortgage and the other Security Documents, be entitled (but not bound) at any time and as often as may be necessary to take any such action as it may in its discretion think fit for the purpose of protecting or maintaining the security created by this Mortgage and the other Security Documents, and each and every loss, damage, liability or expense incurred by the Lender for these purposes shall be repayable to it by the Owner on demand, together with interest (as well after as before any judgment) at the Default Rate in accordance with the relevant provisions of the Agreement.

Without prejudice to the generality of the foregoing:

7.1.1 if the Owner fails to comply with any of the provisions of Clause 5, the Lender shall be at liberty to effect, and thereafter to maintain, all such Insurances upon or in respect of the Vessel as in its discretion it may think fit;

7.1.2 if the Owner fails to comply with any of the provisions of Clause 6.3, the Lender shall be at liberty to arrange for the carrying out of such repairs and/or surveys as it deems expedient or necessary; and

7.1.3 if the Owner fails to comply with any of the provisions of Clause 6.8, the Lender shall be at liberty to pay and discharge all such debts, damages and liabilities as are there mentioned and/or to take any such measures as it deems expedient or necessary for the purpose of securing the release of the Vessel.

8 ENFORCEMENT

8.1 Right to enforce security

The security constituted by this Mortgage shall become immediately enforceable upon the occurrence of an Event of Default.

8.2 Powers upon enforcement

Upon this Mortgage becoming enforceable the power of sale and other powers conferred by this Mortgage shall become exercisable and the Lender shall become immediately entitled, without being required to obtain any court order or declaration that an Event of Default has occurred and whether or not the Lender has made any demand for payment under Clause [13.2] of the Agreement, as and when it may see fit, to put into force and to exercise all or any of the powers possessed by it as mortgagee, chargee and assignee of the Mortgaged Property (whether by law or otherwise) and. in particular, but without prejudice to the generality of the foregoing:

8.2.1 to take possession of the Vessel whether actually or constructively and/or otherwise to take control of the Vessel and/or to order the Vessel to proceed forthwith at the Owner's risk and expense to a port or place nominated by the Lender (and the Owner undertakes to give the necessary instructions to the Master of the Vessel to comply with any such order of the Lender and if the Owner fails to give such instructions for any reason whatsoever the Lender shall have the right and power to give such instructions direct to the Master);

8.2.2 to exercise all the rights and remedies in foreclosure and otherwise given to mortgagees by applicable law, including, without limitation, those under the provisions of Chapter 3 of Title 21 of the Liberian Code of Laws of 1956, as amended;

8.2.3 to require that all policies, contracts, certificates of entry and other records relating to the Insurances (including details of and correspondence concerning outstanding claims) be forthwith delivered to or to the order of the Lender;

8.2.4 to collect, recover, compromise and give a good discharge for all claims then outstanding or thereafter arising under the Insurances or in respect of the Earnings or any Requisition Compensation, and to take over or institute (if necessary using the name of the Owner) all such proceedings in connection with such claims as the Lender in its absolute discretion thinks fit and to permit the brokers through whom collection or recovery-is effected to charge the usual brokerage;

8.2.5 to discharge, compound, release or compromise claims against the Owner in respect of the Vessel which have given rise to any charge or lien on the Vessel or which are or may be enforceable by proceedings against the Vessel;

8.2.6 to sell the Vessel or any share therein, with or without advertisement or notice to the Owner, free from any claims of or by the Owner of any nature whatsoever, and with or without the benefit of any charterparty, by public auction or private contract or tender, at home or abroad, for cash or on credit, and upon such terms as the Lender in its absolute discretion may determine, with power to postpone any such sale and without being answerable for any loss occasioned by such sale or resulting from its postponement and with power itself to purchase the Vessel at any such public auction and to set off the purchase price against all or any part of the Outstanding Indebtedness;

8.2.7 to navigate, manage, insure, maintain and repair the Vessel and to employ or lay up the Vessel in such manner, upon such terms and for such period as the Lender in its absolute discretion deems expedient, the Lender being entitled to do all acts and things incidental or conducive to this end, and in particular to enter into such arrangements respecting the Vessel, her navigation, management, insurance, maintenance, repair, classification and employment in all respects as if the Lender were the owner of the Vessel, and without being responsible for any loss thereby incurred; and

8.2.8 to recover from the Owner on demand all losses, damages, liabilities and expenses incurred by the Lender in or about or incidental to the exercise by it of any of the above powers, together with interest at the Default Rate in accordance with the relevant provisions of the Agreement.

For the avoidance of doubt, the powers of the Lender by virtue of this Mortgage shall not be limited to those specified in Title 21 of the Liberian Code of Laws of 1956 as amended.

8.3 **No duty to enquire or take other action**

The Lender shall not be obliged to make any enquiry as to the nature or sufficiency of any payment received by it under this Mortgage or to make any claim, take any action or enforce any rights or benefits to which the Lender may be at any time entitled under this Mortgage or otherwise.

8.4 **Exclusion of liability**

Neither the Lender nor its servants or agents (except in the case of its gross negligence or wilful misconduct) shall be liable for any loss, damage, liability or expense whatsoever and howsoever suffered or incurred by the Owner arising out of or in connection with the exercise or purported exercise by or on behalf of the Lender of any rights, powers or discretions under this Mortgage.

8.5 **Dealings with the Lender**

Upon any sale of the Vessel or any share in the Vessel by the Lender pursuant to Clause 8.2.6 the purchaser shall not be bound to see or enquire whether the power of sale of the Lender has arisen in the manner provided by this Mortgage, the sale being deemed to be within the power of the Lender, and the receipt of the Lender for the purchase money shall effectively discharge the purchaser who shall not be concerned with the manner of application of the proceeds of sale or in any way answerable for the sale.

9 **APPLICATION OF PROCEEDS**

9.1 All moneys received or recovered by the Lender or any Receiver in respect of:

9.1.1 sale of the Vessel or any share in the Vessel;

9.1.2 the Earnings, following a direction made by the Lender under Clause [9.8.2] of the Agreement;

9.1.3 recovery under the Insurances (other than any such sum or sums as may have been received by the Lender in respect of a Major Casualty and paid over to the Owner);

9.1.4 Requisition Compensation; or

9.1.5 the net profits arising out of the employment of the Vessel by or on behalf of the Lender or the Receiver,

shall be held by it or him upon trust, in the first place, to pay the remuneration of the Receiver and to pay or make good all costs, expenses and liabilities whatsoever incurred by the Lender or the Receiver in or about or incidental to the recovery of such moneys, and the balance shall be applied in accordance with Clause [7.2] of the Agreement.

The Owner hereby irrevocably waives any rights of appropriation to which it may be entitled.

10 **INDEMNITY BY THE OWNER**

10.1 The Owner shall indemnify and keep the Lender and any Receiver indemnified against all costs, charges, expenses, claims, proceedings (whether civil or criminal), liabilities, losses, damages and injury (personal or economic), penalties, fines, duties and fees (including, but not limited to, legal fees and expenses on a full indemnity basis) and taxes thereon suffered or incurred by the Lender or such Receiver for any reason and whether sustained or incurred during or after the Security Period:

10.1.1 arising directly or indirectly in any manner out of the ownership, possession, management, control, chartering, sub chartering, navigation, victualling, fuelling, manning, supply, insurance, use, operation, laying up or storage of or loss of or damage to the Vessel or any part thereof or from any maintenance, service, modification, repair, classification or overhaul of, or otherwise in connection with, the Vessel or any part thereof and regardless of when the same shall arise and whether or not the Vessel or the relevant part thereof is in the possession or control of the Owner;

10.1.2 because of any design, article or material of, on or in the Vessel or any part thereof or relating thereto, whether because of infringement of patent, copyright, design, trademark or other rights or otherwise;

10.1.3 relating to or arising directly or indirectly in any manner or for any cause or reason whatsoever out of an Environmental Claim or asserted against the Lender and/or the Vessel, or out of any actual or threatened Environmental Incident relating to the Vessel or any other Relevant Ship; or

10.1.4 arising out of any act or omission made by the Lender in good faith in connection with the Vessel or in connection with any of the matters dealt with in the Security Documents.

11 **POWER OF ATTORNEY**

11.1 The Owner by way of security hereby irrevocably appoints the Lender and any Receiver. jointly and severally, its true and lawful attorneys for the duration of the Security Period with full power in its name to do any and all acts which the Owner itself could do in relation to the Vessel and the other Mortgaged Property (including, but without limitation, to sell or otherwise dispose of the Vessel or any share therein), provided always that:

11.1.1 neither the Lender nor any Receiver nor its respective servants or agents (except in the case of its gross negligence or wilful misconduct) shall be liable to the Owner for any loss, damage, liability or expense whatsoever and howsoever suffered or incurred by the Owner as a result of the exercise of such powers;

11.1.2 no such power will be exercisable by or on behalf of the Lender or any Receiver until this Mortgage shall have become immediately enforceable pursuant to Clause 8.1; and

11.1.3 the exercise of any such power by or on behalf of the Lender or any Receiver shall not put any person dealing with the Lender or the Receiver upon any enquiry as to whether this Mortgage has become enforceable, nor shall such person be in any way affected by notice that this Mortgage has not become so enforceable, and the exercise by the Lender or the Receiver of such power shall be conclusive evidence of its right to exercise the same.

12 ASSIGNMENTS AND TRANSFERS

12.1 No assignment by Owner

The Owner may not assign or transfer all or any of its rights, benefits or obligations under this Mortgage.

12.2 Assignment and transfer by Lender

The Lender may assign or transfer all or any of its rights, benefits or obligations under this Mortgage to the same extent that it is permitted by the Agreement to assign or transfer its rights, benefits or obligations under the other relevant Security Documents.

12.3 Delegation

The Lender may at any time and from to time to time delegate any one or more of its rights, powers and/or obligations under this Mortgage to any person (provided that the Lender shall remain fully responsible for the exercise or performance of any rights, powers and/or obligations delegated by it).

12.4 Owner to assist

The Owner undertakes to do or to procure all such acts and things and to sign, execute and deliver or procure the signing, execution and deliver of all such instruments and documents as the Lender may reasonably require for the purpose of perfecting any such assignment or transfer as mentioned above.

13 DISCHARGE OF SECURITY

Upon the repayment of the whole of the Outstanding Indebtedness, the Lender upon the request and at the expense and cost of the Owner shall execute and deliver to the Owner a discharge of this Mortgage, and do such other acts and execute such other documents as may be reasonably necessary to discharge the security created by this Mortgage.

14 MISCELLANEOUS

14.1 Time of essence

Time is of the essence as regards every obligation of the Owner under this Mortgage.

14.2 Remedies and waivers

No failure to exercise, nor any delay in exercising, on the part of the Lender, any right or remedy under this Mortgage shall operate as a waiver of it, nor shall any single or partial exercise of any right or remedy prevent any further or other exercise of it or the exercise of any other right or remedy. The rights and remedies provided in this Mortgage are cumulative and not exclusive of any rights or remedies provided by law.

14.3 Waivers and amendments to be in writing

Any waiver by the Lender of any provision of this Mortgage, and any consent or approval given by the Lender under or in respect of this Mortgage, shall only be effective if given in writing and then only strictly for the purpose and upon the terms for which it is given. This Mortgage may not be amended or varied orally but only by an instrument signed by the Lender and the Owner.

14.4 Severability

If at any time one or more of the provisions of this Mortgage is or becomes invalid, illegal or unenforceable in any respect under any law by which it may be governed or affected, the validity, legality and enforceability of the remaining provisions shall not be in any way affected or impaired as a result.

14.5 Counterparts

This Mortgage may be executed in any number of counterparts and all such counterparts taken together shall be deemed to constitute but one and the same instrument.

14.6 Further assurance

The Owner shall, upon demand, and at its own expense, sign, execute, perfect, do and register all such further assurances, documents, acts and things as the Lender may require for:

14.6.1 perfecting or protecting the security constituted by this Mortgage;

14.6.2 the exercise by the Lender of any right, power or remedy vested in it under this Mortgage;

14.6.3 enforcing the security constituted by this Mortgage after the same shall have become enforceable.

15 NOTICES

All notices (which expression includes any demand, request, consent or other communication) to be given by one party to the other under this Mortgage shall be given in the manner provided in the Agreement.

16 APPLICABLE LAW AND JURISDICTION

16.1 Governing law

This Mortgage shall be governed by and construed in accordance with the laws of the Republic of Liberia.

16.2 Submission to jurisdiction

The Owner hereby irrevocably agrees for the exclusive benefit of the Lender that the English courts shall have jurisdiction in relation to any dispute and any suit, action or proceeding (referred to together in this Clause 16 as "**Proceedings**") which may arise out of or in connection with this Mortgage, and for such purposes irrevocably submits to the jurisdiction of such courts.

16.3 Service of process

The Owner hereby irrevocably agrees:

16.3.1 that, for the purpose of Proceedings in England, any legal process may be served upon [●] whose registered office is presently at [●] and who, by this Mortgage, are authorised to accept service on its behalf, which shall be deemed to be good service on the Owner; and

16.3.2 that throughout the Security Period the Owner will maintain a duly appointed process agent in England, duly notified to the Lender, and that failure by any such process agent to give notice thereof to the Owner shall not impair the validity of such service or of a judgment or order based thereon.

16.4 **Choice of forum**

Nothing in this Clause 16 shall affect the right of the Lender to serve process in any manner permitted by law or limit the right of the Lender to take Proceedings against the Owner in any other court of competent jurisdiction, nor shall the taking of Proceedings in one or more jurisdictions preclude the taking of Proceedings by the Lender in any other jurisdiction, whether concurrently or not.

The Owner shall not commence any Proceedings in any country other than England in relation to any matter arising out of or in connection with this Mortgage.

16.5 **Action against the Vessel**

Without prejudice to the generality of Clause 16.4, the Lender shall have the right to arrest and take action against the Vessel in whichever place the Vessel may from time to time be situate, and for such purpose any legal process may be served upon the Master of the Vessel, who is hereby authorised to accept service on behalf of the Owner, which shall be deemed to be good service on the Owner.

16.6 **Forum convenience**

The Owner irrevocably waives any objection which it may at any time have on the grounds of inconvenient forum or otherwise to Proceedings being brought in any such court as is referred to in this Clause 16, and further irrevocably agrees that a judgment or order in any Proceedings brought in the English courts shall be conclusive and binding upon the Owner and may be enforced without review in the courts of any other jurisdiction.

16.7 **Consent**

The Owner consents generally in respect of any Proceedings arising out of or in connection with this Mortgage to the giving of any relief or the issue of any process in connection with such Proceedings, including, without limitation, the making, enforcement or execution against any property or assets whatsoever of any order or judgment which may be made or given in such Proceedings.

16.8 **[Waiver of immunity**

To the extent that the Owner may be entitled in any jurisdiction to claim for itself or its property or assets immunity in respect of its obligations under this Mortgage from service of process, jurisdiction, suit, judgment, execution, attachment (whether before judgment, in aid of execution or otherwise) or legal process, or to the extent that in any jurisdiction there may be attributed to it or its property or assets such immunity (whether or not claimed), the Owner irrevocably agrees not to claim and irrevocably waives that immunity to the fullest extent permitted by the laws of that jurisdiction.][7]

[7] Use only in cases where the Owner is state-owned or there is otherwise a risk that the Owner may claim immunity for itself or its assets.

17 INFORMATION FOR RECORDING

For the purposes of recording this Mortgage as required by Chapter 3 of Title 21 of the Liberian Code of Laws 1956 as amended, the total amount of this Mortgage is [$][€][●] and interest and performance of mortgage covenants. The date of maturity is [●] 20[●] and the discharge amount is the same as the total amount. For property other than the Vessel, if any should be determined to be covered by this Mortgage, the discharge amount is 0.01% of the total amount.

IN WITNESS WHEREOF the Owner has caused this Mortgage to be duly executed the day and year first before written.

[●]

By…………………………...…..

ACKNOWLEDGEMENT OF MORTGAGE

LONDON)
UNITED KINGDOM) S.S.

On this day of 201[●], before me personally appeared [●] to me known who being by me duly sworn did depose and say that [he][she] resides at [●]; that [he][she] is an attorney-in-fact of [●], the Corporation described in and which executed the foregoing instrument; that [he][she] signed [his][her] name thereto by order of the Board of Directors of the said Corporation and that the foregoing instrument is the act and deed of the said Corporation.

………………………………...
LISCR Registrar/Special Agent

Appendix 2

R208 - Mortgage Registration Form

THE COMMONWEALTH OF THE BAHAMAS

MORTGAGE REGISTRATION FORM

(Page 1 of 2)

Official Number	IMO Number	Name of Ship	Port of Registry
			NASSAU

Propulsion and Engine Details	Vessel Dimensions
Propulsion: Type of Engines: Total Power:	Length: metres Breadth: metres Depth: metres

Particulars of Tonnage	
GROSS TONNAGE: tons	NET TONNAGE: tons

Whereas (a)

Now we the (b)...in consideration of the premises for ourselves and our successors, covenant with the said (c) .... and (d)...........assigns to pay to him or them or it the sums for the time being due on this security, whether by way of principal or interest, at the times and manner aforesaid. And for the purpose of better securing to the said (c) .... the payment of such sums as last aforesaid, we do hereby mortgage to the said (c) .... shares of which we are the Owners in the Ship above particularly described, and in her boats, guns, ammunition, small arms and appurtenances. Lastly, we for ourselves and our successors, covenant with the said (c) .... and (d).........assigns that we have the power to mortgage in manner aforesaid the above mentioned shares, and that the same are free from encumbrances (e)

In witness whereof we have affixed our common seal this .... day of...

Seal	Individual/Corporation	Attestation
	name of individual/corporation per .... signature as Individual/Director/Secretary/ Officer/Attorney-in-fact (h) .... signature as Individual/Director/Secretary/ Officer/Attorney-in-fact (h) .... in the presence of the witness whose attestation is given opposite	I, (f) .... of (g) .... hereby testify that in my presence (i) this Mortgage was signed by .... as Individual/Director/Secretary/Officer/ Attorney-in-fact (h) and .... as Individual/Director/Secretary/Officer/ Attorney-in-fact (h) and (ii) the corporate seal (h)/personal seal (h) of the transferor was affixed this .... day of .... Signature of witness ....

(a) Here state by way of recital that there is an account current between the Mortgagor (describing the company and its address) and the Mortgagee (giving full title, address and description, including all joint mortgages), and describe the nature of the transaction so as to show how the amount of principal and interest due at any given time is to be ascertained, and the manner and time of payment, (b) Name of company, (c) Full name of Mortgagee, (d) "his", "hers" or "its", (e) If any prior encumbrance add "save as appears by the registry of the ship", (f) name of witness, (g) address of witness, (h) delete as applicable.

NOTE: The witness to the execution of the document must be a disinterested party, independent of the body corporate or individual executing it e.g. Notary Public, Consular Officer, Magistrate, Justice of Peace. A director, officer or employee of a transferor which is a body corporate should not be an attesting witness.

R208 - Mortgage Registration Form

THE COMMONWEALTH OF THE BAHAMAS

MORTGAGE REGISTRATION FORM

(Page 2 of 2)

Official Number	IMO Number	Name of Ship	Port of Registry

TRANSFER OF MORTGAGE

I/we, the within mentioned
in consideration of-this day paid to me/us
(a) by...

hereby transfer to it/him/her/them (a) the benefit of the within-written security. In witness whereof I/We (a)

have hereto affixed our seal this .... day of ....

Seal	Individual/Corporation	Attestation
	name of individual/corporation per .... signature as Individual/Director/Secretary/ Officer/Attorney-in-fact .... signature as Individual/Director/Secretary/ Officer/Attorney-in-fact .... in the presence of the witness whose attestation is given opposite	I. (b) .... of (c) .... hereby testify that in my presence (i) this Transfer of mortgage was signed by .... as Individual/Director/Secretary/Officer/ Attorney-in-fact (a) and .... as Individual/Director/Secretary/Officer/ Attorney-in-fact (a) and (ii) the corporate seal/personal seal (a) of the transferor was affixed this .... day of .... Signature of witness ....

MEMORANDUM OF DISCHARGE

By individual or Joint Mortgagees

Received the sum of ....
in discharge of this within-written security. Dated at .... this .... day of...
In witness whereof we have hereto affixed our common seal this .... day of ....

	name of individual/corporation per .... signature as Individual/Director/Secretary/ Officer/Attorney-in-fact .... signature as Individual/Director/Secretary/ Officer/Attorney-in-fact .... in the presence of the witness whose attestation is given opposite	I. (b) .... of (c) .... hereby testify that in my presence (i) this Discharge of mortgage was signed by .... as Individual/Director/Secretary/Officer/ Attorney-in-fact (a) and .... as Individual/Director/Secretary/Officer/ Attorney-in-fact (a) and (ii) the corporate seal/personal seal (a) of the mortgagee was affixed this .... day of .... Signature of witness ....

(a) delete as appropriate, (b) insert name of witness, (c) insert address of witness
NOTE: The witness to the execution of the document must be a disinterested party, independent of the body corporate or individual executing it e.g. Notary Public, Consular Officer, Magistrate, Justice of Peace. A director, officer or employee of a transferor which is a body corporate should not be an attesting witness.

Appendix 3

GENERAL ASSIGNMENT FOR BILATERAL LOAN (BORROWER AS ASSIGNOR)

Draft 00.00.00

DATED 201[●]

[●]
as Owner

and

[●]
as Lender

GENERAL ASSIGNMENT

in respect of m.v. "[●]"

holman fenwick willan hfw

INDEX

THIS ASSIGNMENT is made on 201[●]

BETWEEN

(1) [●], a [company] incorporated in [●] [with company registration number [●]] whose registered office is at [●] (the "**Owner**"); and

(2) [●], a [bank] incorporated in [●] acting through its branch at [●] (the "**Lender**").

WHEREAS

(A) The Owner is the sole owner of the motor vessel "[●]" registered in the ownership of the Owner under the laws and flag of [●] at the port of [●] with official number [●] and IMO number [●] (the "**Vessel**").

(B) By a loan agreement dated [●] 201[●] (the "**Agreement**") made between (1) the Owner as borrower and (2) the Lender as lender, the Lender has agreed to make available to the Owner a loan of [$][€][●].

(C) As security for the payment of the Outstanding Indebtedness and the performance of and compliance with all the terms, conditions and obligations of the Obligors contained in the Security Documents, the Owner has executed and registered in favour of the Lender a first [priority][preferred] [●] ship mortgage [and collateral deed of covenants] over the Vessel dated the same date as this Assignment (the "**Mortgage**") and has agreed to enter into this Assignment.

IT IS AGREED as follows:

1 DEFINITIONS AND INTERPRETATION

1.1 Definitions

Words and expressions defined in the Agreement shall, unless otherwise expressly provided herein or the context otherwise requires, have the same meanings when used in this Assignment, including the Recitals. In addition, in this Assignment:

"Assigned Property" means all of the Owner's present and future rights, title and interest in, to and under the Earnings, [Charter Rights[1].] Insurances and Requisition Compensation of the Vessel (and references thereto shall mean any or all of the constituent parts thereof, as the context may require);

"Major Casualty" means any casualty to the Vessel or incident (other than a Total Loss) in respect of which the claim or the aggregate of the claims against all insurers, before adjustment for any relevant franchise or deductible, exceeds [$][€][●];

[“Mortgaged Property” means all of the Owner's right, title and interest, both present and future, in and to the Vessel and the Assigned Property.][2]

[**“Receiver”** has the meaning given to it in the Mortgage.][3]

1.2 General interpretation

In this Assignment:

[1] Only include if assignment of charter specifically required by term sheet.

[2] Only include the definition of "Mortgaged Property" if Clause 6.4 (Receivers) is to be retained.

[3] Only include the definition of "Receiver" if Clause 6.4 (Receivers) is to be deleted.

1.2.1 unless the context otherwise requires, words in the singular include the plural and vice versa;

1.2.2 references to any document include the same as varied, supplemented or replaced from time to time;

1.2.3 references to any enactment include re-enactments, amendments and extensions thereof;

1.2.4 references to any person include that person's successors and permitted assigns;

1.2.5 clause headings are for convenience of reference only and are not to be taken into account in construction;

1.2.6 unless otherwise specified, references to Clauses, Recitals and Schedules are to Clauses of and the Recitals and Schedules to this Assignment.

1.3 **Agreement to prevail**

This Assignment shall be read together with the other Security Documents and, in the case of any conflict between this Assignment and the Agreement, the latter shall prevail.

1.4 **Third party rights**

A person who is not a party to this Assignment may not enforce, or otherwise have the benefit of, any provision of this Assignment under the Contracts (Rights of Third Parties) Act 1999.

2 **ASSIGNMENT**

2.1 **Assignment**

As security for the payment of the Outstanding Indebtedness and the performance of and compliance with all the terms, conditions and obligations of the Obligors contained in the Security Documents, the Owner with full title guarantee hereby assigns and agrees to assign to the Lender absolutely all its rights, title and interest, both present and future, in and to the Assigned Property (all of which the Owner warrants that it has not assigned, mortgaged, charged or otherwise encumbered or disposed of to any other person).

2.2 **Application of Insurances**

Unless and until an Event of Default shall occur (whereupon all insurance recoveries shall be payable to the Lender and applied in accordance with the provisions of Clause 7), any sums receivable in respect of the Insurances shall be payable as follows:

2.2.1 there shall be paid to the Lender all sums receivable in respect of a Total Loss, and, unless otherwise authorised by the Lender, any and every sum receivable in respect of a Major Casualty, but so that the insurance moneys received by the Lender in respect of any such Major Casualty shall be paid over to the Owner upon the Owner's furnishing evidence satisfactory to the Lender that all loss and damage resulting from the casualty has been properly made good and repaired, and that all repair accounts and other liabilities whatsoever in connection with the casualty have been fully paid and discharged by the Owner, provided that the insurers may with the consent of the Lender make payment on account of repairs in the course of their being effected; and

2.2.2 all other sums receivable in respect of the Insurances (other than in respect of protection and indemnity risks insurance or loss of hire insurance) shall be paid to the Owner and shall be applied by it for the purpose of making good the loss and fully repairing all damage in respect of which the insurance moneys have, been received;

2.2.3 all sums receivable in respect of protection and indemnity risks insurance shall be paid direct to the person to whom the relevant liability was incurred or to the Owner in reimbursement of moneys expended by the Owner to discharge such liability;

2.2.4 all sums receivable in respect of loss of hire insurance shall be paid to the Earnings Account and applied in the same manner as the Earnings in accordance with Clause 2.3.

2.3 **Application of Earnings**

Unless and until the Lender shall otherwise direct in accordance with Clause [9.8.2] of the Agreement (whereupon the Earnings shall be payable in accordance with such directions and applied in accordance with the provisions of Clause 7), the Earnings shall be paid to the Earnings Account[4] and applied in accordance with the provisions of Clause [9] of the Agreement.

2.4 **Application of Requisition Compensation**

Any Requisition Compensation shall be paid to the Lender and be applied in accordance with the provisions of Clause 7.

3 **CONTINUING SECURITY**

3.1 **Continuing security; assignment not affected by other security**

The security created by this Assignment:

3.1.1 is and shall at all times be a continuing security for the payment of the full amount of the Outstanding Indebtedness from time to time;

3.1.2 shall not be satisfied by any intermediate payment or satisfaction of any part of the Outstanding Indebtedness;

3.1.3 shall be in addition to and shall not merge with or be prejudiced or affected by any other security for the Outstanding Indebtedness which may have been, or may at any time hereafter be, given to the Lender by the Owner or any other person.

3.2 **Right to consolidate**

The Lender shall be entitled to consolidate this Assignment with any other security held by the Lender for any other indebtedness or obligation of the Owner.

3.3 **Exclusion of statutory provisions**

Neither Section 93 nor Section 103 of the Law of Property Act 1925 shall apply to this Assignment or to the security hereby created.

3.4 **(New accounts**[5]

If the Lender receives notice of any subsequent Encumbrance or other interest affecting all or part of the Assigned Property, the Lender may open a new account for the Owner in the Lender's books.

[4] Note: This provision assumes that all Earnings are to be paid to an Earnings Account.

[5] [This wording is only required if further advances may be made under the facility agreement after the date of the assignment].

Without prejudice to the Lender's right to combine accounts, no money paid to the credit of the Owner in any such new account shall be appropriated towards, or have the effect of discharging, any part of the Outstanding Indebtedness. If the Lender does not open a new account immediately on receipt of notice under this Clause, then, unless the Lender gives express written notice to the contrary to the Owner, all payments made by the Owner to the Lender shall be treated as having been credited to a new account of the Owner and not as having been applied in reduction of the Outstanding Indebtedness, as from the time of receipt of the relevant notice by the Lender.]

4 **UNDERTAKINGS**

4.1 The Owner hereby covenants with the Lender and undertakes:

4.1.1 to procure that immediately following the execution of this Assignment and at all times thereafter during the Security Period the following are duly endorsed upon all slips, cover notes, policies, certificates of entry or other instruments of insurance issued or to be issued in connection with the Insurances:

(a) a notice of assignment to the Lender signed by the Owner in the form of Schedule 1 or in such other form as the Lender may require;

(b) (in respect of protection and indemnity insurance) a loss payable clause in the form of Schedule 2 or in such other form as the Lender may require; and

(c) (in respect of hull, machinery and equipment marine and war risks (including excess risks) insurance) a loss payable clause in the form of Schedule 3 or in such other form as the Lender may require;

4.1.2 [immediately following the execution of this Assignment to give a notice to the Initial Charterer [and the Initial Charter Guarantor] in the form set out in Schedule 4 (or in such other form as the Lender may require or approve)] and to procure that on or before the Drawdown Date [of the final Advance[6]][of the Tranche relating to the Vessel][7] the Initial Charterer [and the Initial Charter Guarantor each] duly acknowledges such notice and delivers an acknowledgement to the Lender in the form set out in Schedule 4 (or in such other form as the Lender may require or approve);][8]

4.1.3 immediately upon the execution of any new Charter [having a term which exceeds, or which by virtue of any optional extensions might exceed, [6][12] months' duration] to give a notice to the relevant Charterer in the form set out in Schedule 4 (or in such other form as the Lender may require or approve) and to procure that such Charterer duly acknowledges such notice and delivers an acknowledgement to the Lender in the form set out in Schedule 4 (or in such other form as the Lender may require or approve);

4.1.4 immediately upon the execution of any new Charter Guarantee which relates to a Charter in respect of which notice has been or is required to be given to the relevant Charterer under this Assignment, to give a notice to the relevant Charter Guarantor in the form set out in Schedule 4 (or in such other form as the Lender may require or approve) and to procure that such Charter Guarantor duly acknowledges such notice and delivers an acknowledgement to the Lender in the form set out in Schedule 4 (or in such other form as the Lender may require or approve);

6 Use this wording if the loan is a pre- and post-delivery loan with the final Advance on delivery.

7 Use this wording if there is more than one vessel with a separate Tranche for each.

8 Only include this provision if there is an "Initial Charter" under the loan agreement.

4.1.5 from time to time immediately upon the written request of the Lender to give written notice to the relevant authority in such form as the Lender shall require of the assignment of Requisition Compensation contained in this Assignment;

4.1.6 not, without the consent of the Lender, to:

(a) create or suffer the creation of an Encumbrance (other than a Permitted Encumbrance) over the whole or any part of the Assigned Property nor dispose of the whole or any part of the Assigned Property otherwise than in accordance with Clause 2, or enter into any agreement or arrangement whereby the Assigned Property may be shared or pooled with any person;

(b) terminate any Charter or Charter Guarantee for any reason whatsoever or agree to amend any Charter or Charter Guarantee in any [material] respect (other than for amendments which are favourable to the Owner) or release the Charterer or Charter Guarantor from any of its duties and liabilities under any Charter or Charter Guarantee or waive any breach of any of the said duties and liabilities or consent to any such act or omission by the Charterer or Charter Guarantor which would otherwise constitute such a breach;

(c) permit payment of any amount from time to time payable by the Charterer under any Charter or by the Charter Guarantor under any Charter Guarantee to be diminished, rebated, diverted or delayed, or to be made otherwise than in full on its due date to the Earnings Account or such other account as may be specified by the Lender pursuant to Clause [9] of the Agreement;

4.1.7 to perform and observe the covenants imposed on it under the other Security Documents with respect to the Assigned Property;

4.1.8 upon demand and at its own expense, to sign, perfect, do, execute and register all such further assurances, documents, acts and things as the Lender may require for:

(a) perfecting or protecting the security constituted by this Assignment;

(b) the exercise by the Lender of any right, power or remedy vested in it under this Assignment;

(c) enforcing the security constituted by this Assignment after it has become enforceable (and the Owner undertakes to allow its name to be used as and when required by the Lender for that purpose).

5 CONTINUING LIABILITY OF OWNER

5.1 It is agreed and declared that, notwithstanding the assignment contained in Clause 2:

5.1.1 the Lender shall not be obliged to make any enquiry as to the nature or sufficiency of any payment received by it under this Assignment or to make any claim or take any other action to collect any moneys or to enforce any rights and benefits hereby assigned to the Lender or to which the Lender may at any time be entitled under this Assignment; and

5.1.2 the Owner shall remain liable to perform all the obligations assumed by it in relation to the Assigned Property and the Lender shall not be under any obligation of any kind whatsoever in relation thereto or be under any liability whatsoever in the event of any failure by the Owner to perform its obligations in respect of the Assigned Property.

6 ENFORCEMENT

6.1 Right to enforce security

The security constituted by this Assignment shall become immediately enforceable upon the occurrence of an Event of Default.

6.2 Powers upon enforcement

Upon this Assignment becoming enforceable the power of sale and other powers conferred by Section 101 of the Law of Property Act 1925, as varied by this Assignment, shall become exercisable and the Lender shall become immediately entitled, without being required to obtain any court order or declaration that an Event of Default has occurred and whether or not the Lender has made any demand for payment under Clause [13.2] of the Agreement, as and when it may see fit, to put into force and to exercise all or any of the powers possessed by it as assignee of the Assigned Property (whether by law or otherwise) and, in particular, but without prejudice to the generality of the foregoing:

6.2.1 to require that all policies, contracts, certificates of entry and other records relating to the Insurances (including details of and correspondence concerning outstanding claims) be forthwith delivered to or to the order of the Lender;

6.2.2 to collect, recover, compromise and give a good discharge for all claims then outstanding or thereafter arising under the Insurances or in respect of the Earnings or any Requisition Compensation, and to take over or institute (if necessary using the name of the Owner) all such proceedings in connection with such claims or otherwise in connection with the Assigned Property as the Lender in its absolute discretion thinks fit and to permit the brokers through whom collection or recovery is effected to charge the usual brokerage;

6.2.3 to exercise (to the exclusion of the Owner) all the rights and remedies of the Owner in respect of the Assigned Property in such manner as it may think fit; and

6.2.4 to recover from the Owner on demand all losses, damages, liabilities and expenses incurred by the Lender in or about or incidental to the exercise by it of any of the above powers, together with interest at the Default Rate in accordance with the relevant provisions of the Agreement.

For the avoidance of doubt, the powers of the Lender by virtue of this Assignment shall not be limited to those specified in Section 101 of the Law of Property Act 1925.

6.3 Exclusion of liability

Neither the Lender nor its servants or agents (except in the case of its gross negligence or wilful misconduct) shall be liable for any loss, damage, liability or expense whatsoever and howsoever suffered or incurred by the Owner arising out of or in connection with the exercise or purported exercise by or on behalf of the Lender of any rights, powers or discretions under this Assignment.

6.4 [Receivers[9]

The Lender may, at any time after this Assignment has become enforceable, appoint in writing, under the hand of any officer or officers of the Lender or under the seal of the Lender, any person, whether an officer of the Lender or not, to be receiver or receiver and manager (each of which is referred to below as a "**Receiver**") of the Mortgaged Property or any part thereof and may in like manner, from

[9] Only include this receiver language if the ship mortgage or deed of covenants omits it.

time to time, remove any Receiver so appointed and appoint another in his stead. Any Receiver so appointed shall:

6.4.1 be the agent of the Owner, who shall be solely liable for his remuneration, costs, charges and expenses and for his acts and defaults;

6.4.2 have all the powers conferred by the Law of Property Act 1925, without the restrictions contained in Sections 93 and 103 of that Act, together with all the powers conferred by the Insolvency Act 1986, and, in addition, shall have the power, on behalf of and at the cost of the Owner, to do or omit to do anything which the Owner could do or omit to do in relation to the Mortgaged Property and to exercise all the rights, powers and remedies of the Lender under this Assignment, for which purpose the benefit of all the immunities and limitations of liability conferred on the Lender by this Assignment shall extend to the Receiver and his servants and agents;

6.4.3 be entitled to remuneration appropriate to the work and responsibilities involved, upon the basis of charging adopted by the Receiver in accordance with the current practices of his firm, without being limited to the maximum rate specified in Section 109(6) of the Law of Property Act 1925.]

7 APPLICATION OF PROCEEDS

7.1 All moneys received or recovered by the Lender or any Receiver in respect of:

7.1.1 the Earnings, following a direction made by the Lender under Clause [9.8.2] of the Agreement;

7.1.2 recovery under the Insurances (other than any such sum or sums as may have been received by the Lender in respect of a Major Casualty and paid over to the Owner);

7.1.3 Requisition Compensation; or

7.1.4 the net profits arising out of the employment of the Vessel by or on behalf of the Lender or the Receiver,

shall be held by it or him upon trust, in the first place, to pay the remuneration of the Receiver and to pay or make good all costs, expenses and liabilities whatsoever incurred by the Lender or the Receiver in or about or incidental to the recovery of such moneys, and the balance shall be applied in accordance with Clause [7.2] of the Agreement.

The Owner hereby irrevocably waives any rights of appropriation to which it may be entitled.

8 POWER OF ATTORNEY

8.1 The Owner by way of security hereby irrevocably appoints the Lender its true and lawful attorney with full power in the name of the Owner, should the Lender so elect, to ask, require, demand, receive, compound and give acquittance for any and all moneys, and claims for any and all moneys, due under or arising out of this Assignment, and to endorse any cheques or other instruments or orders in connection with such moneys, and to make any claims, take any action and institute any proceedings which the Lender may consider to be necessary or advisable in this respect and otherwise to do any and all things which the Owner itself could do in relation to the Assigned Property provided always that:

8.1.1 neither the Lender nor its servants or agents (except in the case of its gross negligence or wilful misconduct) shall be liable to the Owner for any loss, damage, liability or expense whatsoever and howsoever suffered or incurred by the Owner as a result of the exercise of such powers;

8.1.2 the Lender will not exercise such powers unless and until an Event of Default has occurred; and

8.1.3 notwithstanding the terms of Clause 8.1.2, third parties shall not be bound to see or enquire whether the right of the Lender to exercise such powers has arisen.

9 **ASSIGNMENTS AND TRANSFERS**

9.1 **No assignment by Owner**

The Owner may not assign or transfer all or any of its rights, benefits or obligations under this Assignment.

9.2 **Assignment and transfer by Lender**

The Lender may assign or transfer all or any of its rights, benefits or obligations under this Assignment to the same extent that it is permitted by the Agreement to assign or transfer its rights, benefits or obligations under the other relevant Security Documents.

9.3 **Delegation**

The Lender may at any time and from to time to time delegate any one or more of its rights, powers and/or obligations under this Assignment to any person (provided that the Lender shall remain fully responsible for the exercise or performance of any rights, powers and/or obligations delegated by it).

9.4 **Owner to assist**

The Owner undertakes to do or to procure all such acts and things and to sign, execute and deliver or procure the signing, execution and deliver of all such instruments and documents as the Lender may reasonably require for the purpose of perfecting any such assignment or transfer as mentioned above.

10 **DISCHARGE OF SECURITY**

Upon the repayment of the whole of the Outstanding Indebtedness, the Lender upon the request and at the expense and cost of the Owner shall re-assign the Assigned Property to the Owner, without recourse or warranty, to the extent then still subsisting and capable of reassignment.

11 **MISCELLANEOUS**

11.1 **Time of essence**

Time is of the essence as regards every obligation of the Owner under this Assignment.

11.2 **Remedies and waivers**

No failure to exercise, nor any delay in exercising, on the part of the Lender, any right or remedy under this Assignment shall operate as a waiver of it, nor shall any single or partial exercise of any right or remedy prevent any further or other exercise of it or the exercise of any other right or remedy. The rights and remedies provided in this Assignment are cumulative and not exclusive of any rights or remedies provided by law.

11.3 **Waivers and amendments to be in writing**

Any waiver by the Lender of any provision of this Assignment, and any consent or approval given by the Lender under or in respect of this Assignment, shall only be effective if given in writing and then only strictly for the purpose and upon the terms for which it is given. This Assignment may not be amended or varied orally but only by an instrument signed by the Lender and the Owner.

11.4 **Severability**

If at any time one or more of the provisions of this Assignment is or becomes invalid, illegal or unenforceable in any respect under any law by which it may be governed or affected, the validity, legality and enforceability of the remaining provisions shall not be in any way affected or impaired as a result.

11.5 **Counterparts**

This Assignment may be executed in any number of counterparts and all such counterparts taken together shall be deemed to constitute but one and the same instrument.

12 **NOTICES**

All notices (which expression includes any demand, request, consent or other communication) to be given by one party to the other under this Assignment shall be given in the manner provided in the Agreement.

13 **APPLICABLE LAW AND JURISDICTION**

13.1 **Governing law**

This Assignment and any non-contractual obligations arising out of or in connection with it shall be governed by and construed in accordance with English law.

13.2 **Submission to jurisdiction**

The Owner hereby irrevocably agrees for the exclusive benefit of the Lender that the English courts shall have jurisdiction in relation to any dispute and any suit, action or proceeding (referred to together in this Clause 13 as "**Proceedings**") which may arise out of or in connection with this Assignment, and for such purposes irrevocably submits to the jurisdiction of such courts.

13.3 **Service of process**

The Owner hereby irrevocably agrees:

13.3.1 that, for the purpose of Proceedings in England, any legal process may be served upon [●] whose registered office is presently at [●] and who, by this Assignment, are authorised to accept service on its behalf, which shall be deemed to be good service on the Owner; and

13.3.2 that throughout the Security Period the Owner will maintain a duly appointed process agent in England, duly notified to the Lender, and that failure by any such process agent to give notice thereof to the Owner shall not impair the validity of such service or of a judgment or order based thereon.

13.4 **Choice of forum**

Nothing in this Clause 13 shall affect the right of the Lender to serve process in any manner permitted by law or limit the right of the Lender to take Proceedings against the Owner in any other court of competent jurisdiction, nor shall the taking of Proceedings in one or more jurisdictions preclude the taking of Proceedings by the Lender in any other jurisdiction, whether concurrently or not.

The Owner shall not commence any Proceedings in any country other than England in relation to any matter arising out of or in connection with this Assignment.

13.5 **Forum convenience**

The Owner irrevocably waives any objection which it may at any time have on the grounds of inconvenient forum or otherwise to Proceedings being brought in any such court as is referred to in this Clause 13, and further irrevocably agrees that a judgment or order in any Proceedings brought in the English courts shall be conclusive and binding upon the Owner and may be enforced without review in the courts of any other jurisdiction.

13.6 **Consent**

The Owner consents generally in respect of any Proceedings arising out of or in connection with this Assignment to the giving of any relief or the issue of any process in connection with such Proceedings, including, without limitation, the making, enforcement or execution against any property or assets whatsoever of any order or judgment which may be made or given in such Proceedings.

13.7 **[Waiver of immunity**

To the extent that the Owner may be entitled in any jurisdiction to claim for itself or its property or assets immunity in respect of its obligations under this Assignment from service of process, jurisdiction, suit, judgment, execution, attachment (whether before judgment, in aid of execution or otherwise) or legal process, or to the extent that in any jurisdiction there may be attributed to it or its property or assets such immunity (whether or not claimed), the Owner irrevocably agrees not to claim and irrevocably waives that immunity to the fullest extent permitted by the laws of that jurisdiction.][10]

AS WITNESS the parties hereto have entered into this Assignment as a deed the day and year first before written.

[10] Use only in cases where the Owner is state-owned or there is otherwise a risk that the Owner may claim immunity for itself or its assets.

EXECUTION PAGE

THE OWNER

SIGNED AND DELIVERED AS A DEED[11])
by)
duly authorised for and on behalf of) ....
[●])
in the presence of:)

Signature:

Name:

Occupation:

Address:

THE LENDER

SIGNED AND DELIVERED AS A DEED)
by)
duly authorised for and on behalf of) ....
[●])
in the presence of:)

Signature:

Name:

Occupation:

Address:

[11] Note that some jurisdictions, e.g. Bermuda, will require the words "SIGNED, SEALED AND DELIVERED" to be used and a wafer seal to be affixed if the Owner is incorporated in that jurisdiction.

SCHEDULE 1

NOTICE OF ASSIGNMENT

(for attachment by way of endorsement to every cover note, contract and policy)

m.v. "[●]"

We, [●] of [●], the owners of the above vessel, hereby give notice that by an assignment in writing dated [●] 201[●] we have assigned to [●] acting through its office at [●] (the "**Mortgagee**") all insurances in respect of the above vessel and all moneys to become payable thereunder or in respect thereof and **WE HEREBY AUTHORISE** you to supply the Mortgagee with copies of all policies and/or certificates of entry upon issue, together with any renewals of the same and copies of all endorsements thereon.

Dated: 201[●]

....
For and on behalf of
[●]

SCHEDULE 2

LOSS PAYABLE CLAUSE

(in respect of protection and indemnity insurance)

"Payment of any recovery the Owner is entitled to make out of the funds of the Association in respect of any liability, costs and expenses incurred by it shall be made to the Owner or to its order, unless and until the Association receives notice from [●] acting through its office at [●] (the "**Mortgagee**") that the Owner is in default under the Mortgage, in which event all recoveries shall thereafter be paid to the Mortgagee or its order provided always that no liability whatsoever shall attach to the Association, its Managers or their Agents for failure to comply with the latter obligation until after the expiry of two clear business days from the receipt of such notice.

Notwithstanding anything contained herein, the Association shall (unless and until the Mortgagee shall have given notice in writing to the contrary) be at liberty at the request of the Owner to provide bail or other security to prevent the arrest or obtain the release of the vessel."

SCHEDULE 3

LOSS PAYABLE CLAUSE

(in respect of hull, machinery and equipment marine
and war risks (including excess risks) insurance)

"It is hereby noted that:

(a) by a first priority mortgage dated [●] 201 [●] **[●]** of [●] (the **"Owner")** has mortgaged the m.v. "[●]" to [●] acting through its office at [●] (the "**Mortgagee**"); and

(b) by an assignment dated [●] 201 [●] the Owner has assigned to the Mortgagee these insurances and all benefits thereof including all claims of whatsoever nature (including return of premiums) hereunder.

Save as hereinafter provided, all claims arising under these insurances, whether in respect of an actual, constructive, arranged or compromised total loss or otherwise howsoever, shall be paid to the Mortgagee or as it may direct, provided however that unless and until written instructions to the contrary are received from the Mortgagee claims (other than total loss claims) not exceeding [$][€][●] or its equivalent in any other currency (before adjustment for any franchise or deductible) in respect of any one claim may be paid to the Owner."

SCHEDULE 4

NOTICE OF ASSIGNMENT OF EARNINGS

To: [Name]
[Address]

Dear Sirs

m.v. "[●]"

We refer to the [describe contract] dated [●] 201 [●] (together with all amendments and supplements thereto the "**Contract**") made between ourselves and yourselves in respect of the m.v. "[●]" (the "**Vessel**").

WE HEREBY GIVE YOU NOTICE:

1 That by an assignment dated [●] 201[●] (the "**Assignment**") made by us in favour of [●] acting through its office at [●] (the "**Mortgagee**") we have assigned to the Mortgagee (which expression includes its successors and assigns) all our rights, title and interest, both present and future, in and to [the Contract and][12] all moneys whatsoever (and all claims for such moneys) due or to become due to us or for our account under the Contract (the "**Earnings**"), including (but not limited to) damages for breach, or payments for variation or termination, of the Contract.

2 That you are hereby irrevocably authorised and instructed to pay all such moneys as aforesaid to our account number [●] at [●], [●] branch unless and until the Mortgagee directs to the contrary whereupon you shall pay all such amounts in accordance with the directions of the Mortgagee.

3 That we have agreed with the Mortgagee that:

3.1 we shall not terminate the Contract for any reason whatsoever or agree to amend the Contract in any [material] respect (other than for amendments which are favourable to us) or release you from any of your duties and liabilities under the Contract or waive any breach of any of the said duties and liabilities or consent to any such act or omission by you which would otherwise constitute such a breach, unless in each such case the Mortgagee has given its prior written consent;

3.2 we shall not permit payment of any amount from time to time payable by you under the Contract to be diminished, rebated, diverted or delayed, or to be made otherwise than in full on its due date to the account specified above or as the Mortgagee may direct, unless in each such case the Mortgagee has given its prior written consent; and

3.3 we shall remain liable to perform all the obligations assumed by us in relation to the rights and property assigned by us to the Mortgagee under the Assignment, and the Mortgagee shall not be under any obligation of any kind whatsoever in relation thereto or be under any liability whatsoever in the event of any failure by us to perform our obligations in respect thereof.

The authority and instructions contained in this Notice cannot be revoked or varied by us without the prior written consent of the Mortgagee.

[12] Only include if the assignment includes a specific assignment of the relevant Contract.

Would you kindly acknowledge receipt of this Notice and your agreement to its terms by signing the form of acknowledgement on the attached copy of this Notice and returning one copy to the Mortgagee and one copy to us.

Dated: 201[●]

....
For and on behalf of
[●]

ACKNOWLEDGMENT TO ASSIGNMENT OF EARNINGS

To: [Lender's name]
[Lender's address]

Copy: [Owner's name]
[Owner's address]

Dear Sirs

m.v. "[●]"

We acknowledge receipt of the foregoing Notice of Assignment in respect of m.v. "[●]" and for good and valuable consideration (receipt and the sufficiency of which are hereby acknowledged) we hereby [consent to the Assignment referred to therein and][13] agree to comply in all respects with the instructions contained in such Notice.

For the same consideration, we confirm that we have received no notice of any previous assignment of, or other third party right affecting, the Contract or all or any part of the Earnings.

Dated 201[●]

....
For and on behalf of
[●]

[13] Only include this wording if the Charterer's consent is required under the terms of the Charter.

Appendix 4

CORPORATE GUARANTEE (WITH SECURITY) FOR BILATERAL LOAN

Draft 00.00.00

DATED 201[●]

[●]
as Guarantor

and

[●]
as Lender

GUARANTEE AND INDEMNITY

relating to the obligations of [●]

holman fenwick willan hfw

INDEX

THIS DEED OF GUARANTEE AND INDEMNITY is made on 201 [●]

BETWEEN

(1) [●], a [company] incorporated in [●] [with company registration number [●]] whose registered office is at [●] (the "**Guarantor**"); and

(2) **[●]**, a [bank] incorporated in [●] acting through its branch at [●] (the "**Lender**").

WHEREAS

(A) By a loan agreement dated [●] 201[●] (the "**Agreement**") made between (1) [●] as borrower (the "**Borrower**") and (2) the Lender, the Lender has agreed to make available to the Borrower a loan of [$][€][●].

(B) As security for the repayment of the Loan, and the payment of interest thereon and of all other moneys from time to time due or owing to the Lender under or pursuant to the Agreement, the Guarantor has agreed to enter into this Guarantee.

IT IS AGREED as follows:

1 **DEFINITIONS AND INTERPRETATION**

1.1 **Definitions**

Words and expressions defined in the Agreement shall, unless otherwise expressly provided in this Guarantee or the context otherwise requires, have the same meanings when used in this Guarantee, including the Recitals. [In addition, in this Guarantee:

[●]][1]

1.2 **General interpretation**

In this Guarantee:

1.2.1 unless the context otherwise requires, words in the singular include the plural and vice versa;

1.2.2 references to any document include the same as varied, supplemented or replaced from time to time;

1.2.3 references to any enactment include re-enactments, amendments and extensions thereof;

1.2.4 references to any person include that person's successors and permitted assigns;

1.2.5 clause headings are for convenience of reference only and are not to be taken into account in construction;

1.2.6 unless otherwise specified, references to Clauses and Recitals[2] are respectively to Clauses of and Recitals to this Guarantee

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[1] Define here any expressions used in the guarantee which are not defined in the loan agreement

[2] Insert references to Schedules if any Schedules are to be added (e.g. attaching the form of any compliance certificate).

1.3 Third party rights

A person who is not a party to this Guarantee may not enforce, or otherwise have the benefit of, any provision of this Guarantee under the Contracts (Rights of Third Parties) Act 1999.

2 GUARANTEE AND INDEMNITY

2.1 Guarantee and indemnity

The Guarantor irrevocably and unconditionally:

2.1.1 guarantees the due and punctual payment by the Borrower to the Lender of each and every part of the Outstanding Indebtedness in accordance with the terms of the Security Documents;

2.1.2 undertakes that, if and whenever the Borrower fails to pay on the due date any sum whatsoever due and payable under or pursuant to any Security Document, the Guarantor shall pay such sum on demand by the Lender; and

2.1.3 agrees, as a separate and independent stipulation, that if any amounts intended to be guaranteed by Clause 2.1.1 are not recoverable on the footing of a guarantee, whether by reason of illegality, incapacity, lack or exceeding of powers, ineffectiveness of execution or any other fact or circumstance, whether or not known to the Lender or the Guarantor, then such amounts shall nevertheless be recoverable from the Guarantor as sole or principal debtor by way of indemnity and shall be payable by the Guarantor to the Lender on demand.

2.2 [Guarantee amount[3]

Without prejudice to the Guarantor's obligations under Clauses 2.3, 6.2 and 10 and any other relevant provision of this Guarantee, the maximum liability of the Guarantor under Clause 2.1 shall not exceed [$][€][●] [nor, in respect of any particular unpaid amount of the Outstanding Indebtedness or its equivalent under Clause 2.1.3, [●]% of that amount[4]].]

2.3 Default interest

If the Guarantor fails to pay any amount payable by it under this Guarantee on its due date, interest shall accrue on the overdue amount from the due date up to the date of actual payment (both before and after judgment) at a rate which is [●]% higher than the rate which would have been payable if the overdue amount had, during the period of non-payment, constituted part of the Loan for successive periods, each of a duration selected by the Lender (acting reasonably). Any interest accruing under this Clause 2.3 shall be immediately payable by the Guarantor on demand by the Lender. If unpaid, any such interest will be compounded with the overdue amount at the end of each period applicable to that overdue amount but will remain immediately due and payable.

2.4 Nature of guarantee

The guarantee contained in this Clause 2 is a guarantee of payment and performance and not of collection.

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[3] Only include this provision in limited recourse guarantees.

[4] Use this wording if, for example, there are joint and several guarantors and each guarantor is only liable for its relevant percentage of each amount due.

2.5 **Guarantor as principal debtor**

The Guarantor agrees that it is, and will throughout the Security Period remain, liable under this Guarantee as a principal debtor and not as a surety only.

2.6 **Immediate recourse**

The Guarantor waives any rights which it may have to require the Lender first to enforce any of the other Security Documents or claim payment from the Borrower or any other person before enforcing any rights of the Lender against the Guarantor under this Guarantee.

3 **PRESERVATION OF THE GUARANTOR'S LIABILITY**

3.1 **Continuing security; guarantee not affected by other security**

This Guarantee:

3.1.1 is and shall at all times throughout the Security Period remain a continuing security for the payment of the full amount of the Outstanding Indebtedness from time to time;

3.1.2 shall not be satisfied by any intermediate payment or satisfaction of any part of the Outstanding Indebtedness;

3.1.3 shall be in addition to and shall not merge with or be prejudiced or affected by any other security for the Outstanding Indebtedness which has been, or may at any time be, given to the Lender by the Borrower or any other person.

3.2 [**Opening of new accounts**[5]

3.2.1 If this Guarantee or the security created by any other Security Document to which the Guarantor is at any time a party ceases for any reason whatsoever to be continuing, the Lender may open a new account or accounts in the name of the Borrower.

3.2.2 If the Lender does not open a new account or accounts pursuant to Clause 3.2.1, it shall nevertheless be treated as if it had done so at the time that this Guarantee or such other security ceased to be continuing whether by termination, calling in or otherwise, in relation to the Borrower.

3.2.3 As from the time of opening or deemed opening of a new account or accounts, all payments made to the Lender by or on behalf of the Borrower shall be credited or be treated as having been credited to the new account or accounts and shall not operate to reduce the amount for which this Guarantee or any other Security Document is available at that time, nor shall the liability of the Guarantor under this Guarantee or any other Security Document in any manner be reduced or affected by any subsequent transactions, receipts or payments.]

3.3 **Waiver of defences**

Neither the rights of the Lender nor the obligations of the Guarantor under this Guarantee or any other Security Document to which it is at any time a party shall be discharged, impaired or otherwise affected by reason of any of the following, whether or not known to the Guarantor, the Lender or any other person:

[5] Note: This clause is strictly only required if the guarantee relates to an overdraft or revolving credit facility (i.e. where amounts can be repaid and redrawn).

3.3.1 any time or indulgence granted to, or composition with, the Borrower or any other person; or

3.3.2 any termination, renewal, extension or variation of any credit, accommodation or facility granted by the Lender to the Borrower or any other person or any amendment of, or the making of any supplement to, any Security Document or any other document or security; or

3.3.3 the taking, variation, compromise, renewal, enforcement, realisation or release of, or refusal or neglect to take, perfect, release or enforce, any rights, remedies or securities against, or granted by. any Obligor or other person; or

3.3.4 any incapacity, disability, or defect in powers of any Obligor or other person, or any irregular exercise thereof by, or lack of authority of, any person purporting to act on behalf of any Obligor or other person; or

3.3.5 any illegality, invalidity, avoidance or unenforceability on any grounds whatsoever of, or of any obligations of any Obligor or other person under, any Security Document or any other document or security; or

3.3.6 the death, liquidation, administration, insolvency, amalgamation, reorganisation or dissolution, or any change in the constitution, name or style, of any Obligor, the Lender or any other person; or

3.3.7 any other act, omission, matter or thing which, but for this provision, might operate to exonerate the Guarantor from liability, whether in whole or in part, under this Guarantee.

4 RESTRICTIONS ON GUARANTOR

4.1 Deferral of Guarantor's rights

Until the expiry of the Security Period, the Guarantor shall not be entitled, nor shall the Guarantor claim, by virtue of any payment made by the Guarantor under this Guarantee:

4.1.1 to exercise any right of subrogation or indemnity or any other right or remedy in relation to any rights, security or moneys held by or recovered or receivable by the Lender under the Security Documents; or

4.1.2 to exercise any right of set-off or counterclaim against the Borrower or any other Obligor; or

4.1.3 to exercise any right of contribution from any other Obligor in respect of the Outstanding Indebtedness; or

4.1.4 to receive, claim or have the benefit of any payment, distribution or security from the Borrower or any other Obligor; or

4.1.5 unless so directed by the Lender (in which case the Guarantor shall prove in accordance with the Lender's directions), to rank as a creditor or have any right of proof in the bankruptcy, liquidation or insolvency of the Borrower or any other Obligor in competition with the Lender.

4.2 No security to be taken by the Guarantor

The Guarantor represents and warrants that it has not taken, and undertakes that it will not take, without the prior written consent of the Lender, any security from the Borrower or any other Obligor in respect of the Guarantor's liability under this Guarantee.

4.3 Application of payments or benefits received by the Guarantor

If the Guarantor is required by the Lender to prove in the bankruptcy, liquidation or insolvency of the Borrower or any other Obligor, or receives any payment, distribution or security from the Borrower or any other Obligor, or exercises any right of set off or counterclaim in respect of any payment made by it under this Guarantee, or otherwise acts in breach of any provision of this Clause 4, then in each such case the Guarantor shall hold on trust for the Lender and forthwith pay or transfer (as may be appropriate) to the Lender any such payment, amount set off, distribution or benefit of such security received by it.

5 PAYMENTS

5.1 Place, time and manner of payment

Unless otherwise specified by the Lender, all moneys to be paid by the Guarantor under this Guarantee shall be paid to the Lender in [Dollars][Euro] on the due date and in same day funds to such account as the Lender may from time to time notify the Guarantor.

5.2 Non-Banking Days

Any payment which is due to be made on a day that is not a Banking Day shall be made on the next Banking Day in the same calendar month (if there is one) or the preceding Banking Day (if there is not).

5.3 Accrual of interest and periodic payments

All payments of interest and other payments of an annual or periodic nature to be made by the Guarantor shall accrue from day to day and be calculated on the basis of the actual number of days elapsed and a 360[6] day year.

5.4 Application of receipts

Without prejudice to Clause 5.5, all moneys received or recovered by the Lender pursuant to this Guarantee shall be applied, in the first place, to pay or make good all costs, expenses and liabilities whatsoever incurred by the Lender in or about or incidental to the recovery of such moneys, and the balance shall be applied in accordance with Clause [7.2] of the Agreement.

5.5 Suspense account

The Lender may at its discretion:

5.5.1 place to the credit of a suspense account any moneys received or recovered under or in connection with this Guarantee in order to preserve the rights of the Lender to prove for the full amount of all its claims against the Borrower or any other person in respect of the Outstanding Indebtedness; and

5.5.2 at any time and from time to time apply all or any moneys held in any such suspense account in or towards satisfaction of the Outstanding Indebtedness.

5.6 Waiver of rights of appropriation

The Guarantor irrevocably waives any rights of appropriation to which it may be entitled in respect of any payment made under this Guarantee.

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[6] Change to 365 for Sterling loans.

6 NO SET-OFF, COUNTERCLAIM OR TAX DEDUCTION

6.1 No set-off or counterclaim

All payments to be made by the Guarantor under this Guarantee and any other Security Document shall be made without set-off or counterclaim and free and clear of, and without deduction for or on account of, any present or future taxes, unless the Guarantor is compelled by law to make payment subject to any such tax.

6.2 Gross up

If the Guarantor is compelled by law to make payment subject to such taxes, the Guarantor will:

6.2.1 promptly notify the Lender upon becoming aware of that requirement;

6.2.2 pay the tax deducted to the appropriate taxation authority promptly, and in any event before any fine or penalty arises;

6.2.3 pay the Lender such additional amount as is necessary to ensure that the Lender receives a net amount equal to the full amount which it would have received had that tax deduction not been required to be made; and

6.2.4 as soon as reasonably practicable after making the relevant tax deduction, deliver to the Lender a copy of the receipt from the relevant taxation authority evidencing that the tax had been paid to that authority.

6.3 Tax credit

If, following any such tax deduction as is referred to in Clause 6.2 from any payment by the Guarantor, the Lender shall receive or be granted a credit against or remission for any taxes payable by it, the Lender shall, subject to the Guarantor having made any increased payment in accordance with Clause 6.2 and to the extent that the Lender can do so without prejudicing the retention of the amount of that credit or remission and without prejudice to the right of the Lender to obtain any other relief or allowance which may be available to it, reimburse the Guarantor with such amount as the Lender shall in its absolute discretion certify to be the proportion of that credit or remission as will leave the Lender (after such reimbursement) in no worse position than it would have been in had there been no such deduction or withholding from the payment to the Lender. Such reimbursement shall be made immediately upon the Lender certifying that the amount of such credit or remission has been received by it. Nothing contained in this Agreement shall oblige the Lender to rearrange its tax affairs or to disclose any information regarding its tax affairs and computations. Without prejudice to the generality of the foregoing, the Guarantor shall not by virtue of this Clause 6.3 be entitled to enquire about the Lender’s tax affairs

6.4 Double tax treaties

Where the Guarantor is or may be obliged to withhold tax from any payment to the Lender under this Guarantee and its obligation to withhold such tax may be eliminated or reduced under any applicable double taxation agreement or treaty, the Lender will promptly comply with all appropriate formalities required to be performed by it under such double taxation agreement or treaty (save as may depend on action being taken by a third party which has not been taken) so that it can receive payments from the Guarantor under this Guarantee without deduction of such tax or with deduction at the reduced level permitted by such double taxation agreement or treaty.

7 DISCHARGE CONDITIONAL

Any release, discharge or settlement between the Guarantor and the Lender in relation to this Guarantee shall be conditional on no right, security, disposition or payment to the Lender by the Guarantor, the Borrower or any other person in respect of the Outstanding Indebtedness being avoided, set aside or ordered to be refunded pursuant to any enactment or law relating to breach of duty by any person, bankruptcy, liquidation, administration, protection from creditors generally or insolvency or for any other reason. If any such right, security, disposition or payment is avoided, set aside or ordered to be refunded, the Lender shall be entitled subsequently to enforce this Guarantee against the Guarantor as if such release, discharge or settlement had not occurred and any such security, disposition or payment had not been made.

8 REPRESENTATIONS AND WARRANTIES

8.1 Date of representations and warranties

The Guarantor represents and warrants that the following matters are true at the date of this Guarantee.

8.2 Existence, powers, compliance and solvency

The Guarantor:

8.2.1 is a company[7] duly incorporated with limited liability, validly existing and in good standing under the laws of its place of incorporation;

8.2.2 has full power to own its property and assets and to carry on its business as it is now being conducted;

8.2.3 has complied with all statutory and other requirements relative to its business;

8.2.4 is solvent and not in liquidation or administration or subject to any other insolvency procedure, and no receiver, administrative receiver, administrator, liquidator, trustee or analogous officer has been appointed in respect of it or all or any part of its assets.

8.3 Capacity and authorisation

The entry into and performance by the Guarantor of this Guarantee and the other Security Documents [and the Transaction Documents] to which it is (or is to become) a party are within the corporate powers of the Guarantor and have been duly authorised by all necessary corporate actions and approvals and no limitation on its powers will be exceeded as a result of the liabilities incurred under this Guarantee.

8.4 No contravention of laws or contractual restrictions

The entry into and performance by the Guarantor of this Guarantee and the other Security Documents [and the Transaction Documents] to which it is (or is to become) a party do not and will not:

8.4.1 Contravene in any respect the constitutional documents of the Guarantor or any law, regulation or contractual restriction binding on the Guarantor or any of its assets; or

8.4.2 result in the creation or imposition of any Encumbrance (other than a Permitted Encumbrance) on any of its assets in favour of any party.

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[7] Amend if dealing with a partnership.

8.5 **Licences and approvals in force**

All licences, authorisations, approvals and consents necessary for the entry into, performance, validity, enforceability or admissibility in evidence of this Guarantee and the other Security Documents [and the Transaction Documents] to which it is (or is to become) a party have been obtained and are in full force and effect and there has been no breach of any condition or restriction imposed in this respect.

8.6 **Validity and enforceability**

This Guarantee and each other Security Document to which the Guarantor is or is to become a party (when duly executed, delivered and, where applicable, registered):

8.6.1 constitutes the legal, valid and binding obligations of the Guarantor enforceable against it in accordance with its terms; and

8.6.2 (to the extent that by its terms it purports to do so) creates a legal, valid and binding first priority Encumbrance in accordance with its terms over all the assets to which by its terms it relates,

except insofar as enforcement may be limited by any applicable laws relating to bankruptcy, insolvency, administration and similar laws affecting creditors' rights generally and by principles of equity.

8.7 **No third party Encumbrances; title**

At the time of execution of each Security Document to which the Guarantor is or is to become a party, no third party will have any Encumbrance (other than a Permitted Encumbrance) on any asset over which an Encumbrance is to be created pursuant to that Security Document and the Guarantor will be the sole and absolute legal and beneficial owner of that asset.

8.8 **Status of Transaction Documents**

The copies of the Transaction Documents delivered to the Lender before the date of this Guarantee are true and complete copies. The Transaction Documents constitute legal, valid, binding and enforceable obligations of the parties to them in accordance with their respective terms except insofar as enforcement may be limited by any applicable laws relating to bankruptcy, insolvency, administration and similar laws affecting creditors' rights generally and by principles of equity. No amendments or additions to the Transaction Documents have been agreed nor has any party to any Transaction Document waived any of its respective rights under that Transaction Document.

8.9 **No litigation current or pending**

No litigation, arbitration, tax claim or administrative proceeding is current or pending or (to the knowledge of the Guarantor) threatened, which, if adversely determined, would have a Material Adverse Effect.

8.10 **No defaults**

8.10.1 No Event of Default or Potential Event of Default is continuing or might reasonably be expected to result from the advance of the Loan.

8.10.2 The Guarantor is not in default under any other agreement where such default would or might have a Material Adverse Effect.

8.11 **Governing law and enforcement**

The choice of English law as the governing law of this Guarantee and each other Security Document expressed to be governed by English law to which to the Guarantor is (or is to become) a party will be recognised and enforced in the Guarantor's jurisdiction of incorporation, and any judgment obtained in England in relation to this Guarantee or any such other Security Document will be recognised and enforced in that jurisdiction[, subject to any reservation set out in any relevant legal opinion delivered to and accepted by the Lender pursuant to the Agreement].

8.12 [**No immunity**

The Guarantor is not entitled to claim any immunity in relation to itself or its assets under any law or in any jurisdiction in connection with any legal proceedings, set-off or counterclaim relating to this Guarantee or any other Security Document or in connection with the enforcement of any judgment or order arising from such proceedings.]

8.13 **Truth of financial and other information**

All factual information furnished in writing to the Lender by or on behalf of the Guarantor in connection with the negotiation and preparation of this Guarantee and the other Security Documents was (when given) true and correct in all material respects and there are no other facts or considerations the omission of which would render any such information materially misleading.

8.14 **No liability to deduction or withholding**

All payments to be made by the Guarantor under this Guarantee or any other Security Document may be made free and clear of and without deduction or withholding for or on account of any taxes, and neither this Guarantee nor any other Security Document to which the Guarantor is (or is to become) a party is liable to any registration charge or any stamp, documentary or similar taxes imposed by any authority, including without limitation, in connection with its admissibility in evidence.

8.15 **Tax compliance**

The Guarantor has complied in all material respects with all relevant tax laws and regulations applicable to it and its business.

8.16 [**Ownership of shares**

[All] of the issued shares in the share capital of the Guarantor are wholly owned, legally and beneficially, [directly or indirectly], by [●]].

8.17 **Pari passu obligations**

The payment obligations of the Guarantor under this Guarantee and the other Security Documents to which it is (or is to become) a party] rank at least pari passu with the claims of all its other unsecured and unsubordinated creditors, except for obligations mandatorily preferred by law applying to companies generally.

8.18 [**Environmental matters**[8]

Except as may have been disclosed by the Guarantor in writing to, and acknowledged in writing by, the Lender:

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[8] Only include this provision if the Guarantor is granting security over a vessel owned by it.

8.18.1 the Guarantor and the other Obligors and, to the best of the Guarantor's knowledge and belief (having made due enquiry), their respective Environmental Affiliates have complied with the provisions of all Environmental Laws;

8.18.2 the Guarantor and the other Obligors and, to the best of the Guarantor's knowledge and belief (having made due enquiry), their respective Environmental Affiliates have obtained all Environmental Approvals and are in compliance with all Environmental Approvals;

8.18.3 neither the Guarantor nor any other Obligor nor, to the best of the Guarantor's knowledge and belief (having made due enquiry), any of their respective Environmental Affiliates has received notice of any Environmental Claim that alleges that the Guarantor or any other Obligor or any Environmental Affiliate is not in compliance with any Environmental Law or any Environmental Approval;

8.18.4 there is no Environmental Claim pending or, to the best of the Guarantor's knowledge and belief (having made due enquiry), threatened against the Guarantor or any other Obligor or any Relevant Ship or, to the best of the Guarantor's knowledge and belief (having made due enquiry), any of their respective Environmental Affiliates; and

8.18.5 no Environmental Incident which could or might give rise to any Environmental Claim has occurred.]

8.19 **Familiarity with the terms of the Agreement**

The Guarantor has received a copy of the Agreement and is familiar with and has approved its terms and conditions.

8.20 **Continuing nature of representations and warranties**

The Guarantor agrees that the representations set out in this Clause 8 (other than the ones in Clauses 8.5, 8.9, 8.10.1, 8.14 and 8.16) shall survive the execution of this Guarantee and shall be deemed to be repeated on [the][each] Drawdown Date and each Interest Date with reference to the facts and circumstances then subsisting, as if made on that date.

9 **UNDERTAKINGS**

9.1 **Duration of undertakings**

The undertakings in this Clause 9 remain in force from the date of this Guarantee to the end of the Security Period.

9.2 **General undertakings**

The Guarantor shall:

9.2.1 procure the performance and observance by the Borrower of the covenants and obligations imposed upon it under the Security Documents;

9.2.2 maintain its corporate existence as a limited liability company[9] duly organised, validly existing and in good standing in its place of incorporation;

9.2.3 obtain and maintain in force, and promptly furnish certified copies to the Lender of, all licences, authorisations, approvals and consents, and do all other acts and things, which

[9] Amend if dealing with a partnership.

may from time to time be necessary or desirable for the continued due performance of its obligations under this Guarantee and the other Security Documents [and the Transaction Documents] to which it is (or is to become) a party or which may be required for the validity, enforceability or admissibility in evidence of this Guarantee or any such Security Document [or any Transaction Document];

9.2.4 ensure that its obligations under this Guarantee and the other Security Documents to which it is (or is to become) a party rank at least pari passu with all its other present, future and/or contingent unsecured and unsubordinated obligations;

9.2.5 conduct its business in a proper and efficient manner in compliance with all relevant applicable laws and regulations [(including, without limitation, all relevant Environmental Laws)[10]] and notify the Lender immediately upon becoming aware of any breach of any such law or regulation;

9.2.6 pay all taxes, assessments and other governmental charges as they fall due, except to the extent that it is contesting them in good faith by appropriate proceedings and has set aside adequate reserves for their payment if those proceedings fail;

9.2.7 keep proper books of account in respect of its business in accordance with GAAP consistently applied and, whenever so requested by the Lender, make them available for inspection by or on behalf of the Lender;

9.2.8 provide to the Lender:

(a) within [●] days of the end of each financial year, certified copies of the consolidated financial statements of the Group and the profit and loss accounts and balance sheets of the Guarantor for that financial year, prepared in accordance with GAAP and audited by auditors previously approved in writing by the Lender;

(b) within [●] days of the end of each financial [half-year][quarter], certified copies of the unaudited consolidated financial statements of the Group and the unaudited profit and loss accounts and balance sheets of the Guarantor for that period, prepared in accordance with GAAP;

(c) [within [●] days after the beginning of each financial year, a certified copy of the financial projections of the Guarantor [and the Group] for that financial year;]

(d) promptly, such further information in the possession or control of the Guarantor regarding the financial condition and operations of the Group as the Lender may reasonably request;[11]

9.2.9 inform the Lender promptly of any litigation, arbitration, tax claim or administrative proceeding instituted or (to its knowledge) threatened and of any other occurrence of which it becomes aware which might [have a Material Adverse Effect][materially adversely affect:

(a) its ability, or the ability of any other Obligor, to perform its respective obligations under the Security Documents; or

(b) the security constituted by the Security Documents];

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[10] Only include this wording if the Guarantor is granting security over a vessel owned by it.

[11] Note: Consider including a requirement for a compliance certificate from the Guarantor if the Guarantee contains financial covenants.

9.2.10 promptly after the happening of any Event of Default or a Potential Event of Default, notify the Lender of that event and of the steps (if any) which are being taken to remedy it;

9.2.11 provide the Lender with any information requested by the Lender in order for it to comply with any anti-money laundering or "know your customer" legislation, regulation or procedures applicable to the Lender from time to time;

9.2.12 promptly provide the Lender with such other financial and other information concerning itself and its affairs [and the Vessel][12] as the Lender may from time to time require[, including (but without limitation) full information regarding the employment, condition, geographical position, crewing and engagements of the Vessel and particulars of all contracts concerning the Vessel[13]].

9.3 **Consent of Lender required**[14]

The Guarantor shall not, without the prior consent of the Lender:

9.3.1 [except as contemplated by this Guarantee, [sell or agree to sell the Vessel [(unless the Loan is prepaid in full in accordance with Clause [5.3.1] of the Agreement upon the completion of that sale)][15] or] convey, assign, transfer, sell or otherwise dispose of or deal with any of its [other] real or personal property, assets or rights, whether present or future;]

9.3.2 [create or permit to exist any Encumbrance (other than a Permitted Encumbrance) over any part of its undertaking, property, assets or rights, whether present or future (provided that where any such Encumbrance arises in the ordinary course of business, the Guarantor shall promptly discharge it);]

9.3.3 [incur any Financial Indebtedness (except under the Security Documents and unsecured Financial Indebtedness which is subordinated to its obligations under this Guarantee) nor incur any obligations as lessee under leases;]

9.3.4 [except as contemplated by this Guarantee, assume, guarantee or endorse, or otherwise become or remain liable for, any obligation of any other person;]

9.3.5 [authorise or accept any capital commitment;]

9.3.6 [waive or fail to enforce any provision of, or agree to any amendment or supplement to, the Transaction Documents to which it is a party;]

9.3.7 [issue any further shares or stock or register any transfer of any of its shares or stock, or admit any new member, whether by subscription or transfer;]

9.3.8 consolidate, amalgamate or merge with any other entity or demerge or enter into any form of reconstruction or reorganisation or do anything analogous thereto;

9.3.9 [form or acquire any subsidiary;]

9.3.10 change its place of incorporation;

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[12] Only include this wording if the Guarantor is owner of the Vessel.

[13] Only include this wording if the Guarantor is owner of the Vessel.

[14] Note: The following provisions are generally all relevant if the Guarantor is a special purpose company but will be inappropriate in many instances for a holding company with wider business activities. In such cases, consider deleting the clauses in square brackets.

[15] Note: Conform this wording, if relevant, with the relevant provisions of the loan agreement.

9.3.11 alter or extend its financial year for the purposes of the preparation of its accounts, or change its auditors;

9.3.12 [make any loans or advances to, or any investments in, any person (including, without limitation, any officer, director, stockholder, employee or customer of the Guarantor);]

9.3.13 [make any payment of principal or interest to any of its shareholders in respect of any loans or capital made available to it by its shareholders;]

9.3.14 [declare or pay any dividends upon any of its shares or stock or otherwise distribute any assets to any of its shareholders whether in cash or otherwise;]

9.3.15 consolidate or subdivide or alter any of the rights attached to, or reduce, any of its share capital, or capitalise, repay or otherwise distribute any amount outstanding to the credit of any capital or revenue reserves, redeem any of its share capital in any way or enter into any arrangement with its creditors;

9.3.16 change the nature, organisation or conduct of its business or conduct any business other than that of [●];

9.3.17 undertake any transaction with any person, company or other entity which is an affiliate of the Guarantor unless such transaction is conducted at arm's length on normal commercial terms.

9.4 **[Financial covenants]**

[Insert any financial covenants here].

10 **INDEMNITIES AND EXPENSES**

10.1 **Indemnity against costs**

The Guarantor shall pay to the Lender on demand, and indemnify and keep the Lender indemnified against, all costs, charges, expenses, claims, liabilities, losses, duties and fees (including, but not limited to, legal fees and expenses on a full indemnity basis) and taxes thereon suffered or incurred by the Lender:

10.1.1 in the negotiation, preparation, printing, execution and registration of this Guarantee and the other Security Documents;

10.1.2 in the enforcement or preservation or the attempted enforcement or preservation of any of the rights and powers of the Lender under this Guarantee and the other Security Documents or of the security constituted by the Security Documents;

10.1.3 in connection with any actual or proposed amendment of or supplement to this Guarantee or any other of the Security Documents, or with any request of the Lender to grant any consent or waiver in respect of any provision of this Guarantee or any other Security Document, whether or not the same is given;

10.1.4 arising out of any act or omission made by the Lender in good faith in connection with any of the matters dealt with in the Security Documents.

10.2 **Tax indemnity**

The Guarantor shall pay all taxes imposed in relation to this Guarantee [and the other Security Documents to which it is at any time a party] (other than tax on the Lender's overall net income) and shall indemnify the Lender on the Lender's written demand against any and all liabilities with respect to, or resulting from, delay or omission on the part of the Guarantor to pay such taxes.

10.3 **Currency indemnity**

If any sum due from the Guarantor under the Security Documents (a "**Sum**"), or any order, judgment or award given or made in relation to a Sum, has to be converted from the currency (the "**First Currency**") in which that Sum is payable into another currency (the "**Second Currency**") for the purpose of making or filing a claim or proof against the Guarantor or obtaining or enforcing an order, judgment or award in relation to any litigation or arbitration proceedings, the Guarantor shall as an independent obligation, within 3 Banking Days of demand, indemnify the Lender against any cost, loss or liability arising out of or as a result of the conversion including any discrepancy between (a) the rate of exchange used to convert that Sum from the First Currency into the Second Currency and (b) the rate or rates of exchange available to the Lender at the time of its receipt of that Sum.

10.4 [**Environmental indemnity**[16]

Without prejudice to or limitation of any other rights or remedies that may at any time be available to or exercisable by the Lender, the Guarantor shall indemnify and hold harmless the Lender on demand against all costs, expenses, liabilities, losses, damages, and injury, personal or economic, sustained or incurred by the Lender or its property (real or personal) for any reason as a result of or in connection with any release or the emission, presence, discharge of Material of Environmental Concern on, from, affecting or caused by the Vessel or any other Relevant Ship under any applicable Environmental Laws including, but not limited to, costs and expenses incurred to clean up or remove discharged oil or other Material of Environmental Concern, damages to third parties, natural resource damage, assessments or penalties, and whether sustained or incurred during or after the Security Period.]

10.5 **Survival of indemnities**

The indemnities contained in this Guarantee [and the other Security Documents to which the Guarantor is at any time a party] shall continue in full force and effect after the full and final discharge of the Outstanding Indebtedness with respect to matters arising prior to such discharge.

11 **ASSIGNMENTS AND TRANSFERS**

11.1 **No assignment by Guarantor**

The Guarantor may not assign or transfer all or any of its rights, benefits or obligations under this Guarantee.

11.2 **Assignment and transfer by Lender**

The Lender may assign or transfer all or any of its rights, benefits or obligations under this Guarantee to any person to whom it assigns or transfers a corresponding proportion of its rights, benefits or obligations under the Agreement.

11.3 **Disclosure of information**

The Lender may disclose to any potential transferee, assignee or sub-participant, or to any other party with whom it may propose to enter into contractual relations in connection with the Agreement and the other Security Documents, such information about the Guarantor and its business, assets or financial condition as the Lender shall consider appropriate.

[16] Only include this wording if the Guarantor is owner of the Vessel.

11.4 **Change of lending office**

The Lender may at any time change the lending office through which it performs its obligations under this Guarantee and the other Security Documents.

11.5 **Delegation**

The Lender may at any time and from to time to time delegate any one or more of its rights, powers and/or obligations under this Guarantee and the other Security Documents to any person (provided that the Lender shall remain fully responsible for the exercise or performance of any rights, powers and/or obligations delegated by it).

11.6 **Guarantor to assist**

The Guarantor undertakes to do or to procure all such acts and things and to sign, execute and deliver or procure the signing, execution and deliver of all such instruments and documents as the Lender may reasonably require for the purpose of perfecting any such assignment or transfer as mentioned above.

12 **SET-OFF**

The Lender may set off any matured obligation due from the Guarantor under this Guarantee or any other Security Document to which the Guarantor is at any time a party (to the extent beneficially owned by the Lender) against any matured obligation owed by the Lender to the Guarantor, regardless of the place of payment, booking branch or currency of either obligation. If the obligations are in different currencies, the Lender may convert either obligation at a market rate of exchange in its usual course of business for the purpose of the set-off.

13 **MISCELLANEOUS**

13.1 **Time of essence**

Time is of the essence as regards every obligation of the Guarantor under this Guarantee and the other Security Documents.

13.2 **Remedies and waivers**

No failure to exercise, nor any delay in exercising, on the part of the Lender, any right or remedy under the Security Documents shall operate as a waiver of it, nor shall any single or partial exercise of any right or remedy prevent any further or other exercise of it or the exercise of any other right or remedy. The rights and remedies provided in this Guarantee are cumulative and not exclusive of any rights or remedies provided by law.

13.3 **Waivers and amendments to be in writing**

Any waiver by the Lender of any provision of this Guarantee or any other Security Document, and any consent or approval given by the Lender under or in respect of this Guarantee or any other Security Document, shall only be effective if given in writing and then only strictly for the purpose and upon the terms for which it is given. Neither this Guarantee nor any of the other Security Documents may be amended or varied orally but only by an instrument signed by the Lender and each of the other parties to it.

13.4 **Severability**

If at any time one or more of the provisions of this Guarantee or any other of the Security Documents is or becomes invalid, illegal or unenforceable in any respect under any law by which it may be governed or affected, the validity, legality and enforceability of the remaining provisions shall not be in any way affected or impaired as a result.

13.5 **Counterparts**

This Guarantee may be executed in any number of counterparts and all such counterparts taken together shall be deemed to constitute but one and the same instrument.

13.6 **Conclusiveness of Lender's certificates**

The certificate or determination of the Lender of a rate or amount under this Guarantee and any other Security Document is, in the absence of manifest error, conclusive evidence of the matters to which it relates and is binding on the Guarantor.

13.7 **Further assurance**

The Guarantor shall, upon demand, and at its own expense, sign, perfect, do, execute and register all such further assurances, documents, acts and things as the Lender may require for the purpose of more effectually accomplishing or perfecting the transaction or security contemplated by this Guarantee and the other Security Documents.

14 **NOTICES**

14.1 **Addresses**

All notices (which expression includes any demand, request, consent or other communication) to be given by one party to the other under this Guarantee shall be in writing and (unless delivered personally) shall be given by telefax or first class pre-paid post (airmail if sent internationally) and be addressed:

14.1.1 in the case of the Lender, to it at:

[●]

Telefax No: +[●]

Attn: [●]

14.1.2 in the case of the Guarantor, to it at:

[●]

Telefax No: **+[●]**

Attn: [●]

or to such other address and/or number as is notified by one party to the other under this Guarantee.

14.2 **Deemed receipt of notices**

Notices addressed as provided above shall be deemed to have been duly given when despatched (in the case of telefax), when delivered (in the case of personal delivery), 2 days after posting (in the case of letters sent within the same country), or 5 days after posting (in the case of letters sent internationally), provided that any notice to the Lender shall be effective only upon its actual receipt by the Lender and then only if it is expressly marked for the attention of the relevant department or officer named above (or any substitute from time to time notified by the Lender). In each of the above cases any notice received on a non-working day or after business hours in the country of receipt shall be deemed to be given at the opening of business hours on the next working day in that country.

14.3 **English language**

All notices and documents to be given or delivered pursuant to or otherwise in relation to this Guarantee and the other Security Documents shall be in the English language or be accompanied by a certified English translation.

15 **APPLICABLE LAW AND JURISDICTION**

15.1 **Governing law**

This Guarantee and any non-contractual obligations arising out of or in connection with it shall be governed by and construed in accordance with English law.

15.2 **Submission to jurisdiction**

The Guarantor irrevocably agrees for the exclusive benefit of the Lender that the English courts shall have jurisdiction in relation to any dispute and any suit, action or proceeding (referred to together in this Clause 15 as "**Proceedings**") which may arise out of or in connection with this Guarantee and/or any of the other Security Documents, and for such purposes irrevocably submits to the jurisdiction of those courts.

15.3 **Service of process**

The Guarantor irrevocably agrees:

15.3.1 that, for the purpose of Proceedings in England, any legal process may be served upon [●] whose registered office is presently at [●] and who, by this Guarantee, are authorised to accept service on its behalf, which shall be deemed to be good service on the Guarantor; and

15.3.2 that throughout the Security Period it will maintain a duly appointed process agent in England, duly notified to the Lender, and that failure by any such process agent to give notice to the Guarantor of such service shall not impair the validity of that service or of a judgment or order based on it.

15.4 **Choice of forum**

Nothing in this Clause 15 shall affect the right of the Lender to serve process in any manner permitted by law or limit the right of the Lender to take Proceedings against the Guarantor in any other court of competent jurisdiction, nor shall the taking of Proceedings in one or more jurisdictions preclude the taking of Proceedings by the Lender in any other jurisdiction, whether concurrently or not.

The Guarantor shall not commence any Proceedings in any country other than England in relation to any matter arising out of or in connection with this Guarantee and/or any of the other Security Documents.

15.5 **Forum convenience**

The Guarantor irrevocably waives any objection which it may at any time have on the grounds of inconvenient forum or otherwise to Proceedings being brought in any such court as is referred to in this Clause 15, and further irrevocably agrees that a judgment or order in any Proceedings brought in the English courts shall be conclusive and binding upon it and may be enforced without review in the courts of any other jurisdiction.

15.6 **Consent**

The Guarantor consents generally in respect of any Proceedings arising out of or in connection with this Guarantee to the giving of any relief or the issue of any process in connection with those Proceedings, including without limitation, the making, enforcement or execution against any property or assets whatsoever of any order or judgment which may be made or given in those Proceedings.

15.7 [**Waiver of immunity**

To the extent that the Guarantor may be entitled in any jurisdiction to claim for itself or its property or assets immunity in respect of its obligations under this Guarantee from service of process, jurisdiction, suit, judgment, execution, attachment (whether before judgment, in aid of execution or otherwise) or legal process, or to the extent that in any jurisdiction there may be attributed to it or its property or assets such immunity (whether or not claimed), the Guarantor irrevocably agrees not to claim and irrevocably waives that immunity to the fullest extent permitted by the laws of that jurisdiction.][17]

IN WITNESS of which the parties to this Guarantee have executed this Guarantee as a deed the day and year first before written.

[17] Use only in cases where the Guarantor is state-owned or there is otherwise a risk that the Guarantor may claim immunity for itself or its assets.

EXECUTION PAGE

THE GUARANTOR

SIGNED AND DELIVERED AS A DEED[18]	)	
by	)	
duly authorised for and on behalf of	)	....
[●]	)	
in the presence of:	)	

Signature:

Name:

Occupation:

Address:

THE LENDER

SIGNED AND DELIVERED AS A DEED	)	
by	)	
duly authorised for and on behalf of	)	....
[●]	)	
in the presence of:	)	

Signature:

Name:

Occupation:

Address:

[18] Note that some jurisdictions, e.g. Bermuda, will require the words "SIGNED, SEALED AND DELIVERED" to be used and a wafer seal to be affixed if the Guarantor is incorporated in that jurisdiction.

Appendix 5

FACILITY AGREEMENT - POST-DELIVERY TERM LOAN - SYNDICATED WITH AGENT AND SECURITY TRUSTEE - ONE BORROWER - ONE SHIP

11.3.11 alter or extend its financial year for the purposes of the preparation of its accounts, or change its auditors;

11.3.12 make any loans or advances to, or any investments in, any person (including, without limitation, any officer, director, stockholder, employee or customer of the Borrower);

11.3.13 make any payment of principal or interest to any of its shareholders or their affiliates in respect of any loans or loan capital made available to it by them;

11.3.14 declare or pay any dividends upon any of its shares or stock or otherwise distribute any assets to any of its shareholders whether in cash or otherwise;

11.3.15 consolidate or subdivide or alter any of the rights attached to, or reduce, any of its share capital, or capitalise, repay or otherwise distribute any amount outstanding to the credit of any capital or revenue reserves, redeem any of its share capital in any way or enter into any arrangement with its creditors;

11.3.16 change the nature, organisation or conduct of its business or charter-in any vessel or conduct any business other than that of its [purchase and subsequent] ownership of the Vessel;

11.3.17 undertake any transaction with any person, company or other entity which is an affiliate of the Borrower unless such transaction is conducted at arm’s length on normal commercial terms.

11.4 [Financial covenants]

[insert any financial covenants here].

12 VALUATIONS AND ASSET PROTECTION

12.1 Valuations

Subject to Clause 12.4, the Agent may from time to time arrange for valuations of the Vessel to be carried out in order to determine her market value. Such valuations shall be prepared:

12.1.1 with or without a physical inspection of the Vessel (at the discretion of the Agent) in [Dollars] [Euro] on the basis of a sale for prompt delivery, charter-free, at arm’s length between a willing seller and a willing buyer;

12.1.2 by any two [Approved Shipbrokers][independent first-class international sale and purchase shipbrokers or valuers] as the Agent may from time to time select;

and the market value of the Vessel shall be the mean average of those valuations.

The Borrower shall provide such assistance as the Agent shall require in connection with all valuations prepared under this Clause 12 and each such valuation shall be conclusive and binding on the Borrower save in the case of manifest error.

12.2 Consequences of security shortfall

If the aggregate of (a) the market value of the Vessel determined pursuant to Clause 12.1 and (b) the market value of any additional security previously provided under this Clause 12 is at any time less than [●]% of the Loan, the Borrower shall, within [30] days of a demand by the Agent to that effect, either:

12.2.1 provide additional security over such assets and in such form as is acceptable to the [Majority Lenders] where such assets have a market value at least equal to the shortfall; or

12.2.2 prepay such part of the Loan as will eliminate the shortfall in accordance with the relevant provisions of Clause 5.4; or

12.2.3 make good the shortfall by combining the provision of additional security under Clause 12.2.1 with a partial prepayment of the Loan under Clause 12.2.2.

12.3 **Valuation of additional security**

The market value of any additional security provided or to be provided under this Clause 12 shall be determined at the cost of the Borrower by independent valuers appointed by, and on a basis acceptable to, the Agent, [subject to the following:

12.3.1 the value of any cash collateral will be valued at its principal amount;

12.3.2 any additional vessel will be valued in accordance with Clause 12.1; and

12.3.3 any letter of credit or first class bank guarantee will be valued at the maximum amount which may be drawn under it at any time,

in each case after deducting the amount secured by any prior Encumbrances over such assets].

12.4 **Timing and cost of valuations**

The Borrower shall pay the costs for the Vessel to be valued under this Clause 12 at [6] monthly intervals [from and including the Drawdown Date], provided that following the occurrence of an Event of Default which is continuing all valuations shall be at the cost of the Borrower.

13 **EVENTS OF DEFAULT**

13.1 **Defaults**

Each of the following events or circumstances is an Event of Default:

13.1.1 **Non-payment** An Obligor does not pay on the due date any amount payable pursuant to the Security Documents at the place and in the currency in which it is expressed to be payable or, in respect of moneys payable on demand, (unless otherwise specifically provided) within [3] Banking Days from the date of demand.

MOCK EXAMINATION
SHIPPING FINANCE

Time Allowed - Three Hours

Answer any FIVE questions- All questions carry equal marks

1. ‘In the context of the cyclical nature of the international shipping business, the debt-equity structure is entirely irrelevant’. Discuss.

2. Identify, compare and contrast, the various types of loans which may be made available to a shipping company by a bank, discussing their appropriateness or otherwise through the different phases of the shipping cycle.

   What are the main factors which a lender will take into account before making a loan to a shipping company? Briefly, what are the implications of such loans for a bank’s balance sheet?

3. Critically evaluate the effectiveness of the different forms of security which may be available to a lender to a shipping company.

4. i. Discuss the characteristics of any **three** from the following **five** types of share issues:

      Partly paid shares

      Rights issues

      Cumulative participating preference shares

      Convertible preferred stock

      Participating preferred stock

   ii. Discuss the implications of the Sarbanes-Oxley Act 2002 for shipping companies looking to list their shares on US stock exchanges.

   iii. Discuss the main characteristics of convertible bonds.

   iv. What is meant by ‘mezzanine financing’?

5. You are the Chief Financial Officer of a shipping company which is looking to securitise its future freight receipts under a series of long-term charterparties. You are asked to write a briefing note to the Chief Executive Officer describing the main requirements and components of a securitisation, and how bonds issued might be marketed to the investment community.

6. You are the Chief Financial Officer of a shipping company which is looking to raise debt in the capital markets of the Middle East. You have concluded that an Islamic investment offering may be cost-effective. You are asked to write a briefing note to the Chief Executive Officer describing the principles which have to be taken into account when structuring such a financial offering to investors in this context. You are also required to advise as to whether or not it is possible to structure a hybrid financial structure which incorporates both Islamic and non-Islamic elements.

7. i. Discuss the functions of the principal participants to a syndicated loan issue.

   ii. Why would a shipping company look to raise funding via a syndication rather than through a loan from a single provider?

   iii. Discuss the main instruments which may be used by a borrower to hedge its interest rate risk under a syndicated loan.

8. i. Describe the ways in which debt issues (types of bonds) can be structured to take account of the various phases of the shipping cycle.

   ii. What is meant by 'mezzanine financing', and what are its implications for the debt-equity mix of a shipping company?

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