STEPHENSON HARWOOD

October 2020

PRC Leasing- The Charterer's Perspective

PRC leasing has become mainstream following the departure of a number of key lenders from the shipping finance space. In one sense this is a new capital for shipowners as Chinese lessors have developed their sale and leaseback product with the assistance of English lawyers versed in operating and finance leasing during the last 8 years or so but in another sense this source of capital is not a new product. Rather it is an evolution of tax and non-tax leasing under English law that has existed for many years in shipping finance. Further PRC leasing houses typically view leases as "financing" and much of the charter or lease contains classic loan facility wording (representations, covenants and events of default/termination events for example) that will be familiar to charterers who have hitherto financed their vessels using debt finance.

Charterers have nothing to fear from entering into sale and lease backs with the PRC Leasing Houses so long as they are aware of the contractual relationship created by the sale (the memorandum of agreement) and leaseback (the charter most likely based on the BIMCO Barecon form as amended by additional clauses), the consequences of default or termination events as they are more commonly described under a lease and the differences between a debt financing and a lease financing. In this article we use lease and charter interchangeably.

In a lease financing the shipowner is not the owner of the asset but the lessor and the shipowner is the charterer: a role reversal. There are important differences between a debt financing where the lender must take action to obtain possession of the vessel on enforcement. In a lease a lessor already has title. He is the owner. But he still needs to obtain possession on enforcement and relevant provisions will be included in the lease.

What are the lessor's typical remedies on a default of the charterer under a lease (a termination event)?

- Termination of the lease for non-payment and/or other breaches
- A requirement to deliver up of possession
- A requirement to payment of the "termination sum" being a predetermined sum comprising of (amongst other things) arrears of accrued but unpaid charter hire and all charter hire that would have been paid during the period of the charter but for the termination
- A call on any charter performance guarantee from perhaps the parent of the charterer
- A call on charter security documents, for example a charterer's assignment of insurances and earnings

So, what are the lessee's protections in a lease upon the occurrence of a termination event? The answer to this question depends on the agreement that is reached with the lessor which is documented in the charter and in reaching agreement the charterer needs to be aware of the position under English law which is almost invariably the governing law of the charter.

One of the principal aims of the charterer on early termination whether triggered by default, total loss or a voluntary termination is to secure recovery of its' investment or "equity" which typically takes the form of an advance payment of charterhire that has been paid at the commencement of the lease.

One possible solution to protect this equity is to place a limit on the amount secured by any mortgage the lessor grants to his financiers. The charterer will wish to limit the ability of the lessor to create liens over the vessel.

Another solution is to document the protection of the equity in the contract. If the charterer pays a termination sum, then usually the lessee will obtain title unlike debt financing where the lender is secured by a mortgage. English law provides certain protections to a mortgagor when a mortgagee enforces its rights – an obligation to preserve value. A mortgagee needs to take "reasonable precautions to obtain the fair or the true market value or the proper price of the mortgaged property". This English law requirement does not exist in the context of a lease unless the parties agree to it.

A further protection is ensuring that there is no "double accounting" by which we mean the charterer is not obliged to effectively pay twice. Firstly, the proceeds of sale on termination, total loss and early termination must be applied in reduction of the termination sum. Secondly, the lessee will wish to ensure that the lessor cannot both claim the termination sum from the lessee and charterer guarantor and retain title to the asset.

If the charterers are well advised, then certain protections can be included in the lease documentation.

The types of protection that a charterer can seek include:

- protecting advance hire/equity as described above
- restrictions on sale of the vessel by the lessor
- restrictions on assignment/transfer of rights of the lessor in the lease
- lessor parent company support
- lessor default provisions
- ease of voluntary termination, notice periods
- flexibility in the documentation to allow for example change of flag, modification of vessels, limiting scope of indemnities given to lessor
- obtaining the benefit of a letter of quiet enjoyment from a mortgagee to ensure the charterer enjoys no interference on a mortgage enforcement.

One final thought on possible protections regarding the charterer's position revolves around the new Corporate insolvency and Governance Act 2020 (CIGA). The new Act introduced by the UK Government aims to protect businesses from the effects of economic downturn as a result of COVID19.

CIGA made changes to the so called "ipso facto" clauses. An "ipso facto" clause is where an insolvency constitutes an event of default/termination right under a contract. In the leasing context insolvency of the lessee is automatically a termination right under a lease.

CIGA introduced provisions preventing such termination i.e. preventing a supplier of goods from terminating on insolvency of its customer. Such clauses are invalidated.

The intention of the new provisions was to enable such companies to carry on trading through a rescue and restructuring process. Certain contracts are excluded from the new ipso facto provisions. Such exclusions include "financial contracts" referred to as "lending and financial leasing" amongst other things. "financial leasing" is not defined.

The concern from a lessor perspective is that as a result of CIGA a non-English lessor may not be able to terminate a lease on the occurrence of an insolvency of the charterer. The further concern is whether leases fall into the exclusion of "financial leasing". The position is not entirely clear but there are several arguments that we feel that a lease would fall into the exclusion.

Firstly, you could take the view that "financial leasing" is meaning a full pay out lease. A full pay out lease is one where the total hire pays out the full cost of the asset incurred by the lessor over the lease period and returned to the lessor. It is clear that loans are exempt from ipso facto prohibitions so the same could apply to a full pay out lease which should be exempt.

Secondly, we are not certain the term "financial leasing" was an attempt to refer to finance leases as opposed to operating lease or a more generalised term; and

Thirdly, to apply to a lease then the charterer would have to have a sufficient connection with the United Kingdom in order to invoke the ipso facto prohibition on termination for insolvency. There are a number of steps to achieve this but it is not that difficult.

Finally, even if CIGA were to apply then there are some practical steps for a lessor to take. These include actively monitoring the financial position of the charterer and adopting a stricter approach to a breach of contract such that the lessor will never have to rely upon the insolvency termination event under a lease to terminate the lease.

Whether CIGA can be used by a charterer to its benefit remains to be seen.

Jonathan Ward
Partner
T: +44 20 7809 2081
E: jonathan.ward@shlegal.com

Jonathan is head of Stephenson Harwood's Chinese ship finance practice in London and is recognised as a Leading Individual in ship finance in the Legal 500 directory.