THE BIG (SHIPPING) SHORT: RECESSION PROOFING CHARTERS

You don't have to be Christian Bale in *The Big Short* to see that there is a real possibility of a recession in the near future. Food and energy prices are spiralling, interest rates rising (hitting a 13 year high at 1.25% in the UK on 16 June 2022), and banks are becoming more cautious lenders. This all follows (in part) from the perfect storm of the Russia/Ukraine crisis and the longer-term pandemic effects.

Lloyd's List recently reported that the average value of a 6,500 TEU containership had doubled from around US$75m in early 2021 to around US$150m in June 2022 (a period of about 18 months). New daily hire records seem to be reported for containerships on almost a weekly basis, driven by a scarcity of ships and consumer demand. Sky high rates are seen in other vessel sectors too. However, less credit and demand for consumer goods in the coming months or years and the effects of inflation could have a big effect on shipping and potentially see an era of default litigation if those rates no longer represent market value. With this in mind, now might be the time to sure up contractual terms when entering into mid/long terms charters and COAs; it might be too late if and when a recession does hit. Below is a short guide to some of the charter issues worth considering now.

Whilst we all hope fears of a recession fade away, there is nothing wrong with the old adage: prepare for the worst and hope for the best.

Creditworthiness

What assets does your counterpart have and where? Can you easily enforce against them? This due diligence should be performed at least pre contract and each time the exercise of an option period is considered.

A charterer should also be aware that even if an owner has vessels in its fleet, they could be mortgaged, with the mortgage bank typically ranking as a secured creditor. If the owner or charterer are special purpose vehicles in a limited disclosure jurisdiction then a parent company guarantee should be considered (see below).

Guarantees

It is vital to comply with formalities, including where possible making sure the guarantee is physically signed. A common issue in a charter is where the guarantee is set out in the body of the charter and the guarantor is within the same group as the owner or charterer being guaranteed. One signature supposedly covering the owner/charterer (as applicable) and their guarantor might not be enough to constitute execution of the guarantee and may therefore render it unenforceable. A standalone signed guarantee is always best, with evidence that the person signing has authority,

You may also want the right to inspect the annual financial statements of the guarantor to assess their creditworthiness throughout the contract duration, and the right to terminate or require a replacement guarantor if there are any concerns as to the current guarantor's standing.

Use of option periods

Even if the intention is to charter for three years, a 1+1+1 year charter offers more flexibility for a charterer to get out of a bad deal if the market changes compared to 3 firm years or even 2+1 years. Flexibility is key for a charterer, but conversely an owner will want to maximise their guaranteed income and thus the length of the firm period.

If you are using option periods, clear wording is required as to how the option is exercised and its expiry date. Consideration must also be given to cross referencing notice provisions – can the option be exercised by email or must it be done via letter, courier or some other means (and to a specific person / address)? Given that options are usually 'use it or lose it' rights, these are the type of technical points that will be considered by parties looking for an exit rather than extension.

Events of default & termination rights

Extensive events of default provisions are common in LNG and bareboat charters, but less so in other sectors. The solvency of the parties and their guarantors, evidence of insurance being in place and the timely payment of all sums (not just hire – e.g. reimbursement of carbon credits/ taxes, etc.) properly due under a charter are all basic events of default to consider. Normally it is best for these clauses to give the innocent party the option of terminating rather than termination being automatic (so that laden voyages can be completed, etc.).

No fault termination / wash out provisions can also be considered. I.e. a liquidated sum that a party pays (typically a percentage of the future hire (or freight under a COA) due) can be attractive to avoid disputes as to loss of profit and mitigation, particularly when the charter-rate to market-rate delta could be significant in a falling market.

Cross default provisions may also be relevant where parties have a multi-contract relationship.

Anti-technicality & suspension clauses

This is the grace period afforded to a charterer to pay hire before an owner can terminate a time charter in the event the charterer does not pay on the contractual due date. The shorter the grace period the better for an owner (it is not uncommon to see charterers pushing this period to 14, 21 days or more in long term / project charters). Make sure the clause is clear in terms of when notices are to be given and the definition of banking days (specifically what is an EU banking day?). Strict compliance with anti-technicality clauses is vital; get it wrong and the owner might be in repudiatory breach, offering the charterer a get-out-of-jail free card.

It is important for owners to remember that by terminating under a withdrawal clause alone, the owner is forfeiting the right to future hire/ damage that would have accrued for the balance of the charter period. An owner should always consider if they can additionally cancel for repudiatory breach (and thus preserve the right to claim future losses) before exercising a contractual withdrawal.

The right to suspend performance is a powerful halfway house that is often omitted in charters. It means an owner can exert pressure by stopping the ship, without actually terminating.

LOIs – Contracts (Rights of Third Parties) Act 1999 (the Act)

Some charters contain the wording of LOIs to be accepted, or automatically issued, in return for discharging cargo without production of original bills of lading. Charterers (other than the head charterer) will want to ensure that these LOIs (i) expressly exclude the Act; and (ii) are only addressed to their immediate disponent owner. This is to ensure that if a party in the middle of the chain fails, the head owners cannot pursue an indemnity directly against a more financially sound charterer further down the chain (typically there is no standard P&I cover for mis-delivery claims).

For an owner, the automatic obligation to accept an LOI from a charterer is a potential credit risk if the charterer's financial standing deteriorates during the charter period. An owner might be wise to ensure it has a right of veto in respect of a request to accept an LOI in return for discharging cargo without production of original bills of lading, or the right to at least revoke the charterer's right to provide an LOI if its creditworthiness changes during the course of the charter.

Law and Jurisdiction

A good law and jurisdiction clause will be important to allow proceedings to be commenced and interim remedies sought quickly. Difficulties arise where clauses prescribe for the parties to first discuss a sole arbitrator within (for example) 30 days and only if the parties do not agree to do you move to the mechanism for each party appointing their arbitrator. It can take months to constitute a tribunal during which time your counterpart may be taking steps to frustrate enforcement.

Lien rights

Liens over cargo, bunkers, bills of lading freight, sub hire and sub freight as well as the right to sell cargo are all key tools for an owner, but whether these contractual rights can be exercised often depends on local law requirements and ownership of the cargo.

Quiet enjoyment & step-in rights

These are important rights for long term charters, particular for project vessels (i.e. vessels built for a specific project). Under English common law, a charterer has the legal right to the undisputed use and enjoyment of the vessel provided the charterer has complied with its obligations, the security of a mortgagee is not affected and the owner is able and willing to perform the charter.

Often this common law right is superseded by an express contractual quiet enjoyment agreement (or letter). The purpose of this is to regulate when the vessel's financiers can interfere with the vessel. This is usually balanced by a step-in agreement, which will give a financier an express right to substitute itself in the place of a defaulting owner to perform the balance of the charter. The terms of the quiet letter of enjoyment and step-in agreement will largely be negotiated between the charterer and the owner's financier. These agreements can fetter an owner's right to terminate the charter so an owner will be interested in their terms too.

A charterer might also want step-in rights for a new building vessel that is being constructed by a yard for an owner specifically for a charterer's long-term project. If the owner defaults during the construction phase, the charterer might want the right to step in to complete the construction and take delivery of the vessel.

Beware of internal contracts

Internal contracts are sometimes used because of group structures or for tax reasons, however, they have the potential to cause headaches passing on losses between different group companies – recent litigation under a COA in *Palmali Shipping SA v Litasco SA*[1] being a cautionary tale. Beware of time bars and the use of the Inter-Club Agreement in these internal charters too.

1 *Palmali Shipping SA v Litasco SA* [2021] EWHC 1161 (Comm)

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