

Major Problems in the Shipping Industry – Many Challenges and Some Solutions

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Buyer defaults, credit squeezes, falling freight rates and the shadow of over-capacity in the market are just some of the problems that the shipping industry has faced since the financial meltdown started in autumn 2008. Most specialist law firms will admit to have been inundated with work during the course of 2009, while owners and their charterers faced a radically different situation than the boom times that have been the hallmark of the industry in recent years.

The boom times, when owners could command premium prices for chartering their vessels are over. Charterers are seeking to renegotiate contracts now that freight rates have plummeted. At the same time, the boom resulted in a flurry of new orders being placed at yards around the world, leading to an over-capacity problem that is unlikely to go away any time soon.

While high profile casualties have been relatively limited compared with expectations when the crash took place, an early failure was Senator Lines, Hanjin Shipping's German affiliate, with other casualties including Eastwind Maritime, Britannia Bulk and Armada. Rumours still abound about other well known players, who may be fighting to put off the evil day. Shipping is a truly global market, but a lack of sophisticated insolvency rules or policing in certain jurisdictions on one hand, and secret government subsidies on the other, make early identification of technical insolvency a serious problem. Many companies have filed for Chapter 15 protection for their assets in the United States pending proceedings in their own jurisdiction.

The scale of the rapid downturn in the market is shown by the Review of Maritime Transport 2009, published by the UN Conference on Trade and Development. It confirms that the Baltic Dry Index, which measures prices for dry bulk

products, had shown a decline in rates of more than 90% by the end of 2008 compared to a record high in May of that year. While the report states there was a partial recovery during the course of 2009, with rates back up to about 40% of the previous peak, it suggests that price volatility will continue, with all that that means for countries, and indeed shipping lines, dependent on the commodities trade.

Another area which has been the focus of considerable attention given the downturn of the markets is forward freight agreements, which offer owners and charterers the opportunity to hedge their exposure to freight rate volatility. Given the huge declines in rates over a relatively small period of time, reliance on indices has become a matter for legal dispute.

A recent case to reach the courts centred attention on the 1992 International Swap Dealers Association rules which govern the operation of FFAs – *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI*. As paper trading is a relatively new phenomenon in the shipping industry, this case was the first to test the ISDA master rules in the courts. It is bound to lead to all traders in derivatives having to review their past and future exposures to paper trades. If this first instance decision stands, the consequences of default will be magnified, which may precipitate further insolvencies. More litigation in this area is to be expected.

While trade volumes have declined, the merchant fleet has continued to expand, with fleet capacity reaching 1.19bn dwt in January 2009, up 6.7% compared to the previous year, according to UNCTAD figures. Some commentators suggest that if all the ships on order at the end of 2008 are delivered in the next two years, containership capacity will expand by 50% and that of tankers and bulk carriers by 40%.

Others believe that as many as 30% of the ships on order will not be delivered, although over-capacity will continue to be a problem. Downturns in demand in the container sector have already resulted in big players like Orient Overseas Container Line having to reconsider delivery dates on new tonnage.

Indeed because of the large decline in asset values many owners will not even be able to arrange finance if they wanted to. In the meantime, prospective owners and shipyards will be looking closely at the small print of contracts.

Delivery deferrals and outright cancellations aside, recent moves in the Chinese market suggest that the government will support the shipbuilding industry to build those ships on order – perhaps with a view to selling on vessels to local concerns if the original buyer pulls out of the contract. Other governments are also putting in place mechanisms to provide financial back-up. Shipbuilding yards have taken a beating during the course of 2009 with, for example, orders down 62% last year at Hyundai Heavy Industries and a number of cancellations or postponements.

Many yards, including Hanjin Heavy Industries and Construction, have been forced to cut back on their workforces, but all are optimistic about an increase in orders for the coming year. Big operators like Maersk have also had to cut back their staffing requirements and restructure. On the other hand, Chinese government export credits were made available to back a deal funded by French bank Société Générale in December to fund tanker newbuilds for Danish company Torm.

Many owners have been arguing that it may be better to pay the penalties resulting from defaulting on a newbuilding contract rather than going through with a project and taking delivery of a vessel that is now worth substantially less than the contract price when it was negotiated. Banks have also been looking closely at loan to value clauses in contracts.

Debt collection in such an international sector is always problematic. As the currency of international shipping business is US Dollars, one remedy that has been increasingly used in the last year has been to attach assets passing by electronic fund transfer through the New York banking system, using the so-called Rule B Procedure. The procedure, which has proved so popular as to overwhelm judges presiding in the Southern District of New York with applications, has been widely used to secure assets ahead of proceedings, often in arbitration tribunals, against owners, charterers and other creditors.

While Rule B can still be used for the attachment of maritime assets, like ships or cargoes, it cannot be used for electronic fund transfers after a ruling this summer in *Shipping Corporation of India Ltd v Jaldhi Overseas Pte Ltd*. This has probably freed up a fair amount of frozen cash at a timely moment.

Arbitrators and mediators have also been seeing an upturn in business since the downturn commenced as counterparties seek to resolve their disputes without having to go into court. Arbitration proceedings also have the benefit, at least in English Courts, of being confidential. One criticism of the use of Rule B to attach assets has been that this allowed the details of the dispute to be made public in advance of an attachment order being made and arbitration proceedings started.

In the current market, dispute resolution seems to go to two extremes. Experience suggests that parties have been very pragmatic when dealing with the downturn, often renegotiating contracts to reflect the reduced market, with

an income escalation clause to deal with some theoretical future upturn, or even accepting equity in a company in return for writing off debts.

This is a market where the identity and location of the counter-party really matters. In one recent case, the claimant appeared to have a strong claim, all be it calculated on the back of an envelope, for about US\$110 million. However, on the back of an envelope it remained – the defaulting party was a BVI company, which ceased trading with no traceable assets.

Also many disputes involve attempts to set off one debt against another, whether between the same companies or between different companies in the same group. There are also many cases of "artificial" disputes, fought more in hope than expectation, where a party is prepared to outlay substantial legal costs in order to postpone a debt.

Shipping is a truly global market, but a lack of sophisticated insolvency rules or policing in certain jurisdictions on one hand, and secret government subsidies on the other, make early identification of technical insolvency a serious problem.

The problem of insolvency in an international business like shipping means that the issue cannot just be determined by English law alone and many jurisdictions adopt different approaches to the issue, whether more or less lenient to the creditor. A successful outcome for creditors is all about finding and securing an asset in an accessible jurisdiction.

In the event of trying to recover assets, now that Rule B has had its wings clipped, jurisdictions like South Africa are popular as they offer recourse action for maritime claims against sister vessels or those that can be linked to the insolvent company by means more remote than in other countries. It is necessary only that a ship is in the same "control" as the guilty vessel.

In addition, different jurisdictions will adopt different approaches to the pecking order when it comes to paying debts – generally the crew's wages will be first in line. Abandonment of crews is clearly a serious issue in a downturn, as some owners may decide to leave their crews without means of support in a foreign port to be cared for by maritime charities or repatriated by seafarers unions.

Another serious issue to arise out of the downturn will be whether maintenance and quality issues take a back seat as far as both crew and ships are concerned. Not only do crews have to be trained – and in a downturn commitment to training can be left to one side – but ships have to be maintained and no shortcuts taken in terms of, for example, the quality of bunker fuel used in ships. Speculation continues whether bunker quality disputes will start to diminish once there is an economic upturn or will sharp practices in supplying poor quality/blended bunkers continue? What seems certain is that now is the time for vigilance so as to ensure that cutting costs does not mean cutting corners. 🚨