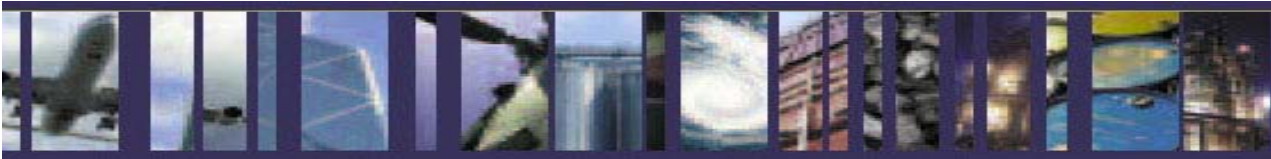


MARITIME LONDON

GLOBAL CREDIT CRUNCH EFFECT ON GLOBAL SHIPPING



RICHARD BAINES
11 APRIL 2008

hfw.com

Global Credit Crunch – Effect on Global Shipping

**Text of a talk given by Richard Baines, Partner, Holman Fenwick Willan
to Maritime London on 11 April 2008**

The credit crunch first reached public consciousness towards the end of July last year. As everyone now knows the problems began in the US sub-prime home mortgage market. Some two or three years or so before that there were some very significant changes made in the lending practices some banks were adopting mainly in the US markets, including the quite widespread adoption of something called "covenant-lite".

Covenant-lite was a new style of loan documentation, which from the lender's point of view was far less rigorous than traditional loan documentation particularly in terms of the usual covenants borrowers had to give to the lender. The real driver to this was not that borrowers were demanding less stringent covenants in favour of the banks, but it had become widespread practice amongst the banks themselves to seek to sell on their loans rather than keeping them on their own books in the traditional fashion.

It was easier to sell on the loans if the documentation was covenant-lite. Very complicated debt instruments were being traded on the inter-bank markets, including collateral debt obligations (CDOs), things that most businessmen and lawyers had not heard of until the credit crunch. These debt instruments comprise a package or bundle of mortgages and other loans often insured against default, which could easily be traded, as arranging investment banks often managed to obtain a Triple A or other high rating for the CDO. Before the credit crunch gained public attention I heard from American lawyers and bankers about the serious concern over the US sub-prime mortgage market. The talk was about mortgage brokers and bank salesmen who had been finding borrowers who could not afford to buy a chicken coop and selling them a mortgage to buy a four bedroom house. These sub-prime mortgages were then sold on as part of the book of the original lender, subsequently to be sliced up and bundled up with other loans to create a financial instrument. The result, as we all know now, is that banks dealing on the money markets around the world have found themselves holding debt instruments which are either worthless or worth far less than they were originally thought to be worth.

The Inter-Bank Market

As a result of being exposed to these markets some banks have posted monumental losses resulting in a banking crisis the like of which has not been seen for about 40 years, according

to bank insiders. Banks which had adopted a model of trading short and lending long have posted the worst losses and Northern Rock is the most infamous of these. Northern Rock raised funds on the money markets in order to lend long to its borrowers many of whom apparently fell into the sub-prime category. When it became known that Northern Rock could not raise funds it needed on the money markets, the result was a run on the bank – the first time this had happened in England since the 1860s and as a result Northern Rock had to rely heavily on government guarantees in order to pay funds to customers withdrawing their deposits.

As an insolvency lawyer it seemed to me that Northern Rock must be insolvent as it was unable to pay its debts as they fell due, according to the classic test. However, there is in the Insolvency Act an alternative test of corporate insolvency, known as the balance sheet test. Apparently, according to the balance sheet test, Northern Rock had assets well in excess of its liabilities but, of course, it still could not pay its debts as they fell due, which was why it needed the government guarantee.

In the US, the investment bank Bear Stearns was particularly exposed to the money markets and apparently collapsed as a result of market rumour that it was about to default. Under the supervision of the Federal Reserve a fire sale to JP Morgan Chase was negotiated which valued Bear Stearns at only a fraction of its market value a fortnight before news of its difficulties broke.

Will the contagion spread to other parts of the economy?

Currently the money markets appear to be frozen with banks not wishing to be involved in further trades which might expose them to the losses contained in the complex instruments that had been widely traded. Investment banks and some retail banks have been affected adversely and as a result of their losses, they have less cash to lend and are naturally now extremely cautious about to whom they lend. From a time of unprecedented liquidity the Western economies are now experiencing an acute shortage of liquidity.

On top of these problems in the financial markets, the US economy is now apparently slowing down. Some economists are predicting a recession in the US. The reason is said to be that the boom of the last 10 to 12 years was based mainly on consumer spending which in turn was based upon credit leveraged off residential property. Whatever the reason, statistics appear to show that the US economy is indeed slowing down and the question now is whether there will be a recession and, if so, how long will it last. Of course the other big question is, if

the US economy does go into recession - as it constitutes about one third of the global economy - will it have the effect of dragging down the UK economy into recession? What will be the effect on the wider European economy, the Middle East and the Far East?

The oil and gas industry is currently not affected by the slow down and oil prices are close to an all time high. The Middle Eastern oil states are known to have huge funds of cash and it is to the sovereign debt funds that some of the investment banks are looking in order to make up their capital. As is well known, China's economy has grown at a tremendous rate in the last five or six years with a boom in manufacturing based mainly on the supply of goods to consumers in the US and Europe. Some economists are even talking about a slow down or a recession in China based on the premise that with less demand for their products, the Chinese economy is bound to slow. Other economists talk about the Chinese economy overheating and a cyclical slow-down being inevitable in China. Then, of course, there is the worldwide spectre of inflation. Some economists are particularly worried that inflation might take root on a global scale such that the effective policies and strategies of the UK government over the last 10 to 15 years will no longer have the effect. This has led some economists to talk about a perfect storm in the sense that we would have rising inflation together with a prospect of a recession.

Will shipping markets be affected?

Of course, the big question for all of us in this room today is whether shipping markets will be affected. On that score many of you are better placed than I am to know the state of the current markets and what might lie ahead. As regards the shipping markets I am speaking anecdotally based on what I hear from clients, colleagues, lenders and investors.

What I am hearing is that some bank lenders are exiting the ship finance market - in particular a number of German banks have effectively left the shipping market for the time being at least. Obviously this is not surprising, as for the reasons I have mentioned the banks are having to take a much more cautious approach to lending than in the last few years. An added factor is that the Basle II agreement relating to banks' required capital ratios which (broadly speaking) puts a greater burden on the banks because of the higher capital requirements. There is talk by some economists that the Basle II requirements may have to be relaxed in the current exceptionally difficult situation for banks.

Lenders are now seeking a greater proportion of owner equity and offering lower advance ratios - around about 65% as opposed to 75%. I gather those banks still in the market are

keen to stay in the market but wish to lend to blue-chip shipowners with visible earnings and strong credit. Of course, the cost of borrowing has increased and I am told this now means 75 to 80 basis points (bps) over LIBOR as opposed to 55 to 60 bps before the credit crunch. I understand that fees have increased pro rata more than margins as banks are passing along their cost of capital. I gather from colleagues active in the ship finance market that most deals now have to be syndicated.

Private Equity entering the shipping finance market

Another trend is that a number of private equity funds are becoming interested and some are becoming active, to some extent because of the vacuum left as a result of some of the banks leaving the ship finance market.

However, there is now a real worry concerning the oversupply of tonnage, for two main reasons. First, the slowdown in the US economy and secondly, the fact that shipyards particularly in Asia were inundated with orders in the last three or so years. I gather that one or two large shipbuilding contracts have already been cancelled by the buyer (despite thereby incurring multi million dollar cancellation fees) and this may be a sign of things to come.

The China effect

There seem to be two views about whether the Chinese economy can take over from the US as the real driver of the global economy. Some economists fear that China will suffer as a result of the predicted US downturn which in turn would lessen the demand for consumer goods causing a downturn in the global shipping industry. Others are much more optimistic and on one analysis, even if US economic growth is reduced close to zero for the next three to five years there would still be demand for consumer goods coming from China, resulting (it is said) in an increase in container traffic, though not as rapid an increase as in previous years. Apparently, Chinese banks are sitting on huge funds and will wish to continue to provide liquidity to well-run container shipping companies.

According to this view, the Chinese economy will remain the real driver of maritime growth. In 2007 China accounted for 10% of global dry bulk trade, 27% of the world's container volumes and one third of oil demand growth.

The test of insolvency

The credit crunch has already given us new law as regards the corporate test of insolvency which I mentioned earlier. The case is called *Cheyne Finance*¹ and is about a special investment vehicle (SIV). SIVs are one of those things that few outside specialist financial markets had ever heard of until recently. As a result of the freezing up of the financial markets this particular SIV was unable to raise funds needed and was in breach of a major capital loss test which obliged the Bank of New York as security trustee to appoint partners in Deloitte as administrative receivers to the SIV with the task of realising its assets in the financial markets in order to pay its creditors. A significant part of Cheyne's assets consisted of securities backed by US home mortgage loans. The problem the administrative receivers faced was that although SIV had sufficient cash to pay short term creditors, they identified a future point based on projections of likely realisations when the SIV would very likely become insolvent because it would become unable to pay its debts as they fell due. The short term creditors naturally argued in Court that the receivers should use currently available cash to pay their debts as they fell due until the point came when the SIV ran out of cash. Perhaps not unsurprisingly, the judge found that the provisions of the trust deed should be interpreted such that the SIV should declare itself insolvent at this stage, in order to permit its assets to be realised on a planned basis and creditors paid on a "pari passu" basis (as opposed to a "pay as you go" basis). This would mean that short term creditors would not be paid immediately but would result in fairness as between the short term creditors and the long term creditors.

Although a sensible and practical decision in relation to the specific facts of the case, it has the unfortunate effect that the distinction between the two key tests of insolvency in English law are now blurred. In determining what was the straightforward "cash flow" or "commercial test" – that the company is able to pay its debts as they fall due – it is now also necessary to look also at the balance sheet test to see whether contingent debts will also be capable of being paid in full when they become due. This issue is by no means purely academic. The test of insolvency is critical in relation to corporate restructuring, as it underpins what is legally possible in the restructuring given that the legal rights of all creditors must be recognised.

¹ Re Cheyne Finance Plc [2007] All ER(D) 37 (Dec)

Cross-Border Insolvency: The EC Regulation on Insolvency Proceedings

As in other countries, legislators in the UK have been attempting to improve and adapt the way insolvency laws cope with the globalisation of the world economy. The EC Regulation on Insolvency Proceedings ("the EC Regulation") was adopted in the UK with effect from 31 May 2002 and in all other EU Member States (except Denmark) following an EU directive. Very broadly, the effect of the Regulation is that the law of the jurisdiction where a company is put into administration or liquidation becomes the applicable law across the EU. This is subject to a number of carve-outs in favour of local law, including the rights of mortgagees, lien holders, retention of title, employees and tax.

A key concept in the EC Regulation is that of the centre of main interests (COMI). The EC Regulation provides for a rebuttable presumption that a company's COMI will be the place of its registered office. In turn the law of the COMI will be the law of the main insolvency proceedings. The EC Regulation provides for secondary and territorial proceedings which are ancillary to main insolvency proceedings.

The Cross-Border Insolvency Regulations

The Cross-Border Insolvency Regulations 2006 were recently implemented in UK law based on the UNCITRAL model law². Similar laws have been enacted in the USA and some other countries. The objective is rather similar to the EC Regulation on Insolvency Proceedings in that insolvency proceedings appointing administrators and liquidators in foreign jurisdictions where the corporation has its centre of main interests will now be recognised as foreign main proceedings in England. There will be a practical effect to this which will apply in out of court restructuring as well as actual insolvency proceedings. There have been a number of well-known cases in relation to large groups, in which there have been Chapter 11 proceedings in the US with parallel administration proceedings in the UK. The most well known recent example is perhaps the automotive parts group, Federal Mogul, and its UK subsidiary group, Turner & Newell. The US chief restructuring officer was able to work with the UK administrator to achieve a more effective restructuring than would otherwise have been the case.

² The Model law on Cross-Border Insolvency adopted by the UN Commission on International Trade Law on 31 May 1997

Two Marine Cases:

(1) The Cenargo case

Some of my colleagues in ship finance have been known to say that in the shipping industry the impact of insolvency law is pretty much limited to a lender exercising its rights under its ship mortgage. However, in my own experience, UK insolvency law can have much more relevance to shipping companies. A well-known example is the Cenargo case in which my firm was involved. The Cenargo case is officially an unreported case but happens to be the first example of the EC Regulation having a direct impact on cross-border insolvency proceedings within the European Union. A company in the Cenargo group operated ferries between England and France. One of the ferries, "the Dawn Merchant", was arrested by a creditor at the French port of Dunkirk pursuant to an ex-parte order of the President of the Commercial Court of Dunkirk. Earlier on the same day an administration order had been made by the English High Court in relation to the ferry-owning company. After some argument and debate the French creditor which had made the arrest had to accept that although the vessel was in France, because it was owned by an English company in administration, the administration moratorium applied to the vessel. Because of the effect of the EC Regulation, the French creditor was not free to arrest the vessel without the consent of the administrator or the leave of the English Court. In effect and putting it very simply, the moratorium arising on the making of an administration order under English law was extended to the jurisdiction of another EU Member State by the operation of EC Regulation.

(2) Global Marine Systems

In a recent assignment we represented a major creditor of Global Marine Systems Ltd ("GMS"), a UK sub-sea cable-laying company with a fleet of six or seven vessels, a large workforce and a debt of about half a billion pounds sterling. The company had originally been part of the Cable & Wireless group and (as a matter of historical interest) had laid the first transatlantic under-sea cable before the First World War. Latterly, it was purchased by the US group, Global Crossing Inc., which around the turn of this century had its own problems and went into the US Court supervised bankruptcy procedure known as "Chapter 11". On emerging from Chapter 11, Global Crossing decided to divest itself of this UK subsidiary. The subsidiary was purchased for a nominal price. The new buyer subsequently put GMS into a company voluntary arrangement with the intention of "cramming down" all the creditors. Over a period of weeks of intensive negotiation, together with the other major creditor, we negotiated a much better deal for our clients than was being offered to them

under the original CVA proposals. We managed to negotiate loans secured by mortgages on the company's vessels for the benefit of all the creditors. As a result our client was paid a significant dividend on its debt years earlier than would have been the case under the terms of the CVA as originally proposed by the debtor company.

Stop Press: the HIH decision

Finally, I should mention a decision of the House of Lords made only two days ago concerning a major Australian insurance company which went into liquidation in Australia in 2001. There was a provisional liquidation of the English branch of the Australian company. The House of Lords ruled in the HIH³ case that the English provisional liquidators should remit funds held in England to the Australian liquidators of the company for distribution to creditors under Australian rules. Lord Hoffman referred to the principle of "modified universalism" which he described as "the golden thread running through English Cross-Border Insolvency law since the 18th Century".

It seems that this age-old principle is currently a hot topic again.

11 April 2008

This briefing has been provided for information purposes only. It should not be relied on as a substitute for specific legal advice on any particular topic. Legal comment is from an English law perspective

For further information please contact:

Richard Baines, Partner, on 020 7264 8016 or email richard.baines@hfw.com

Holman Fenwick Willan

Marlow House, Lloyds Avenue, London EC3N 3AL, UK

Tel: +44 (0)20 7488 2300 Fax: +44 (0)20 7481 0316

hfw.com

³ McGrath and others v Riddell and others (sub nom Re HIH Casualty and General Insurance Ltd and other companies) [2008] UKHL 21