Ship Finance Basics

A Practical Guidance® Practice Note by
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This practice note discusses ship finance. This practice note is a primer and examines (1) the typical ship finance loan structure and terms, (2) downside risks unique to ship finance loans and mitigants, and (3) deal structuring considerations.

For more information on ship finance in international jurisdictions, see Ship Finance in International Jurisdictions.

Introduction

Shipping, for the purposes of this practice note, is defined as an industry that generates revenues by making ships and other structures on water available to various end users. The industry has recently garnered much attention because of its role in the global supply chain as well as in the nascent offshore wind industry. Shipping is a capital-intensive industry, where depending on the type and size, a single income-producing asset (i.e., the ship) can cost tens (or even hundreds) of millions of dollars. Traditionally, many shipowners have financed the construction of new ships and the purchase of second-hand ships with bilateral loans, and while changes in the level of availability and sources of capital for the industry have resulted in different structures, many ship finance transactions still follow a familiar pattern.

Anatomy of Ship Finance Loan

A ship finance loan at its core is an asset-based financing and has many of the same elements and techniques as project finance financing. Below is a summary description of a typical structure supporting the construction or purchase of a single ship.

For general information on asset-based loans, see Asset-Based Lending Resource Kit and for more information generally on project finance, see Project Finance Resource Kit.

Borrower Structure

A shipowner sets up a bankruptcy-remote special purpose vehicle (SPV) to own a single ship. Most shipowners set the SPV up in popular jurisdictions for ship registration and tax purposes, such as the Marshall Islands and Liberia. The SPV typically does not own any assets other than the ship, contract rights relating to the ship, and bank accounts.

Tenor and Amortization

A ship finance loan usually takes the form of a term loan and amortizes more like a term loan A than a term loan B. Whereas a term loan B may typically involve a modest 1%

per annum amortization profile, a ship finance loan may amortize much faster (and sometimes down to the ship's scrap value). The tenor of the ship finance loan is also more varied (longer or shorter), as compared to a typical seven-year term loan B.

Security

A typical ship finance loan is a secured loan with a fairly predictable collateral package as further described below. As is the case with any other security device, various perfection steps are required. For information on perfection in various types of collateral, see Collateral Perfection and Release in the Closing Process and Perfection Methods in Various Types of Collateral Chart. For more information on shipping vessels, see Perfection Outside Article 9: Vessels, Aircraft, Intellectual Property, and Life Insurance Policies.

Ship Mortgage

A mortgage over the ship is by far the most important item of collateral for the lender, given that in a typical SPV setting the ship constitutes nearly the entirety of the SPV's assets. A ship mortgage must be registered in the registrar of the flag jurisdiction of the ship.

Assignment of Insurances

A ship is an asset susceptible to a loss, and an insurance policy on the hull and machinery of the ship as well as liability cover are essential for the owner of the ship (and by extension, the lender). An assignment of insurances is nearly always required for a ship finance loan. A lender (or an agent acting for the benefit of multiple lenders) is named as a loss payee and an additional insured under the relevant policy, and extensive diligence is often performed on the sufficiency of the insurance cover. For general information on insurance in financing transactions, see Insurance Issues in Financing Transactions.

Assignment of Earnings and Charterparty

All of the ship's earnings are assigned as security for the lender's loan. If a ship is subject to a long-term employment contract (sometimes called a charter or charterparty), a lender may insist upon taking a collateral assignment of such employment contract with step-in rights.

Bank Account Pledge

The SPV borrower typically opens a bank account (sometimes referred to as an earnings account) with the lender who will then take a pledge of such deposit account. Depending on the terms of the transaction, a lender may institute a strict payment priority "waterfall" pursuant to which funds are disbursed from the bank account, as is often seen in a project finance loan.

Share Pledge and Guarantee

The SPV's equity interests are often pledged by the owner of such interests. Depending on the financing terms, the parent of the SPV also provides credit support in the form of a guarantee, especially if the SPV's earnings are not backed by a stable long-term employment contract.

Perfection Issues

Depending on the jurisdiction in which the particular item of collateral is located and the governing law of the relevant security document, varying perfection steps are required for the lender's security interests in such collateral. A security interest granted pursuant to a U.S.-style security agreement (and governed by the law of one of its states) is generally perfected by observing the requirements of the Uniform Commercial Code (UCC). For many types of such collateral, a financing statement filed in the jurisdiction where the grantor of the collateral is "located" is sufficient. For certain types of collateral, a different step may be required, such as entering into a tripartite agreement with the account bank (in the case of a bank account) or having the policies endorsed to the security agent as a loss payee or additional insured (in the case of insurance policies which are carved out of the scope of the UCC).

For information on collateral packages in general, see Security Interests Resource Kit and Collateral Package Documentation (Security Agreement), and for information on collateral assignments of insurance policies, see Perfection Outside Article 9: Vessels, Aircraft, Intellectual Property, and Life Insurance Policies. For information on guaranties, see Guaranties Resource Kit.

Financial Covenant

A lender typically lends only a percentage of the value of the ship (a loan-to-value, or LTV, ratio). 50%–60% is not an uncommon LTV ratio for a typical ship finance loan. As nearly all the borrower's value is in the ship, a ship finance loan almost always has an LTV maintenance covenant, which measures the value of the ship against the outstanding principal amount of the loan. In order to evidence the value of the ship, one or more of the valuation reports from an agreed-upon list of ship brokers are required on a periodic basis to test this covenant.

As is typical in a project finance loan, a lender also often requires a debt service coverage ratio covenant to ensure that the cash flow generated by the ship is sufficient to

cover debt service. A borrower's diminishing ability to service the lender's debt is a critical early warning sign and depending on the severity and duration of the borrower's breach, the loan terms may need to be restructured to provide for flexibilities.

For general information on financial covenants, see Financial Covenants and EBITDA Calculations in Credit Agreements and Financial Covenants in Project Financing.

Ship Covenant

Needless to say, a lender has an interest in making sure that the ship remains fit to serve its intended purpose and generate revenues. A lender typically requires extensive information from the borrower with respect to the maintenance and management of the ship. For example, the lender may require information ranging from the ship's insurance cover, its seaworthiness, timely payment of crew members and suppliers, and compliance with classification society and flag state requirements. While many of these requirements are technical in nature and beyond the scope of this practice note, in order for a ship to continue to be eligible to trade, it is imperative that the ship maintains its classification status and complies with the requirements set out by its flag state.

Employment Requirement

The borrower's only source of cash flow is the rental income of the ship. An end user that "rents" a ship could be, for example, a big ocean liner company that carries containers for its customers, an energy company that needs a purpose-built ship to service its offshore wind turbine units or transfer crew, or a liquefied natural gas producer that needs to fuel ships. Such rentals can be for a long term, or a shorter term, or even on a single-voyage only basis.

Therefore, the lender closely examines the current employment and future employment prospects of the ship. Employment of a ship is typically documented via a "charter" or "charterparty—the ship that has a long-term charter at a favorable rate is much more finance-able than those that do not. Depending on the deal terms, a ship finance loan agreement contains varying requirements for the employment of the ship, which could be an outright requirement for a long-term charter, or some other metrics to ensure that the loan can be serviced and repaid.

Default Scenarios and Mitigating Factors

What can go wrong in a typical ship finance loan? Below are some examples of default scenarios and some of the protections available to the lender.

Loss of, or Major Damage to, the Ship

As a real operating asset, a ship could sink or suffer a major casualty that involves a significant cash outlay for repair. Lenders should require insurance cover with policy benefits in excess of the lender's loan amount. In the event of a "total loss" of the ship, a lender would be entitled to the proceeds of the insurance policy as a loss payee.

Insufficient Cash Flow

The ship, even if on a long-term employment contract, may not generate enough income to service the debt. For example, this could happen when an existing charter is terminated or not renewed, the ship is unable to get a new charter in the spot market, the ship has unexpected repair needs or the ship is "off hire" because it is arrested, for instance, by a bunker supplier that is unpaid. Often, a ship finance loan requires a certain amount of cash reserves (e.g., $500,000 per ship) to be maintained—while not a perfect fix to a significant long-term issue, the reserves can satisfy the debt service while working out a solution.

Decrease in Collateral Value

A ship has a limited useful life (let's say, 20 years depending on the size and type) and would, all things being equal, decrease in value over time. For this reason, the lender would only lend a percentage of the value of the ship and require regular amortization over the life of the loan. In addition, depending on numerous factors, including the supply and demand in the charter market, a ship's value can fluctuate (and sometimes very quickly). A lender would closely monitor the value of the ship by requiring appraisals on a periodic basis, and the LTV covenant would provide an early warning to the lender.

Other Considerations in Deal Structuring

Some of the other considerations in structuring a ship finance loan include the following:

Technical Manager

The borrower may not have the technical expertise to operate the ship and could well outsource that function. It is important to ensure that the technical manager is reputable because it is the technical manager that deals with the day-to-day maintenance and operation of the ship.

Special Survey

A ship is almost always "classed' by a classification society. A ship class is a group of ships of a similar design and sometimes with a notation for abilities of the ship (such as "ice class," "firefighting," or "oil recovery" capabilities). A ship is said to be "in class" when its hull, structure, machinery, and equipment conform to the standards set out by industry governing bodies. A ship that is "out of" class may not be insurable and will not be able to trade.

In order to maintain its classification status, a ship must undergo periodic "special survey" inspections. This is a major endeavor and can cost hundreds of thousands of dollars or more. Assuming a typical five-year cycle, a lender lending in the middle of, or near the end of, the period, should expect the anticipated amount of the special survey cost added in the borrower's budget.

"Secret" Maritime Liens

Maritime liens are liens that arise by operation of law and need not be recorded. Among other reasons, they may come into existence in connection with the provision of "necessaries" to a ship (e.g., crew wages, repairs, towage, maintenance). Depending on the jurisdiction, such liens are often prioritized in the opposite manner of typical U.S. commercial liens—on a "last in time, first in right" basis. For more information, see Ship Finance in International Jurisdictions.

Global Nature of Shipping Business

With operations worldwide, the borrower may be exposed to geopolitical risk. For example, acts of piracy have historically affected ocean-going ships trading in certain regions of the world such as the South China Sea, the Indian Ocean, the Gulf of Guinea, and in the Gulf of Aden off the coast of Somalia.

The COVID-19 global health crisis has also introduced several new risk factors to the shipping industry. For example, a port shutdown has become prevalent in many parts of the world as the governments around the world have instituted stringent lockdown measures for novel coronavirus outbreaks. Ships that are unable to unload their cargo because of a port shutdown are delayed in reaching their next destinations. Crew changes have also been made difficult in the wake of COVID-19, which affects a ship's operations. Depending on the terms of the employment contracts, such delays can have an impact on the bottom line of the ship.

Sanctions

In the similar vein, by nature of its business, a shipowner has a need to closely monitor the U.S. economic sanctions regime (as well as similar regimes instituted by other jurisdictions), which changes frequently. A violation by the shipowner (whether intentional or inadvertent) can have serious consequences to its lenders. For example, a ship itself can be added to the list of U.S. Specifically Designated Nationals list, which will severely hamper the lender's ability to foreclose on such ship. Careful examination of the borrower's sanctions compliance program is warranted. For more information on such sanctions, see Know Your Customer: Customer Identification Requirements Pursuant to the Bank Secrecy Act.

Regulatory Concerns

Certain types of ships—for example, ships that carry goods between two points within the United States (which would be the case for those trading in connection with U.S.-based offshore wind farms) or those that engage in fisheries trade—are subject to extensive regulation (including a citizenship requirement) known as the Jones Act, which often has implications for the lenders.

For example, a U.S.-flagged ship eligible to engage in the coastwise trade is valued much higher than a comparable ship that is not. Therefore, a lender may want to conduct additional diligence to ensure that the ship is indeed qualified for such trade. On the flip side, in an enforcement scenario, a Jones Act-qualified ship may not be sold to a non-U.S. citizen, and the ways in which a lender may exercises its remedies against such ship may be different. The lender's underwriting process may need to take into account such complications.

Summary

While the deal structure may follow a similar pattern, financing a ship involves risks unique to the asset type and uses. It is important to keep in mind these risks when structuring and documenting a ship finance loan.

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Hoyoon enjoys writing for industry and academic publications and routinely gives lectures and presentations on developments in the transportation industry. He is also a contributor to Seward & Kissel's Maritime Blog.

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Mike is the immediate past Chair of the Marine Financing Committee for the Maritime Law Association of the United States. Mike is also a Member of the Association of the Bar of the City of New York, the American Bar Association and the Maritime Law Association of the United States. He is recognized by Chambers USA and Chambers Global in Transportation: Shipping: Finance, as well as by New York Super Lawyer. Mike is also a contributor to Seward & Kissel's Maritime Blog.

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