WATSON FARLEY
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BRIEFING

THE SERTÃO – JUDICIAL SALES OF (SPECIALIST) SHIPS (IN UNUSUAL MARKET CONDITIONS)

MAY 2018

- ENGLISH COURT OFFERS FLEXIBILITY TO SHIP MORTGAGEES IN ACCEPTING THEIR BROKER'S EVIDENCE ON THE RESERVE PRICE AND THE CONDUCT OF THE SALE
- THE COURT ALSO RECOMMENDED THE APPOINTMENT OF ITS OWN AND OUTSIDE BROKERS TO ASSIST WITH THE SALE

"A CONCERN OF MANY SHIP MORTGAGEES, WHEN ENFORCING THEIR SECURITY BY WAY OF ARREST AND SALE, IS TO ENSURE THAT THE COURT DOES NOT SELL THE MORTGAGED SHIP FOR A LOW 'FORCED SALE' PRICE THAT LEAVES THEM TO ABSORB A SIGNIFICANT LOSS."

A concern of many ship mortgagees, when enforcing their security by way of arrest and sale, is to ensure that the court does not sell the mortgaged ship for a low 'forced sale' price that leaves them to absorb a significant loss. Usually, this risk can be mitigated through protective bidding. But protective bids must be funded, which may raise its own complications, especially where the mortgage security is held for a bank lending syndicate or group of bondholders who may not all wish to commit further funds to finance such a purchase. Aside from protective bidding, the setting of a reserve price will provide the mortgagee with some protection. However, the usual practice of the English court is not to publish the reserve price or 'appraised value' (as it is known) either to interested bidders or to any other party, including the mortgagee. Whether or not the reserve price is published, the practice of the English court and most other courts, if the reserve price is not reached, is either to accept the next best bid or to re-run the auction. What if the mortgagee prefers, in such event, to keep the ship laid up until market conditions improve? Will the court offer such flexibility?

The English Admiralty Court recently did so in making an order for sale in the case of *The Sertão*[1], in which Watson Farley & Williams acted for the successful mortgagee applicant (which held the security for a number of US noteholders).

[1] [2018] EWHC 1013 (Admlty)

How to determine a ship's 'appraised value'

The Sertão is a 6th generation drillship that was moved from Brazil to England at the end of 2015 for arrest and long-term lay-up, after termination of her Petrobras charter. Termination resulted from the financial collapse of Grupo Schahin, with whom her owners and operators were affiliated, in 2015. Given the prolonged downturn in the offshore oil and gas market, a number of deepwater drillships have now remained laid up without employment for many months in different parts of the world.

The mortgagee decided to initiate a formal court sale process to test the market before the noteholders raise further funds to continue 'warm stacking' the Sertão for up to a further two years. That fund raising is intended to be sanctioned by a scheme of arrangement in the Cayman Islands, being the note issuer's place of incorporation. However, in seeking an order for judicial sale, the mortgagee was understandably concerned to ensure that the English court accepted its own view of the Sertão's appraised value and, further, that, in the event of no bid being made at that level, it would be free to continue to stack the Sertão as required.

In the event, the court accepted the mortgagee's evidence as to the Sertão's 'appraised value' and did not order a separate appraisement by the court's broker. The court also accepted the mortgagee's evidence as to its intended 'stacking' strategy, and agreed not to compel a sale of the Sertão for a lower price.

"THE JUDGE WAS SATISFIED THAT, AT LEAST FOR PRESENT PURPOSES, THE SERTÃO COULD PROPERLY BE DESCRIBED AS A WASTING ASSET, EVEN IF THAT POSITION MIGHT LATER CHANGE IN AN IMPROVING MARKET."

Was the Sertão a 'wasting' asset?

The mortgagee applied for an order for sale *pendente lite* (i.e. with the dispute pending or prior to obtaining judgment). By doing so, the mortgagee preserved its ability to include such further sums as may be required to fund the Sertão's continued 'warm' stacking in an application for judgment to be made at a later stage. Sales of ships *pendente lite* are usually ordered to expedite the sale of ships, even if the owner has defended the action, although in such cases, the court will examine the claim 'more critically'[2]. Such orders may therefore be invaluable to mortgagees, as the speed of the sale process is usually critical to preserving value, and the availability of such orders distinguishes common law jurisdictions, including England, Singapore, Hong Kong and Gibraltar, from countries with codified laws whose courts usually require the mortgagee to obtain judgment before a sale may be ordered. In this case, there was no suggestion of the owners defending the claim, and a sale *pendente lite* provided a different benefit.

Given that an order for sale *pendente lite* may be a draconian one, the English court will only make such orders if satisfied that the ship is a 'wasting' or deteriorating asset[3]. Usually, evidence that the secured debt exceeds the ship's market value will suffice to show this. In other words, it will usually be clear that the accrual of interest and ship maintenance costs will erode the mortgagee's recovery the longer the ship remains unsold. However, the mortgagee's evidence here was that its recovery might actually increase over time were the Sertão to remain stacked whilst the market recovers. This initially troubled the court, although the judge was satisfied that, at least for the present, the Sertão could properly be described as a wasting asset, even if that position might later change in an improving market.

[2] *The Myrto* [1977] 2 Lloyd's Rep. 243 at 260.
[3] Ibid.

What about the role of the court brokers?

The usual practice of the English court's Admiralty Marshal is to appoint ship sale and purchase brokers to assist him to market ships for sale. Successive Admiralty Marshals have traditionally engaged the firm of C.W. Kellock & Co., Ltd. (now part of the Eggar Forrester group). Indeed they have done so for over 150 years. Not all courts engage external brokers. For example, in Singapore the court sheriff's office handles ship sales unaided. But where courts do so, it is common for them to engage a shipbroker whom they know and trust. For example, the Gibraltar court has for many years appointed Nigel Hollyer of Howe Robinson Partners as its broker.

In this case, specialist brokers, Pareto Offshore AS, market leaders in offshore oil and gas assets, had already been appointed. Initially, therefore, the mortgagee requested the court to direct the Admiralty Marshal to appoint Pareto in place of Kellocks, and thereby to save the cost of the court's usual brokers. Perhaps unsurprisingly, the Admiralty Marshal reacted by raising concerns about engaging Norwegian brokers whom he did not know, even though specialists in this market. Having taken on board the Admiralty Marshal's views, the mortgagee offered, before the hearing, to accept the joint appointment of Pareto and Kellocks provided that Kellocks share their 1% commission with Pareto. The judge, whilst recognising that he could not compel Kellocks to accept the mortgagee's offer, encouraged them in his judgment to do so. This has fortunately since been agreed and the Sertão has now been advertised for sale.

This is a welcome outcome. The judge clearly recognised that a 1% commission 'appears high' when applied to a valuable asset such as the Sertão. The court noted that the court broker's fee scale had been fixed since 1998 by 'agreement or practice'. The judge further recognised that the court's usual broker might not have the relevant experience of a particular market. But, ultimately, the court did not have to decide whether it was bound by that fee scale or otherwise to engage its usual broker. The judge's pragmatic approach in inviting Kellocks to accept the mortgagee's proposal, led to an agreed solution. The judgment has, nevertheless, highlighted the fee scales payable on Admiralty ship sales. They may be competitive in comparison to Singapore and Gibraltar, but they are difficult to justify when applied to high value vessels. At the other end of the scale, the judge considered that the Admiralty Marshal ought to be able to charge a 'reasonable' fee for 'endeavouring' to sell a ship without success. That is not, however, the Admiralty Marshal's current practice. The judge suggested that we take up these points with the Admiralty Court Users' Committee, and which we shall certainly now do.

"THIS JUDGMENT THEREFORE CONFIRMS THE CONTINUING ATTRACTIVENESS OF ENGLAND AS A JURISDICTION FOR THE SALE OF SHIPS."

Conclusion

In considering the mortgagee's application, the English court had to grapple with a number of proposed changes to its usual form of 'order for appraisement and sale'. In making the order it did in this case, it demonstrated its readiness to show flexibility with a view to preserving value for all creditors and maximising the mortgagee's prospects of making a successful recovery. This judgment therefore confirms the continuing attractiveness of England as a jurisdiction for the sale of ships.

FOR MORE INFORMATION

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