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Red Sea movements and financial security

The ramifications of events in the Red Sea region extend into the ship finance market, and raise issues which financiers may wish to address from the outset of documentation leading to more complex negotiations with owners, writes Amy Lindemann, Managing Associate.

Recent Houthi attacks on vessels passing through the straits of Bab al-Mandab on their way through the Red Sea mean that the shipping industry has moved beyond trade press reporting and onto front page news.

While the causes of the current situation are very different, it is possible to draw a significant parallel with the grounding and arrest of the containership *Ever Given* in the Suez Canal in March 2021.

Then, as now, the spectre of delays in the supply of goods and rising costs ensured that the wider world woke up to its reliance on the globalised shipping industry.

Many ships, whose owners are unwilling to put their crew in the line of fire, are being diverted round the Cape of Good Hope. *Portswatch*, a database maintained by the IMF and Oxford University indicated that the seven-day moving average of daily Suez crossings by bulk cargo ships, container carriers and tankers fell to 49 on 21 January 2024. This was down from 70 transits for the equivalent period a year earlier, and at its lowest flow through since the week after the massive container carrier wedged itself between the canal's banks.

Avoiding the Red Sea adds in the region of 8-10 days and approximately 3,000 nautical miles to a voyage from, for example, China to a major European port.

The current situation throws up many issues for the industry: who bears the costs associated with these longer voyages, increased insurance premiums (war risk insurance, at 0.01% of vessel value in early December, has increased to 0.7%) and the introduction of express restrictions on entering the Straits in insurance policies, applicable particularly to vessels linked to the UK or US who have led the airstrikes on the Houthi bases. This could result in a vessel having no insurance cover to enter the Red Sea.

In addition to these and other matters to deal with in the current climate, a shipowner will also have to consider the impact on a vessel's financing arrangements.

Taking first a possible hijacking of a vessel, as in the case of the *Galaxy Leader*: is the hijack of a vessel a "Total Loss" which therefore constitutes a mandatory prepayment event under the finance documents? This would oblige the shipowner almost immediately to prepay the outstanding indebtedness secured by the vessel.

Under English Law (s57 Marine Insurance Act 1907) actual total loss of the vessel occurs where the insured vessel is destroyed or where the assured is irretrievably deprived thereof. Where, as in the case of a hijacking, the vessel is not destroyed and the owner cannot be said to be "irretrievably deprived thereof" no actual total loss will have occurred. The Act goes on to cover constructive total loss and mission ship. So too the definition of "Total Loss" in a finance agreement will inevitably be drafted widely

to cover other circumstances, including where recovery of the vessel within a reasonable time has become so impractical or expensive so as to be a constructive total loss.

From the financier's perspective, the obligation to prepay should arise as soon as possible following a hijacking. The mortgage over the vessel will be worthless while the vessel is in the hands of hijackers and it is impossible to exercise any right of enforcement. The relevant limb of the definition of Total Loss will specify the number of days which must elapse without a return of the vessel to the owner, in order for a Total Loss to be deemed to have occurred. In the negotiation of the finance documents, the Borrower will have likely pushed for this period, and the number of days after that, by which the prepayment must be made, to be as long as possible. Traditionally, the latter may be anything from 60 to 180 days but usually corresponds to the time it takes for insurance proceeds to be paid in respect of the Total Loss. In the early 2010s, in response to the surge of Somali piracy attacks, insurers insisted on the 12-month detainment clause, rather than agreeing to reduce this to six months- the insured must have lost free use and disposal of the vessel for a continuous period of 12 months before insurance proceeds would be payable.

There lies the tension. Ship owners are understandably unwilling to commit to the prepayment of a potentially large amount of indebtedness without the certainty of receiving insurance proceeds. This could be financially ruinous for a shipowner without the available cash to make that prepayment. There may be scope to negotiate with financiers who may accept additional security, such as a mortgage over another group vessel, pending a resolution of the issue – i.e. a pay out by the insurers or release of the hijacked vessel.

Another concern will be the financiers' scrutiny of vessels' insurances. A keen eye is already kept on this, with extensive undertakings in this regard being a key part of any finance agreement. Financiers, if not seeking to impose additional insurance obligations on ship owner borrowers, may exercise any right to obtain, at borrower's cost, additional insurance reports, to ensure the cover in place is robust in light of recent events.

The prevailing circumstances bring other standard provisions of a shipping finance agreement into focus. The agreement will certainly contain a restriction on entering a "war zone", whether or not this has been officially declared as such, without both the prior written consent of the financier, and requisite additional insurance cover. Notification obligations will arise. At the least these will include the obligation to notify the financier of any event which will, or is likely to, give rise to a 'Major Casualty'. That is a casualty in relation to which the claim against insurers will exceed the Major Casualty Amount (a figure which will have been negotiated during documentation of the financing, relative to the value of the vessel), as well as any which may lead to a Total Loss, which would include a hijack.

Even in the absence of a 'Total Loss', where a ship owner is looking to settle a claim with insurers for an amount in excess of the stipulated "Major Casualty Amount", prior financier consent will be required. In relation to the inevitable repairs, a financier may require an undertaking from the yard not to exercise any liens on the vessel or its earnings for the cost of those repairs. Obtaining this from a shipyard may not be without its challenges.

In extreme cases, financiers, perhaps already looking for justifiable grounds to withdraw investment, could cite that the risks in the Red Sea, and the increased cost of re-routing of vessels, constitute a "material adverse effect" on the business of the borrower or its wider group, which gives rise to a right to accelerate and terminate the financing. While unlikely, prudent ship owners will want to be alive to the small print in their loan documentation.

The ongoing uncertainty and volatility in a region so crucial to global trade, together with the existing risks of shipping will have many ramifications including in the ship finance market. Financiers will want to address these issues from the outset of documentation which may lead to more complex negotiations with owners.

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