

## **Conflicting views: mortgagees v charterers**

### **Roger Heward (right) of Norton Rose, London, and Jim James (left) of Norton Rose, Hong Kong examine the way in which English Law addresses conflicts between mortgagees and charterers**

On occasions, the mortgagees and the charterers of a vessel will be found to have differing commercial interests. Usually, such a conflict will arise in circumstances where the mortgagee wishes to take prompt action to enforce its rights (e.g., by arresting the vessel and having it sold free of charter), but the charterer wishes such action to be deferred until the end of the charter period. If the charterer and the mortgagee are not parties to a priorities agreement, general legal principles govern their respective rights. English law in this area is not entirely clear. Each case depends upon its own facts and circumstances, and specific legal advice should be sought in individual cases.

There are two main reasons why the law on this point may seem somewhat unclear. The first reason is that these cases arise rarely in practice, because either the rights of the parties are governed by a priorities agreement, or it becomes evident that the shipowner is insolvent, which means that the charterparty cannot be performed in any event.

The second reason why the law may appear unclear is that the rights and remedies of the charterer are regarded as falling mainly, or entirely, within the court's 'equitable' jurisdiction. The outcome of each case depends heavily upon its individual facts as established by the court including such matters as the degree of notice which each party has had of the other's position and the conduct of the parties throughout. In many cases, the appropriate remedy for a charterer will be the equitable remedy of an injunction, which will restrain the mortgagee from taking enforcement action. The remedy of damages will also be available in appropriate cases.

#### **Underlying principles**

The underlying principles of English law which favour the mortgagee are as follows:

- a) A mortgagee has a proprietary interest in the mortgaged property, which interest is deferred until the mortgagor (the shipowner) is in default. After a default has occurred, the mortgagee may enforce its proprietary interest by, for example, taking possession of the mortgaged vessel.
- b) Under statutory law, a mortgagee with an unsatisfied claim against a vessel is entitled to apply for the arrest of the mortgaged vessel. In due course, the mortgaged vessel may be sold by the court. Court sales in admiralty proceedings pass clean title to the buyer, free of all claims, liens and encumbrances (including charterparties and other contracts entered into by the shipowner).

#### **The underlying principles of law in favour of the charterer, are as follows:**

- a). If a mortgagee has actual notice of the existence of a charter (or other contract relating to the employment of the vessel) before and at the time the mortgage is granted, the mortgagee may subsequently be restrained by the court from interfering with the performance of that contract.
- b). Successive versions of the Merchant Shipping Act have long provided that, in cases where a vessel is mortgaged, the mortgagor shall be treated as not having ceased to be the owner of the vessel. That provision is currently to be found in section 10, of Schedule 1, to the Merchant Shipping Act 1995. In earlier versions, the statute contained an express proviso to the effect that the shipowner has the right to enter into contracts for the employment of the vessel, as long as the mortgagee's security is not impaired by any such contract. That express proviso no longer

appears in the Merchant Shipping Act, probably because it is thought to be unnecessary. As a matter of general case law, it is a breach of the mortgage for the shipowner to act in such a manner as to impair the mortgagee's security in the mortgaged vessel.

The manner in which these underlying principles are usually applied to conflicts between a mortgagee and a charterer, are set out in the following paragraphs.

### **Charterparty in existence before mortgage**

- a) If a mortgagee has actual notice of the existence of a charterparty before taking a mortgage over the vessel, the charterer may subsequently obtain an injunction to prevent the mortgagee interfering with the performance of the charterparty, except in cases where the shipowner is unable to perform the charterparty. The rule applies even if the charterparty impairs the mortgagee's security. The question of whether the owner is 'unable to perform' the charterparty is a question of fact. If the shipowner is unable to pay his debts as they fall due (i.e., if the shipowner is insolvent), that will constitute 'inability to perform'. Usually a mortgagee's reason for wishing to enforce the mortgage is that the owner is insolvent, so, in the majority of cases, the exception will apply. However, in the *Maule* (1994), where the charterparty was in existence before the mortgage, the charterer had the arrest set aside on grounds that the mortgagee's security was not impaired and the shipowner was capable of performing the mortgage.
- b). If the pre-existing charter is a demise charter, the mortgagee's position is, however, weaker than that which is described above. Under a demise charter, the charterer is given possession of the vessel. Provided the charterer is not in breach of the charter, the mortgagee's rights will always be postponed to those of the charterer. The mortgagee will be restrained from arresting the vessel, and any arrest obtained by the mortgagee set aside. Similarly, the mortgagee will not be entitled to enter into possession of the vessel (because possession lies with the demise charterer).

### **Mortgage in existence before charterparty**

- a). The decision in the *Myrto* (1977) concerned a case in which the shipowner entered into a charterparty after the date of the mortgage. The mortgagee arrested the vessel, in England, after it had been laden with a substantial volume of general cargo for an intended voyage to the Indian subcontinent. The shipowner was found to be insolvent, so the outcome of the case was that the mortgagees were held entitled to enforce their mortgage. In the course of his judgment, the Judge set out the principles applicable to such cases.
- b). The general rule is that where the shipowner makes a contract with a third party for the employment of the mortgaged vessel; and
- i. the contract does not impair the mortgagee's security; and
  - ii. the shipowner is willing and able to perform the contract;
- then the mortgagee is not entitled, by exercising its rights under the mortgage (e.g. by taking possession, or by arresting the vessel in a mortgage action), to interfere with the performance of such contract.
- c). Impairment of security. Circumstances in which the court may regard a charterparty as impairing the mortgagee's security, include the following:
- i. If it is shown that the shipowner is impecunious and is likely to run up debts against the vessel in the ports at which it is proposed that the vessel will call, or
  - ii. If the vessel is uninsured, or inadequately insured (for example, if it is proposed that the vessel will proceed to a war zone, without adequate war risk insurance).
- d). Inability to perform the charterparty If the shipowner is unable, or unwilling, to perform the charterparty, the mortgagee will be permitted to enforce its rights.

'Inability to perform' invariably means that the shipowner is insolvent, although insolvency might be manifested in various ways. Most obviously, a shipowner will be deemed to be insolvent if the loan secured by the mortgage is in default. Similarly, if the shipowner is unable to pay for repairs to the vessel, this will probably be evidence of insolvency. In such cases, the rights of the charterer, or bill of lading holder, lie solely against the shipowner, and rank after the mortgage claim.

### **Conclusion**

Circumstances may arise in which the rights of a mortgagee will be subordinated to those of a charterer of a mortgaged vessel. Those cases will be rare in practice, because the rights of a charterer depend upon the shipowner being willing and able to perform the charter and, in most cases, the shipowner is insolvent. Mortgagees are particularly at risk in cases where the charterparty pre-dates the mortgage, or where the charterparty is by way of demise. The loan documentation usually prohibits the shipowner from entering into a demise charter, or a timecharter of more than one year's duration, without the mortgagee's prior written consent. Mortgagees may protect their position by having the charterer execute a subordination agreement.