WASTING ASSETS:
DETERIORATING VESSEL CONDITION IN SHIPPING FINANCE

By Capt. Max Hardberger

One of the major factors in the success or failure of a shipowning enterprise is the physical condition of the vessel. But with the utilization of contract management in modern shipping, shipowners increasingly find themselves removed from their vessels. Even further removed are mortgagees, bondholders, or shareholders who have an interest in the vessel, but no ability actively to monitor—much less control—the ship's day-to-day operations. Often, their grasp of the vessel's condition, her trading market, and her asset value recede to the background as financial, corporate, and legal considerations take the foreground.

CONSEQUENCES OF IGNORANCE

The lack of current and accurate information on a ship's condition and status often results in disastrous consequences for interest-holders. In one illustrative situation, the owner apparently plotted for about six months to abandon his ship, during which period the ship's debts went unpaid. After the owner received US$500,000 in freight, he had the crew fake an engine room fire during the vessel's departure from her load port. He then replaced the crew—who were necessary conspirators—with another crew of innocent Russians who knew nothing of the situation. The owner then disappeared with the freight money and the vessel's profits from the previous six months. He left behind a ship at the end of her certificates, devoid of spares, in wretched condition, and with a trail of debts. The mortgagee was left holding a mortgage secured by a vessel without value. In fact, the vessel's subsequent auction failed to generate enough money even to cover the court and custodial costs.

The sad truth is that such incidents are not uncommon. An interest-holder usually expresses disbelief after a loss due to vessel condition or mismanagement. He is often astounded to learn that a ship with full certificates and which has been recently trading can become worthless with such amazing speed. However, the warning signs were probably right before their eyes for months, had they known what to look for.

PLANNED DETERIORATION

It is a mistake to think that the demise of every shipping enterprise is a personal tragedy for the shipowner. We have witnessed a number of situations where investigation after a seizure, sinking or other default revealed that the owner had been planning such an exit strategy for many months. Such actions are completely independent of—although sometimes coincidental with—fraudulent insurance claims. In these situations, a shipowner with a heavy debt load on an ocean-trading vessel may plot to continue revenue-producing operations while incrementally reducing expenses. Spares purchases are cut back, repairs are delayed, emergency spares are depleted, food quality is reduced, etc., all according to the owner's timetable for default.

At the same time, routine bills are deliberately unpaid. This is possible due to customary ship-provisioning practices. Chandlers and repair firms traditionally bill a vessel through her agent, with the understanding that the ship will make payment as a part of settling the Final Accounts with the agent. Because this invoicing almost invariably occurs after the ship has sailed from port, collection of an unpaid local debt must usually be accomplished through a foreign arrest—a difficult and expensive task.

The owner will also defer drydocking during the pre-abandonment period. Six month extensions are routine, and by requesting further extension he can delay drydocking up to a year. He will also avoid making other class repairs. Although these deficiencies will eventually lead to class demands for repair and repeated threats of withdrawal from class, the fact is that a clever and dishonest owner can delay the actual withdrawal for a year or more.

The same is true for crew wages, a significant portion of a vessel's fixed operating expenses. Foreign crewmen can often be induced to stay onboard at reduced or no pay through a program of small "advances" and repeated promises. Every crewman knows that when he leaves the ship, his chances of getting paid back wages plummet, and the only way to get paid is to stay onboard. An owner can play on this knowledge by offering full back pay at a coming event: "as soon as we get that Rotterdam cargo" or "when the ship reaches Piraeus." Of course, even if the event occurs, only a pittance—an "advance"—will be forthcoming.

Overall, a shipowner planning to default on a ship's mortgage will pay only those bills that have to be paid for continuing operations, and will use every kind of stratagem to avoid paying the others. The ultimate goal of a planned deterioration strategy is to milk the ship for a maximum return on minimum investment. When employed, the owner will continue the strategy until the vessel finally incurs a debt that the owner is unwilling or unable to pay.

PLUMMETING ASSET VALUES

Even without fraud, ship condition is a fluid thing, given to sudden change as well as gradual deterioration. A ship that cost US$10 million to build can quickly drop to $150,000 in scrap value if her main engine crankshaft cracks. Although these events are usually covered by Hull & Machinery insurance, a ship's loss of value due to gradual decline or planned deterioration are not. Accordingly, even though the interest-holder may have been named as Additional Assured on the owner's insurance, he is assured of very little if the ship is lost to an uninsured risk.

Because a ship's intrinsic value—her value independent of her market—varies directly in relation to its condition, those who do not monitor the conditions of ships in which they possess interests often have grossly inaccurate ideas of their value. We have seen many ships that were ridiculously over-mortgaged, especially in the tramp charter trade, where the mortgage-holder has no way of directly monitoring the vessel's condition. It stands to reason that the more over-mortgaged a ship is, the more motivated the owner is to abandon it.

DEBT ACCUMULATION

In addition to suffering a dramatic reduction in asset value, an unmonitored ship often creates other problems for interest-holders. Because the owner will normally continue operating her until the cost of doing so prompts her abandonment, the interest-holder who gains possession of the asset is faced not only with the cost of bringing her back into class and Port State Control compliance, but also with the payment of outstanding operating expenses as much as a year in arrears. Add to this the seizure-related expenses of court costs, wharfage, custodial services and crew wages/expenses during seizure, etc., and the total claim against the vessel often exceeds her value. When such circumstances exist, the interest-holder is quickly prompted to abandon her to her fate and to write off the investment to experience. Any further investment would be throwing good money after bad.

LOSS AVOIDANCE THROUGH MONITORING

A prudent interest-holder can avoid these pitfalls by periodically monitoring the condition and status of its vessels. A careful analysis of management correspondence, class records, and agency Final Statements of Account almost always reveals a pattern of small (and not-so-small) mishaps, accidents, crew disputes, off-hire times, unpaid debts, and other indicia of growing problems in the ship's trade or management. Among savvy interest-holders, a penny of vessel monitoring and supervision is worth a pound of uninsured losses.

An effective strategy to combat these dangers includes a review of agency accounts, Port State Control detention items, seizures (even those from which the vessel was quickly released), crew accounts, chandler accounts, chartering correspondence, and repair work orders. Of course, the monitoring and supervisory service must be at least as competent as the ship's management, or it will risk falling prey to clever misinformation.

TROUBLE SIGNS

The Statement of Facts is a valuable document when seeking signs of trouble. A high number of off-hire times, lost time due to chartering or stevedore disputes, etc., all indicate poor management and may be indicative of more serious problems. For example, repetitive off-hires due to crane down-time or to hatchcover malfunction indicate a failure to maintain the vessel's gear and equipment. A comparison of crane downtime and subsequent work-orders may also reveal that the owner is "cobbling together" crew repairs rather than ordering shore repairmen, which is also a sign of financial difficulty.

The "stretching" of resources is another indicator of trouble. A given type of ship in a given trade generates a relatively predictable amount and number of repair and supply requirements, the provision of which is usually arranged by a ship chandler. The master submits a requirements list to the owner (or directly to the chandler), and the owner orders or authorizes the chandler to provide them. Often, the owner will make some small deductions of items he wishes to defer providing, usually for perfectly legitimate reasons. However, an examination of the number of stricken items and their reasonableness (especially in comparison to previous chandler orders) may indicate that the owner is forcing the vessel to consume her spares, or even to do without necessary items. This evidence will usually be corroborated by the ship's correspondence, in which the owner will have advised the master that certain requirements are not forthcoming, and ordered him to have the chief engineer or chief mate "make do" with what's onboard.

Another strong indicator of the owner's policy toward his vessel is the level of crew pay. It is imperative that the owner pay his crew a wage within an acceptable range. He doesn't have to pay the most, but he shouldn't pay the least. An owner who instructs the crewing agent to find a chief engineer for $2,000 a month will get one, but the man may not be worth even that. Although an individual crewman, fully licensed and conscientious, may work for minimum wages, generally the quality of a crew is determined by the level of its pay. With a knowledge of representative crew wages for the various crewing nations like Russia, the Philippines, and Honduras, the reviewer can gauge the owners' intentions. Obviously, cheaper crews mean worse crews, but red flags also include a consistent downward trend in crewing sources For example, changing from Filipinos to Russians to Ghanians could indicate an unwillingness to properly maintain the vessel.

An analysis of a vessel's drydocking records may also reveal signs of trouble. The drydocking file should contain a list of proposed items submitted to the drydock for a bid or estimate. This is normally done after the vessel is placed in drydock for inspection, although it can carry items already scheduled for repair, such as known damage to the shell plating. The reviewer should check the number of items deleted from this list—repairs that were first though necessary and then cancelled for whatever reason—to see if the owner was trying to get through drydock at the least possible expense. The reviewer should also look for large numbers of class inspection items being deferred: class surveyors are usually reasonable about extensions for various reasons, and he may not have noticed an emerging pattern in the owner's requests for deferment, or have cared.

DEBTS THAT FOLLOW A SHIP

Another sign of trouble is the accumulation of debt. It is sometimes difficult even for the shipowner to maintain constant vigilance against the acquisition of foreign debt: orders of supplies and provisions by the master, fraudulent claims, adhesive port charges, etc., all engender debts against the vessel that remain after she has left port. Due diligence in monitoring his asset is even more difficult for a remote interest-holder. This is true in any situation, but it is especially difficult when the accumulation of debt is deliberate. Added to these shore-side debts are possible unpaid charter obligations such as bunker buy-back, cargo damage claims, and day-hire overage repayment. If deliberate, these debts are usually accompanied by other unpaid, legitimate debts to ship chandlers and shore repairmen in other ports who were innocent enough or desperate enough to allow the vessel to sail without payment.

Although a close analysis of true and complete copies of the vessel's correspondence and accounts would usually indicate the existence of such obligations, a clever owner can easily conceal them from his interest-holders through forged, changed, and incomplete documentation. This is of special concern now that routine correspondence is handled by email, a form of communication in which the "hard" evidence—the print-out of the emails—bears no evidence of manipulation.

The best defense against fraudulent reporting and accounting is familiarity with the chandlers and agents in the vessel's usual ports-of-call. Because it is unlikely that the shipowner will include shore suppliers in his payment plans, a call to the vessel's agents in the last five ports will normally reveal every unpaid bill. Local agents will gladly provide information concerning unpaid invoices since suppliers will first turn to them for payment.

CONCLUSION

Mortgage defaults do not occur overnight. The signs of a ship in trouble exist well before she is finally lost through seizure, sinking, or abandonment; the well-intentioned owner fighting for survival and the fraudulent owner pursuing an exit strategy both leave obvious signs of operational and financial irregularities in their wake.

By employing effective monitoring techniques, a prudent interest-holder can gain critical advance warning of problem loans and investments. To avoid missing critical red flags, the interest holder must employ technical knowledge, management experience and real-world expertise in the way ships are run.

The only alternative is to rely on the hope that the owner is properly protecting their collective asset and has only the best intentions. It is a natural tendency to say, "Well, she's still trading, so things must be going okay." But the fact is that every ship sails until she sinks, and just because the disaster hasn't happened yet doesn't mean it isn't just over the horizon.

Ship financiers have recently taken some well-reported losses due to seizure and voluntary abandonment. They are well advised to take a closer look at their portfolios during the term of a loan. Otherwise, hard evidence of fraud—and any hope of recovery beyond the hulk of the vessel—may be difficult to find after the owner disappears.

The great majority of shipowners are honest men (by industry standards), but it is of little solace to the defrauded interest-holder that he is the exception rather than the rule.

Captain Max Hardberger is an Unlimited Master Mariner, a Class Surveyor for Panama, Honduras and Belize, and a maritime lawyer. He currently serves as the Operations Director of Vessel Extractions, LLC ("VessEx"), a worldwide ship repossession and loan advisory specialist. VessEx provides a full range of technical and operational services to the shipping finance community at all stages of a loan's lifecycle, including technical due diligence services, ongoing monitoring of ships and their management, technical workout assistance, and ship repossession services. VessEx specializes in freeing ships from problem jurisdictions and moving them to jurisdictions which favor the mortgagee's interests. More information on VessEx can be found at www.vessex.com or can be gained by calling +1-415-276-1500.