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Ref : Chans advice/91

To: Transport Industry Operators

Ship release's security (III)

Remember Chans advice/90 that the Hong Kong Court of Appeal ordered the "Hua Tian Long"'s owner to provide US\$122,412,000 as security for releasing the ship? On 4/6/2008, the Hong Kong High Court held that the bail bonds issued by the Hong Kong branch of China Merchants Bank Co. Ltd. (CMB) as proposed by the shipowner was adequate.

In order to obtain the release of its ship, the shipowner had been ordered to provide bail of over \$122 million. The shipowner proposed to post such bail by way of bonds issued by the Hong Kong branch of CMB. The charterer said that the bail bonds were not an adequate surety and so the Court should reject them. The shipowner, on the other hand, said that CMB was good and sufficient surety for the purpose of providing security.

In support of its contention the charterer advanced a number of points.

First, citing The "PIYA BHUM" [2004] 1 SLR 564 (Selvam JC) the charterer suggested that a bail bond by a person without assets within the jurisdiction was worthless. Although the Hong Kong branch of CMB appeared to have assets of US\$2.4 billion, that "could be no more than the extent of its loan portfolio to Hong Kong entities". It was unclear whether the branch owned tangible movables or fixed assets against which execution could be levied in Hong Kong. Not enough information was known about the nature of CMB Hong Kong's assets.

Second, the charterer referred to a Federal Reserve Bulletin dated Fourth Quarter 2007. That stated:-

"CMB, with total assets of approximately [US]\$145.6 billion, is the sixth largest bank in China. CMB is indirectly controlled by the Government of China through a number of wholly owned companies. One of these companies, China Merchant Group, Limited, Shenzhen, People's Republic of China, indirectly owns approximately 17.6 percent of CMB's total outstanding shares. Two other government-owned companies, China Ocean Shipping (Group) Company and China Shipping (Group) Company, own 6.4 percent and 5.4 percent, respectively, of the shares of CMB. No other shareholder owns more than 5 percent of the shares of CMB."

The charterer was worried that CMB might not be independent of the Central Government or the Guangzhou Salvage Bureau of the Ministry of Communications which owned the ship.

Third, the charterer observed that the bail required was a substantial sum. The resolution of its claim before the Court would likely take "a number of years". Any security had to be good for the long term. In this connection, the charterer noted the following:-

- (1) Standard & Poor (S&P) gave CMB an A3 rating for short-term obligations. This meant that in S&P's view CMB:-
"has adequate capacity to meet its financial obligations. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitments."
- (2) S&P gave CMB a BBB- rating for long-term issue obligations. This meant that in S&P's view long-term financial obligations by CMB:-
"exhibit adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation."

The minus (-) showed "relative standing within the major rating categor[y]".

- (3) The ratings for CMB contrasted with the higher S&P ratings given to certain banks (such as HSBC and Hang Seng) which the charterer had recommended to the shipowner.

The charterer submitted that, in the adverse or changing economic climate which the world was facing, S&P's rating of CMB's creditworthiness legitimately gave rise to concern about CMB's ability to meet the bail bond (if called upon). The charterer further observed that little was known concerning the exposure of Mainland banks to the mortgage-backed securities and the American sub-prime market. Presumably by this comment the charterer meant to imply that CMB might not be as financially sound as it might at first blush seem.

Fourth, the charterer observed that an earlier version of the bond for a lesser amount had not been signed in accordance with CMB's internal requirements. The signatories of the earlier bond did not have the requisite authority to sign. A corrective second bond had to be put up in substitution for the earlier bond. This was a lapse in CMB's corporate governance which could not inspire any confidence in the reliability of its bonds.

In the Judge's view, on balance the proposed bond by CMB was adequate security.

First, the Judge assumed (without necessarily accepting) that Selvam JC was right in his conclusion in The "PIYA BHUM". The Judge also assumed that a substantial portion of the US\$2.4 billion assets of CMB's Hong Kong branch represented the latter's lending portfolio as the charterer supposed. Even then the Judge did not see why the debts owed to the Bank would not constitute assets against which the charterer (if necessary) could seek enforcement on the basis of any judgment in the charterer's favour. The shipowner had drawn the Judge's attention to an article in Business Week indicating that CMB would be acquiring a 53% stake in Hong Kong-based Wing Lung Bank. If that was right, plainly CMB would through the acquisition obtain tangible movable or fixed assets in Hong Kong.

Second, the concerns about possible intermeddling in CMB's affairs by the Mainland Government or the Ministry of Communications seemed to the Judge speculative and unsubstantiated.

Third, insofar as credit ratings were concerned, the shipowner pointed out that P&I Clubs from which the Court routinely accepted bail bonds had similar or lower ratings. Thus, for example, London Steamship Owners Mutual Insurance Association had a BBBpi rating (the "pi" subscript signifying that the rating given does "not reflect in depth meetings with an issuer's management and are therefore based on less comprehensive information than ratings without a 'pi' subscript"); Steamship Mutual Underwriting Association a BBB+ rating; West of England Ship Owners' Mutual Insurance Association a BBBpi rating; Swedish Club a BBB rating; and American Steamship Owners Mutual P & I Association a BB- rating. Accordingly, a BBB credit rating for long-term obligations, while obviously not as good as an A1 rating, should generally be adequate. The Judge was not persuaded by the charterer's speculative suggestion that CMB might have a large exposure in the US mortgage-backed securities and sub-prime lending markets. The Judge noted in relation to this that the Federal Reserve Bulletin referred to by the charterer also said this:-

"China has adopted risk-based capital standards that are consistent with those established by the Basel Capital Accord ('Accord'). CMB's capital is in excess of the minimum levels that would be required by the Accord and is considered equivalent to capital that would be required of US banking organization. Managerial and other financial resources of CMB are consistent with approval [by the Federal Reserve Board of a CMB branch in New York], and CMB appears to have the experience and capacity to support the proposed branch...."

There would in any event be an enormous disincentive for a Government to use its shareholding to intervene in the affairs of a major bank. Such intervention would immediately lead to an irreparable and fatal collapse in the bank's reputation and credibility with considerable financial losses to all, including the Government involved.

Fourth, that any bail bond provided should be a valid document signed by properly authorised officers of CMB seemed to the Judge a genuine matter of concern. But this concern could be catered for by a condition that any security provided be supported by an affidavit of an appropriate CMB officer confirming that the executed security complied with CMB's internal rules and regulations. Subject to such condition, the Judge did not think that it could be said that the proposed security is inadequate. The proposed CMB security was adequate.

Please feel free to contact us if you have any questions or you would like to have a copy of the Judgment.

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