Holland Knight

International Maritime Workouts

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Chapter 16

International Maritime Workouts

§ 16:1 Introduction

The majority of shipping loans are secured by vessels that operate internationally. In developing a workout strategy involving vessels engaged in "blue water" trades, the laws of a number of nations as well as international conventions may be relevant. An analysis not only of the lender's security but also of the relevant laws of nations where vessels are scheduled to call is an important first step in a maritime workout.

§ 16:2 Global nature of the maritime business

A shipping venture may touch a number of countries and involve the laws of a number of jurisdictions. For example, a vessel may be owned by Greek principals through a single-purpose Liberian owning company, fly the Panamanian flag, be chartered to Danish charterers, be mortgaged to a U.S.

bank, be entered with a London protection and indemnity (P&I) club, and have hull insurance placed through the German insurance market. The vessel may operate in a liner service, on the spot market, under a long-term charter, or as a tramp, going wherever her owner or charterer can find an available cargo. The vessel may be managed by owners, through a special-purpose corporation established to provide management services, or by professional managers based, for example, in Hong Kong, the U.K., or Norway. In short, the obligations and legal arrangements of a vessel and her owners may be affected by the laws of a number of nations, not the least of which is the law of the vessel's flag, which governs the vessel's registration and the creation of security interests in the vessel.

In all countries, particularly developing countries that have had little experience in maritime enforcement proceedings, inquiry must be made as to not only what the law says but also how it is applied. The discussion in this chapter refers to U.S. laws and procedures for purposes of illustration and as a measure against which the laws and procedures of other jurisdictions can be assessed. Advice from lawyers in pertinent jurisdictions should be obtained.

A myriad of business and practical concerns arise in workouts relating to vessels, such as chartering arrangements; owner's responsibility to crew, cargo, trade creditors, and other lenders; a vessel's in rem liabilities; insurance arrangements; environmental concerns, a vessel's state of repair; ship values; and local port conditions, to mention a few. Also, whereas U.S. law relating to security interests in oil rigs is the same as that relating to ships, rigs are seldom in port, so many of the problems that arise during workouts relating to rigs are different from those that arise in the workout of debts secured by ships. At an early stage, the workout team should seek the assistance of industry specialists to help evaluate alternatives and formulate workout plans.

§ 16:3 U.S. law governing security interests in vessels

In the U.S., the creation of security interests in ships and rigs is set forth in Chapter 313 of Title 46 of the U.S. Code,

which became effective January 1, 1989.[1] This new law replaced the Ship Mortgage Act (the 1920 Act), as amended.[2]

Prior to the passage of the 1920 Act, a mortgage had no maritime lien status, and the mortgage security, which ranked after all maritime liens, was practically worthless. The 1920 Act gave preferred lien status to mortgages on U.S. flag vessels (i.e., vessels documented under U.S. law).[3] The purposes of the 1989 amendments, which have been codified in Chapter 313, are to accommodate modern financing techniques not contemplated by the 1920 Act, to eliminate or modify certain citizenship requirements, to eliminate some formalistic requirements, and to clarify the rights of so-called Westhampton Trustees and mortgagees, which are not authorized to own vessels documented under U.S. law so that they might buy in a U.S. flag vessel at a foreclosure sale in the U.S. Although Chapter 313 has replaced the 1920 Act, Chapter 313 did not alter the procedure for enforcement of a preferred mortgage lien or the priorities of the preferred mortgage and preferred maritime liens.[4] However, as portions of the 1920 Act have been restated in somewhat different language, it remains to be seen how Chapter 313 will be interpreted by the courts. Section 31325 deals with enforcement. Section 31326 deals with priorities.

§ 16:4 Securing the loan

The first steps in planning a maritime workout are taken when the transaction is documented. These steps are as follows:

1. Determine all possible jurisdictions to which the vessel may trade.
2. Draft documents that reflect any peculiarities required by the laws of the identified jurisdictions, and incorpo-

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[1]46 U.S.C.A. §§ 31301 to 343.

[2]Ship Mortgage Act, 41 Stat. 1000 (1920).

[3]In 1954, Congress amended the 1920 Act to include the enforcement of preferred mortgages on foreign flag vessels.

[4]As originally enacted, the language of Chapter 313 omitted provision for the foreclosure of a preferred mortgage covering a non-U.S. flag vessel through an in rem proceeding in the U.S. district court. Since it was not intended that Chapter 313 change the enforcement procedures existing under the 1920 Act, Congress amended 46 U.S.C. §§ 1021 et seq. to correct this and other inconsistencies between the 1920 Act and Chapter 313.

rate provisions designed to protect the mortgage and give the mortgagee flexibility should enforcement become necessary.
3. Clearly describe owners warranties, and provide for events of default and a range of remedies.
4. Take all actions necessary to perfect the preferred mortgage lien and the mortgagee's security interests in the vessel's earnings and insurance, if applicable.

In a typical ship financing, the lender's principal collateral consists of security interests in the ship (a mortgage), the ship's earnings, and the ship's insurance claims. The lender may also receive personal or corporate guaranties, pledges of stock or of the ship owning company's cash collateral accounts, and interests in nonmaritime property.

Different laws might govern the various pieces of collateral and the security interests to be perfected. If the ship is a U.S. flag vessel, the security interest is governed by Chapter 313. The security interest in the earnings is likely to be governed by the version of the Uniform Commercial Code (UCC) in effect in a particular state of the U.S. The security interest in the insurance policies might require consideration of the law of England or some other jurisdiction, depending on the market in which the insurance is placed.

Even though ships are constantly moving about the world, the lender has limited options as to where to foreclose the mortgage if a default occurs. In some countries where the vessel is scheduled to call, the laws or the court system or both may be unsuited or deficient for dealing with foreign security interests. If it is expected that owners will continuously trade a vessel in or between countries whose legal systems are unfavorable for the enforcement of mortgages, the lenders need other or additional security. These issues should be considered when counsel is drafting the loan documents.

To the extent possible, the mortgage should be clear and understandable. A judge in a court that is not in one of the world's major ports or a judge who has limited or no experience with ship mortgage foreclosures might come to a surprising conclusion when asked to interpret complicated security documents that may have been prepared in another language and to which another country's law is applicable. Even a judge in a major financial center might come to an unexpected conclusion in trying to interpret the complex provisions seen in some mortgages and indentures.

The difficulties in predicting where and in what kind of situation the ship will be when a mortgage default occurs dictate that the mortgage should contain the widest possible range of remedies so as to give the lender maximum flexibility. Most lenders do not want to become a mortgagee-in-possession, but if the ship is stranded in a port where foreclosure is not feasible and the shipowner refuses to cooperate with the mortgagee or has ceased operations, taking possession may be the only alternative available to the mortgagee. Therefore, this remedy should be included in the mortgage provisions. Similarly, the remedy of private sale by exercise of a power of attorney given in the mortgage may be useful in situations where the vessel is, for example, in a jurisdiction where judicial foreclosure is not a viable option and the shipowner is unwilling to sign a bill of sale.

It is also important when drafting loan documents to make sure that the provisions of all of the security documents work together. If there are defaults and acceleration provisions in both the loan agreement and the mortgage, these should be consistent. Likewise, if the lender has a guaranty as part of the security package, the terms of the guaranty should be consistent with the terms of the mortgage. The notice provisions, as well as any grace provisions, should be clear, and periods should be as short as the lender can negotiate so that, when necessary, the lender can move quickly to protect its security interest. It is important to make sure that a bankruptcy filing by the shipowner will result in an automatic default and acceleration of a debt without the need for notice because a bankruptcy filing in the U.S. results in an automatic stay,[5] which precludes the lender from giving notice of default. If the lender is unable to give notice of default, it may not be able to proceed against other collateral not affected by the stay, such as a guaranty or letter of credit.

It is also necessary to ascertain that all security interests have been perfected. In the case of a stock pledge, this means obtaining and maintaining possession of the pledged shares if they are in certificate form, preferably with stock powers and undated resignations of the officers and directors.

§ 16:5 Monitoring the loan

Once a ship financing transaction is properly documented

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[5]11 U.S.C.A. § 362.

and the security interests are perfected, the documents cannot be put aside and forgotten. Typically, the loans are several years in duration, and the lenders must continuously monitor the shipowner's compliance with the requirements of the loan documentation.

Under the terms of the loan documentation, owners are usually required to provide information on charters and periodic financial reports, as well as other financial and operational information to lenders. Such information can presage financial difficulties. The lender must be vigilant to ensure that this information is forthcoming and is evaluated upon receipt.

The loan agreement may also provide the lender with the right to inspect the vessel upon reasonable notice to the owner. It is important that the lender avail itself of this right to inspect the vessel on a periodic basis over the life of the loan. Often, lack of maintenance is one of the first signs of financial trouble.

§ 16:6 Checklist: monitoring fulfillment of loan requirements

1. *Insurance*. Insurance policies expire and must be renewed. Underwriters might change. The lender must make sure that the shipowner remains in good standing with its P&I club, that the lender continues to be a named insured or loss payee in the renewal of hull and machinery policies if that is required in the loan documentation, that deductibles are not increased, that the terms of coverage are not changed in an unsatisfactory manner, and that premiums are paid promptly.
2. *Classification.* All vessels are enrolled with a classification society whose responsibility it is to periodically monitor the condition of the vessel and her machinery and to ascertain compliance with the requirements of class. It can be very helpful to have a provision in the loan documentation authorizing the lender to freely access the vessel's class records.
3. *Charters.* A charter generating cash flow to service the debt might expire. The borrower may enter into new charters with respect to the ship. Charters may be canceled for any of a number of reasons, including but not limited to the outbreak of hostilities between certain specified countries. The lender must make sure that its security interest in the charter or any new charter remains perfected.

4. *UCC filings.* Continuation statements under the UCC should be filed for any form of security where a UCC filing was initially made. The original filings are good for five years, and the continuation statement must be filed within six months of the expiration of the five-year term and is only good for another five years.
5. *Change in terms.* If the lender and shipowner agree to change the original terms of the deal, an amendment to the mortgage might be necessary. If the terms are changed, care must be taken to record the amendment if the laws under which the ship is registered require such.

§ 16:7 Indications of problems

The first indication of an owner's financial difficulty is often a failure by the owner to comply with covenants in a loan agreement or mortgage other than the obligation to pay principal or interest. An owner cannot conceal a missed principal or interest payment and therefore generally continues to make these payments in the hopes of concealing financial difficulties from the lender. In order to make principal and interest payments when insufficient cash flow exists within the company, an owner might, for example, postpone a scheduled drydocking, defer maintenance on the vessel, delay payments to underwriters, or fail to pay third-party creditors who have furnished bunkers or other supplies or provided services to the vessel. The failure to pay crew or to remit payments to its crew's pension and welfare fund can also be an indication of brewing financial troubles. Common indicators of financial trouble include the items given in checklist § 16:8.

The lender may learn of these events through an arrest of the vessel or a communication from a third party. Such communication can take the form of a notice of cancellation of insurance because of a missed premium payment, an attachment of one of the owner's bank accounts with the lender, or a request to post security to free the vessel from an arrest. Any of these indicators should ring alarm bells and the lender should immediately take steps to determine the extent of the owner's financial problems.

§ 16:8 Checklist: warning signs of financial trouble

1. Deterioration of maintenance
2. Deferral of payment due to insurance underwriters

3. Mounting trade debt
4. Vessel arrests
5. Late payments
6. Changes in trading patterns
7. Depressed ship values
8. Depressed freight rates
9. Problems with charterers
10. Requests to post security
11. Request to refinance or to extend further credit
12. Failure to pay crew, home allotments or pension funds

§ 16:9 The workout team and information gathering

The planning of strategy in most ship financing workouts involves collaboration among the lending officers, the lender's in-house workout specialists, legal advisers, and one or more outside organizations or independent experts brought in to give practical advice on the custody and operation of ships, market conditions, ship valuation, insurance, chartering, and other factors.

Once the workout team is in place, it reviews the documentation and gathers information.

§ 16:10 Checklist: workout information to be obtained

1. *Loan documentation.* The loan documentation should be reviewed to determine the lender's rights as well as to determine any weakness in the documents that may affect the lender's ability to enforce its rights.
2. *Charter party.* If the ship is subject to a charter party, its provisions should be reviewed to determine whether it is above or below market, its term, and the extent to which the lender can step in and perform the charter, change the manager of the ship, terminate the charter if necessary, and so on. Many charter parties expressly provide that the charterer can cancel if there is a change in ownership or management. Even absent an explicit provision for cancellation in a charter, a change in the ownership may give the charterer a right, by law, to cancel. This right is based on the proposition that the charterer bargained for performance from a particular owner and is not required to accept performance from another even though the ship is the same.
3. *Trading patterns.* The trading pattern of the ship

should be reviewed. This information is useful for several reasons. It helps, for example, in anticipating problems that will arise if the ship is arrested by trade creditors and in determining whether particular scheduled ports are suitable for foreclosure.

4. *Insurance policies.* Policies can be subject to cancellation if there is a change in the management of the ship without the consent of underwriters or if there is a sale of the ship. Also, it should be determined that the lender will receive sufficient notice of cancellation to protect its interest. The lender must consider the insurance aspects of a casualty or the ramifications of the owner's delinquency in payment of premiums.
5. *Trade debt.* The lender should also obtain as much information as possible about the trade debt on the ship, the nature of the various claims, and the place where each major claim arose. This helps the lender to determine which trade creditors are likely to be significant players in a workout or bankruptcy. The lender can then work with counsel to prepare appropriate strategies to deal with arrests in particular ports.
6. *Review of borrower's books.* In order to obtain information about trade debt and other financial information about the borrower, the lender may put people in the borrower's office for a period of time to review the borrower's books and records with the borrower's financial officers. This is an area in which the lender is particularly in need of guidance. What frequently happens is that the lender's representatives become more and more involved in the day-to-day operations of the borrower, making suggestions as to which bills should be paid and which should be deferred and controlling the release of funds from bank accounts. As the control by the lender increases, so does the risk of the lender's possible exposure to claims by other creditors of the borrower or to lender liability claims by the borrower.
7. *Vessel surveys.* Typically, the loan documentation provides the lender or its authorized representatives with full and complete access to the mortgaged vessel for the purpose of inspecting the vessel, her cargo, and her papers. In order to ascertain the current condition of a vessel's hull and machinery, the workout team should appoint surveyors to inspect the vessel and report back to the lender. Surveys can usually be arranged and carried out promptly and without causing delay to the vessel.

8. *Classification records.* In order to obtain insurance, a vessel must be entered with a classification society which monitors a vessel's construction, hull and machinery repairs, and conducts periodic surveys. Lenders cannot access a vessel's classification records without the owner's consent, which should be obtained if not already contained in the mortgage provisions.
9. *Valuation.* In order to determine what a vessel might bring from a willing and independent buyer at an arm's-length sale and as some measure of what she might bring at auction at any given point in time, valuations can be obtained from ship sale and purchase (S&P) brokers. These are called "desktop" valuations because the valuer does not leave his desk to do it. Unless requested, no physical inspection of the vessel is made. Valuations are particularly relevant if the mortgage contains "top up" provisions that require the owner to provide additional collateral if, for example, the mortgage debt exceeds 80% of the vessel's value. S&P brokers' valuations are given on the assumption that the vessel is in class and in good condition and reflect recent sales of vessels of similar type and class. "Desktop" valuations do not reflect the current physical condition of the vessel and are subject to change with market fluctuations.

§ 16:11 Workout strategies—Analysis of debtor's problems

An initial step in the construction of a workout strategy is an analysis of the reasons for the debtor's financial difficulties. Determine whether the difficulties are due to unanticipated expenses, cash flow difficulties that will correct themselves, a downturn in the global shipping economy, poor management, or other reasons. Once the lender has determined the reasons for the debtor's problems, it can choose one of three principal strategies:

- Liquidation of the collateral
- Infusion of additional cash against additional collateral
- Restructuring the existing loan

§ 16:12 Examination of each vessel in a fleet

When a fleet of ships is involved, the liquidation strategy should be considered on a ship-by-ship basis rather than a fleet basis. Some ships may be old and rundown and suitable

only for scrapping. Others may be new and in good condition but have no employment. Still others may have profitable charters or other forms of employment.

§ 16:13 Relationships with other lenders

The first stage in a workout where there is more than one lender may be a search for a global solution involving all of the lenders and continued operation of all or part of the fleet under auspices of the shipowner with additional working capital supplied by the lenders. Some workout veterans regard this as the "wishful-thinking" or the "whistling-in-the-dark" phase. Generally, the shipowner argues that its problems are short term, arising because of bad luck or a temporary market slump, and requests a cash infusion for working capital to tide it over until the market improves.

The disadvantages to the lender of supporting the operations of a struggling owner are, on the business side, obvious. Usually the additional infusions of cash required from the lender in order to prevent arrests of the ships by trade creditors and to keep the ships moving are substantial. On the legal side, the increased involvement by the lender in the management of the borrower almost inevitably increases the risk mentioned earlier that trade creditors will attempt to establish claims against the lender, either on the basis of an express agreement to pay or because the conduct of the lender's representatives is claimed to have misled a creditor into believing that the lender would take responsibility for the shipowner's debts. Increased involvement in management also increases the lender's exposure to lender liability claims from the borrower after the market turns and ship values increase.[1]

§ 16:14 Action short of foreclosure

In the course of developing a workout strategy, it may become apparent that a restructuring of the loan is in order

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[Section 16:13]

[1]For a general discussion of the issues concerning lender liability, see chapter 8. For lender liability cases involving shipping loans, see *Sharma v. Skaarup Ship Management Corp.*, 916 F.2d 820, 1991 A.M.C. 778 (2d Cir. 1990), in which the Court of Appeals for the Second Circuit limited a borrower's damages for wrongful repossession and breach of good faith to the market value of vessels at the time of their transfer in a workout context. Accord *Midland Bank v. Varardi Shipping Corp.*, No. 89-17532, slip op. (N.Y. S. Ct. Dec. 28, 1990).

rather than liquidation. The borrower might be confronted by one or more unanticipated expenses that make it impossible to meet a scheduled principal or interest payment. The borrower might miss a single payment or several. If it appears that the borrower just needs time to get control of its finances, it may be appropriate to either grant a principal and/or interest moratorium or restructure the loan against new or additional security rather than foreclosure.

Once the decision has been made to grant the borrower a moratorium or enter into a restructuring, such agreement should be formalized. The written agreement should contain a merger clause to preclude a future assertion by the borrower that the agreement was something other than or in addition to what is contained in the security documents. Consideration should be given to obtaining a release from the borrower with respect to any prior conduct of the lender. This is especially important in those situations where a borrower may later attempt to assert, either affirmatively or defensively, a lender liability claim.[1]

It is also prudent to ascertain whether there is additional security that can be obtained from the borrower. This should be one of the primary goals of the workout team. The team should look for additional assets, potential guarantors, and other collateral that the borrower has and against which the loan may be cross-collateralized.

When the workout team considers additional security, it should remember that there is the potential for the additional security to be set aside as a preference in a bankruptcy or other insolvency proceeding. The preference period in the U.S. is 90 days prior to the filing of a petition seeking relief in a bankruptcy proceeding and more time for insiders. Any additional security obtained during this period is subject to avoidance by the trustee if it is determined that it was obtained without sufficient new consideration. Generally, the only penalty for obtaining the preferential security is that it will be set aside. The preferred course of action is to obtain the additional security, even if it may later be set aside. Often, the additional security does become effective because the 90-day period has expired or the borrower never files or is not put into bankruptcy.

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[1]See *Sharma v. Skaarup Ship Management Corp.*, 699 F. Supp. 440, 1989 A.M.C. 910 (S.D. N.Y. 1988), aff'd, 916 F.2d 820, 1991 A.M.C. 778 (2d Cir. 1990).

Any time that additional security is obtained from a borrower, the borrower should be encouraged to consult with independent legal counsel. The independent counsel should be provided with copies of all documentation surrounding the acquisition of the additional security. This is done to anticipate a possible challenge that the additional security was obtained through duress. Members of the workout team should seek affirmative proof that the borrower has in fact consulted its counsel.

There are certain times when a lender should not seek additional security. If the effect of obtaining additional security is likely to cause third-party creditors to force the borrower into bankruptcy, the lender should not seek additional security. Also, the lender should not seek additional security where the effect is to cast suspicion on the lender's original security. For example, it may be more prudent to obtain a second mortgage on another vessel than to amend the original mortgage to cover the second vessel.

The workout team should watch for and attempt to restrict third-party creditors' attempts to obtain additional security without sufficient new consideration.

§ 16:15 Bankruptcy

With respect to traditional ship mortgage financings, bankruptcy has not been an effective way of maximizing recovery on assets of a failing shipping enterprise engaged in worldwide trade. In fact, some shipowners have used a bankruptcy filing as a tactic to avoid foreclosure on a vessel, requiring the creditor to move to lift the automatic stay. More recently, bankruptcy has proved to be an effective tool in restructuring the high yield debt of a shipping enterprise. Drill rig owners have been more successful than mortgage financed shipowners in coming out of Chapter 11, perhaps because the main asset is less mobile.

§ 16:16 Sale of vessels

The principal methods of realizing on the lender's security interest in a ship are:

- Judicial foreclosure by a court with admiralty jurisdiction sitting "in rem";
- Extrajudicial sale of the ship, with the mortgagee exercising the power of sale contained in the mortgage;
- Extrajudicial sale of the ship by the borrower, with the

consent of the lender, the proceeds of the sale being paid to the lender.

§ 16:17 Judicial foreclosure

The greatest advantage of the judicial foreclosure is that with very limited exceptions, it results in a sale of the ship free and clear of all liens, charges and encumbrances. In contrast, the exercise of the power of sale in the mortgage or the sale by the shipowner does not divest the ship of liens, charges, and encumbrances. Therefore, if the ship is burdened by substantial trade debt or other liens, a judicial foreclosure may be necessary, and it may be the only practical way of proceeding if the shipowner is uncooperative.

Other factors to be weighed when considering whether to proceed by judicial foreclosure include the time required to bring the vessel to auction, which, even in the most favorable jurisdiction, is a minimum of two months; the costs of lay-up, maintenance, and other custodial expenses; sale commission and attorney fees; and the price achievable at auction, which might be only a distress price unless the lender is prepared to bid at the auction and take title to the vessel if no higher bidder appears.

§ 16:18 Extrajudicial sales

If trade debt on the ship is minimal and the owner is cooperating with the lender in the workout, judicial foreclosure may not be required. In such case, the right of private or extrajudicial sale should be considered. The extrajudicial sale can be effected in one of two ways: The shipowner can execute and deliver the title documents, or the mortgagee can do this on behalf of the shipowner pursuant to the power of sale contained in the mortgage. The extrajudicial sale is relatively speedy and inexpensive. However, this method requires the owner's cooperation, or at least the owner's acquiescence and noninterference. A disadvantage, from the point of view of the lender, is that in order to obtain the highest possible price for the ship, the lender may be asked to give the buyer an indemnity against third-party liens on the ship. Further, if the private or extrajudicial sale is not conducted in a commercially reasonable manner, a lender runs the risk that any deficiency judgment obtained later will be reduced by the difference between the amount realized on the sale and the then-market value of the vessel. In view of the potential pitfalls associated with an extrajudicial

sale, it is recommended that the lender encourage the shipowner to be represented by counsel during this phase of activity. Recent amendments to the mortgage enforcement provisions of the Maritime Lien Act clarified that the remedies available under the act do not preclude the exercise of other lawful remedies available to mortgagees, including "self-help" remedies.[1]

§ 16:19 Mortgagee-in-possession

A standard ship mortgage contains provisions permitting the mortgagee to assume possession and control of the ship and to become mortgagee-in-possession. For numerous reasons it may become necessary or advisable for the mortgagee, as an interim measure, to take effective possession and control of the vessel in order to protect its value as collateral. The most usual reason for a mortgagee taking possession is to move the vessel of an uncooperative owner from an unfavorable jurisdiction to a jurisdiction favorable for foreclosure of the mortgage.

Normally becoming a mortgagee-in-possession is a matter of de facto control by the mortgagee. Certain countries do not permit a mortgagee to be in possession, while others, such as Greece, permit it only under certain types of mortgages. Furthermore, the rights of a mortgagee-in-possession will vary according to applicable law.

Once lawfully in possession, the mortgagee is generally entitled to receive all earnings of the vessel.

When actual possession is not possible by reason of the vessel's situation, the mortgagee may take constructive possession. This is usually done by giving notice to the owner, the master, and the other persons interested (e.g., underwriters, insurance brokers, charterers, and bill of lading holders).

If the mortgagee takes possession and continues to operate the vessel, it risks being held vicariously liable for damage caused by the negligence of those on board, in particular, for environmental and pollution claims with respect to collisions and spillage or leakage of cargo and bunkers. In the United Kingdom and certain other jurisdictions, the mortgagee-in-possession is entitled to the benefit of the

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[1]46 U.S.C.A. § 313(b)(3).

statutory provisions limiting the shipowner's liability in damages, but this still leaves serious exposure. Protection and indemnity insurance should cover much (if not all) of this exposure.

Another danger is that, as the mortgagee's control increases, the potential liability to the owner and to third parties also increases. As to the owner, the mortgagee may be liable for any mismanagement of the vessel and may be required to account for operating profits during the period of possession and control. As the mortgagee's involvement becomes known in the trade, trade creditors may seek recovery from the mortgagee for their back claims as well as current ones. Creditors will argue that they extended credit in reliance on the mortgagee's credit and may assert that representations have been made to them that the mortgagee agreed to pay their past charges as well as current ones.

In some circumstances, it may be possible for the mortgagee, while maintaining a reasonable level of de facto control over the management and operation of the vessel, to reduce its risk of being considered as a mortgagee-in-possession, with the latter's attendant problems with regard to the owner and other creditors. A mortgagee-in-possession, like an owner or general agent, cannot incur liens on its own behalf. The mortgagee-in-possession is in the same position as was the shipowner insofar as its obligations to third parties are concerned. This status does not make the mortgagee liable for obligations incurred prior to the time that the mortgagee assumed possession. Nevertheless, since most trade debt claims give rise to a lien, the lender who assumes the role of mortgagee-in-possession must be prepared to deal with claims arising prior to the time that it assumes possession in order to avoid arrest of the ship and to continue operation.

In practice, expenses will be incurred in preserving the vessel until it is sold, and in selling it, some of which may be recoverable as part of the mortgage debt. Expenses of the mortgagee-in-possession in the nature of current upkeep, renovation, and repair, will have to be evaluated according to the dual tests of necessity and reasonableness; necessity in the context of preserving the value of the mortgage security, and reasonableness in terms of cost.

If the lender's primary purpose in becoming a mortgagee-in-possession is to permit continued performance of a profitable charter, generally an assignment of all right, title, and interest in the charter that expressly authorizes the

mortgagee to perform, and to which the charterer has consented, is necessary. If the charter assignment is merely an assignment of all moneys due and to become due under the charter, the charterer may not have to accept performance of the charter by the lender as a mortgagee-in-possession.

§ 16:20 Exercise of stock pledge

Another remedy through which the lender may continue operations of the ship is to exercise its rights as pledgee of the stock of the shipowning corporation. If the lender has a stock pledge, the lender can call stockholders' meetings and elect its own directors and officers to manage the corporation. Those elected continue performance of existing charter parties in the name of the corporation. Because performance is continued in the name of the borrower, this procedure might enable the lender to continue performance even where the charterer has not consented to an "all right, title, and interest" assignment. If the lender assumes effective control of the borrower by exercising its rights as pledgee of the stock, the risk exists that the lender will be held liable to third parties to the same extent as if it was mortgagee-in-possession.

§ 16:21 Insurance recoveries

Insurance claims are a potential source of recovery for the lender that are frequently overlooked. A lender should review all the available information on insurance claims. If a large enough amount is at stake, the lender should retain an insurance specialist to assure that the claims are properly presented and to follow up on the adjustments.

§ 16:22 Liquidation: judicial foreclosure

The general rule is that the sale of a vessel in rem, by a court of competent jurisdiction sitting in admiralty, entitles the purchaser at the auction to take the vessel free and clear of all liens, claims, and encumbrances and enables the appropriate court officer—in the U.S., the U.S. marshal—to

deliver a clean bill of sale to the purchaser.[1] All recorded mortgages and unrecorded, secret liens and claims are transferred to the proceeds of the sale and can never again be asserted against the vessel. A proper judicial sale has the effect of transferring title "free of all . . . claims."[2]

§ 16:23 Preliminary considerations—Choice of forum for foreclosure

Of primary importance is that the foreclosure take place in a favorable jurisdiction. A favorable jurisdiction is one where the law gives high priority to the mortgage, where the judicial system is fair and predictable, where there is a tradition of foreclosing mortgages on vessels and experience among both counsel and court so that the process is not overly time-consuming and expensive, where the costs associated with the foreclosure process are reasonable, and out of which the auction proceeds are freely transferable.

§ 16:24 Cargo

It is always a risk to arrest a vessel for the purpose of foreclosing the mortgage when there is cargo aboard. In many jurisdictions, cargo owners are in a position to assert claims against the ship in rem for discharge and transshipment charges and damages incurred by reason of delay or damage to cargo. Discharge and transshipment charges while in custodia legis have been held to qualify as administrative costs with priority to the mortgage.[1] In certain jurisdictions these cargo-related claims might have priority over the mortgage. Every effort should be made to arrest the vessel cargo-free. This avoids the expense, delay, and complication arising from the presence of cargo and also avoids the presence of another party in the proceeding, which can result in further delay.

[Section 16:22]

[1]See *Morgan Guar. Trust Co. of New York v. Hellenic Lines Ltd.*, 38 B.R. 987, 10 Collier Bankr. Cas. 2d (MB) 1156, Bankr. L. Rep. (CCH) ¶ 69752, 1984 A.M.C. 1074 (S.D. N.Y. 1984).

[2]46 U.S.C.A. § 31326. Cf. *The Trenton*, 4 F. 657, 661 (E.D. Mich. 1880) ("In short, the doctrine that the sale of a vessel by a court of competent jurisdiction discharges her from liens of every description, is the law of the civilized world.").

[Section 16:24]

[1]*Morgan Guar. Trust Co. of New York v. Hellenic Lines Ltd.*, 593 F. Supp. 1004, 1985 A.M.C. 800 (S.D. N.Y. 1984).

§ 16:25 Cooperation of owners

If the owner cooperates or is at least passive, the foreclosure process will proceed more expeditiously than if the owner resists. If the mortgage is in default because of nonpayment of principal and interest, the owner has little basis for resisting a foreclosure proceeding. There are, of course, many possible defaults under the standard mortgage terms, such as failure to maintain the vessel in class, failure to make repairs, and failure to maintain insurance, but these types of defaults may be difficult to prove to the satisfaction of a court, which has to decide whether to put the owner's prime, and perhaps only, asset up for auction. The owner might argue about standards of repair or pay up its insurance, and it may argue that the defaults are only "technical" and not substantive defaults. However, if there is a default with respect to payment, the proper notice has been given, the loan has been accelerated, and the owner has been given an opportunity to make payment but fails to do so, the owner is in a poor position to argue that mortgage enforcement proceedings are inappropriate. In such circumstances, owners often choose not to appear in the proceedings.

§ 16:26 Other creditors

Before judicial foreclosure is undertaken, efforts should be made to ascertain the identity of other creditors that may have in rem liens against the vessel. Even within the same fleet and within the same jurisdiction, one vessel might be a candidate for foreclosure and another not, because, for example, one ship might have a large repair claim outstanding and another might be free from claims. One jurisdiction may give priority to a repair claim or bunker claim over a mortgage, whereas, under the laws of the jurisdiction of the next port of call, the mortgage may have priority over the repair or bunker claim. Again, the appearance of a creditor in the court where the lender is trying to enforce the mortgage might affect the speed at which the vessel is brought to judicial sale. Trade creditors might deliberately arrest in a port unfavorable to the mortgagee to try to obtain settlement of their claim in exchange for release of the vessel.

In the situations where a creditor arrests first, the lender must decide whether to join in the arrest and bring the vessel to foreclosure in that jurisdiction or to deal with the creditor and so enable the vessel to sail out of a jurisdiction that

is unfavorable because of unfavorable court procedures, because a particular claim has priority over the mortgage in that jurisdiction, or because the vessel has cargo to be delivered elsewhere.

§ 16:27 Procedure to auction

Assuming that all factors lead to the conclusion that the vessel should be arrested by the mortgagee in the U.S. for the purpose of foreclosing its mortgage, the matter will proceed in a U.S. district court in the manner described here.

§ 16:28 Commencement of proceedings

An in rem arrest leading to a judicial sale is commenced by the filing of a verified complaint in the U.S. district court within whose jurisdiction the vessel is or is expected to be at the time of arrest.[1] After a pre-seizure judicial review to determine the sufficiency of the complaint,[2] and assuming that the court approves issuance of a summons and warrant of arrest, the U.S. marshal will proceed to arrest the ship.[3] Before arresting, the marshal will require a monetary advance to cover insurance and keeping expenses, as the marshal must maintain the vessel in custody. In many ports, the marshal is required to place twenty-four hour guards on the ship. The arresting party is, of course, required to pay this expense. Depending on the requirements of the district court in whose jurisdiction the vessel is arrested, the initial amount required to be advanced can be anywhere from $1,000 to $10,000 or more. The marshal will periodically ask for additional advances to cover expenses incurred throughout the period of arrest. Most districts require that arrangements for a substitute custodian be made prior to arrest, and, in any case, it is advisable to make such arrangements which, are at the arresting party's expense.

The marshal "arrests" the vessel by placing a copy of the court order of arrest on the ship's wheel or another prominent

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[Section 16:28]

[1]See Fed. R. Civ. P. Supp. Rule C.

[2]See Fed. R. Civ. P. Supp. Rule C(3)(ii)(A) for a discussion of the constitutionality of this procedure, see *Washington Mut. Bank v. Bellatrix*, 2 F. Supp. 2d 1458 (N.D. Cal. 1997).

[3]For a description of the Marshal's duties, see pertinent provisions of the Manual for United States Marshals (as revised October 2003) reprinted at 2006 AMC 2083.

place in the wheelhouse. The notice of arrest informs the master of the vessel, as well as the general public, that the vessel is under the custody of the U.S. marshal and that it may not sail pending adjudication of the arrest proceedings.[4] Any person claiming an interest in the vessel has the right to a prompt post-arrest hearing which is in the nature of a show cause hearing.[5]

§ 16:29 Practical matters after arrest

After the arrest, the lender must decide whether to advance funds to pay off the crew and reduce it to a skeleton force. It is in the mortgagee's interest to reduce the crew as crew wages enjoy a priority superior to the mortgage and continue to accrue as long as the crew remains on board the vessel. If a substitute custodian has not been retained in advance of arrest, one should be appointed to see to safe lay-up of the vessel. The substitute custodian can be a local ship's agent. In some circumstances, the ship's master may be appointed substitute custodian. Care should also be taken to see that any advances made to pay off the crew, to maintain the vessel's machinery, or to pay for food for the crew are recognized as an administrative expense and accorded a high priority by the court. A court order should be obtained authorizing these categories of 'expenditures as expenses incurred while a vessel is in "custodia legis" cannot create a maritime lien,[1] and as long as expenses are reasonable and necessarily incurred, they will be reimbursed, with top priority, out of the auction funds as "expenses of justice." Obviously, it is easier to get such an order when there are no other parties to the litigation. The mortgagee is interested in preserving the value of the asset pending judicial sale so as to bring the highest possible price; other creditors are only interested in being paid on their claims.

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[4]To "rescue" a ship from the marshal's custody is a felony. See 18 U.S.C.A. § 2233 (1994). See also *U.S. v. Spicer*, 547 F.2d 1228 (5th Cir. 1977).

[5]Fed. R. Civ. P. Supp. Rule E(4)(f). Cf. *Lion de Mer, S.A. v. M/V Loretta D*, 1998 A.M.C. 1410, 1998 WL 307077 (D. Md. 1998).

[Section 16:29]

[1]See *Oil Shipping (Bunkering) B.V. v. Royal Bank of Scotland plc*, 817 F. Supp. 1254, 1993 A.M.C. 1774 (E.D. Pa. 1993), order aff'd, 10 F.3d 176, 1994 A.M.C. 879 (3d Cir. 1993) and aff'd, 10 F.3d 1015, 1994 A.M.C. 892 (3d Cir. 1993); *Transamerica Commercial Finance Corp. v. F/V Smilelee*, 944 F.2d 186, 1993 A.M.C. 1216 (4th Cir. 1991).

If the owner does not appear in a timely manner after service of the warrant of arrest on the vessel and filing of the complaint with the district court, a notice of owner's default is published. This notice must follow a prescribed form and comply with the local court rules.

§ 16:30 Order of sale

At the appropriate time, the mortgagee's counsel should make a motion for judicial sale of the vessel. In the U.S., a district court will order an interlocutory sale prior to judgment if it can be shown that the ship is a wasting asset (i.e., if it is not being properly maintained and is subject to deterioration, decay, or injury or if the expense of maintaining the vessel under arrest is excessive or there has been unreasonable delay in securing its release).[1] In connection with this motion for interlocutory sale, counsel can also apply to the court for permission for the mortgagee to bid at the auction on credit using its mortgage debt or by submitting a letter of credit rather than cash.[2] If such an order can be obtained, it gives the mortgagee flexibility in its bidding strategy because, if the mortgagee is the high bidder, it will not have to tie up funds in addition to the amounts outstanding under the mortgage except as may be required to secure claims that might be adjudicated to have a higher priority than the mortgage, outstanding administrative expenses and the marshal's poundage, or commission, which is set by statute.

The order of sale issued by the court normally stipulates the court's advertising requirements for the sale, as well as the terms of the sale. The mortgagee, if it chooses, can undertake wider advertising and make contact with its own network of potential buyers with a view to encouraging bidding at the auction.

§ 16:31 Establishment of lender's bidding vehicle

Although a mortgagee is under no obligation to bid, it is in the mortgagee's interest to be prepared to bid at the foreclosure sale and, if necessary, to take title so as to assure that

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[Section 16:30]

[1]See Fed. R. Civ. P. Supp. Rule E(9)(b).

[2]Cf. *Small Business Loan Source, Inc. v. F/V ST. MARY II*, 361 F. Supp. 2d 570, 2005 A.M.C. 1792 (E.D. La. 2005). The local rules in certain districts specifically provide for credit bidding by the mortgagee.

the vessel is not sold at too low a price. Once it is determined that the lender will participate at the foreclosure sale, it is necessary for the lender to consider the ownership structure under which the vessel will be held if the lender turns out to be the highest bidder. The lender must consider the laws of the jurisdiction where the sale will be held, the flag of the vessel at the time of the sale, and whether the vessel will be going into lay-up, will be traded, or will be promptly sold. Normally, a lender should anticipate taking ownership of the vessel through a subsidiary or affiliate in order to attempt to avoid the potential liabilities associated with being a shipowner. The lender might also subsequently determine that it is more advantageous subsequently to sell the shares of the affiliate or subsidiary rather than selling the vessel itself.

The order of sale dictates when the ownership vehicle should be formed. If the terms of the sale require all bidders including the mortgagee to bid with cash, the ownership entity to be used by the mortgagee should be formed prior to the sale and be prepared to bid at the auction in order to protect the mortgagee's interest in the vessel. On the other hand, if the court will allow the mortgagee to bid with its outstanding mortgage debt, the lender should, if necessary, acquire the vessel at the auction and thereafter transfer ownership to the ownership vehicle if a prompt resale is not anticipated.

§ 16:32 Auction

Vessel auctions in the U.S. are usually conducted by open bidding,[1] with the U.S. marshal serving as auctioneer. The auction may be held on the steps of the courthouse, in a hall of the courthouse, in a courtroom, or at some other public location designated by the court. In some instances auctions are conducted aboard the ship itself. The court, in the order of sale, might indicate a minimum initial bid (the upset price), but usually it does not.

It is in the mortgagee's interest to encourage competitive bidding at the auction to show that the vessel has been properly advertised and that the auction has taken place in

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[Section 16:32]

[1]In the U.K., Singapore, and Australia, bids are usually by sealed tender. Open auctions are held in South Africa, Greece, and Holland (Dutch auction).

a commercially reasonable manner. The mortgagee or its representatives should attend the auction and should be prepared to bid up to a certain level in order to assure that the vessel does not go too cheaply to a third party. If the bidding does not reach the bank's target price, then the lender must be prepared to take title in order to protect its interest.

§ 16:33 Payment and transfer of title

The order of sale usually requires that the high bidder deposit 10% of the bid in cash or by certified check with the U.S. marshal immediately following the auction, with the balance to be paid within a certain number of business days as stated in the order of sale. If the full balance is not paid within the time allowed by the court, the auction may be aborted or the vessel offered to the next highest bidder. When the balance is paid, the marshal reports this to the court, and, unless there is objection, the court orders the marshal to issue a bill of sale to the purchaser. In the absence of fraud or collusion, the standard applied by courts in determining whether to confirm or set aside a judicial sale is whether the sale price is so grossly inadequate as to shock the conscience of the court.[1] In some U.S. district courts, a confirmation hearing is held some days after the auction to confirm the sale to the highest bidder provided that the balance of the purchase price has been paid. As noted earlier, the purchaser takes the vessel free and clear of all liens, claims, and encumbrances.

§ 16:34 Maritime liens—Generally

Maritime liens are privileged claims on a vessel arising by operation of law out of some service rendered to the vessel to facilitate its use in navigation, or arising out of an injury caused by a vessel in navigable waters. A maritime lien can arise out of contract (e.g., a cargo claim or a repair claim); or out of tort (e.g., a personal injury or collision claim).

[Section 16:33]

[1]See *Latvian Shipping Co. v. Baltic Shipping Co.*, 99 F.3d 690, 1997 A.M.C. 328 (5th Cir. 1996).

A maritime lien can be foreclosed or executed only by a court[1] sitting in rem, i.e., sitting in judgment over the debts of a vessel as distinct from the debts of the vessel owner. Maritime liens can be eliminated only by judicial sale in rem, by payment or by laches.

Because maritime liens are "secret" liens, our courts state that the types of claims which can give rise to liens should be "strictly construed."[2] Maritime liens are not required to be recorded except, of course, the lien of a preferred ship mortgage which must be recorded. Except for mortgages, there is no central registry listing liens outstanding against a vessel.

The term "maritime lien" means different things in different countries. In the U.S., it is akin to a property right in a vessel. The vessel (as distinct from the vessel owner) is the obligor. The claimant has a right in a vessel which will survive a private sale. In the U.K., maritime liens are procedural—a way to compel an owner to appear by subjecting a vessel to the court's control.

The rules regulating the priorities of maritime liens are complicated and vary from country to country.

In the U.S., the claim of a supplier who furnished bunkers in the U.S. outranks a preferred mortgage on a foreign flag vessel.

In Panama, a preferred ship mortgage outranks all suppliers—even local suppliers.

In Greece, the supplier of bunkers has no maritime lien and the claim of the supplier who delivered bunkers to a vessel in Greece would not be given priority by a U.S. court over a mortgage on a foreign flag ship.[3] In England there is

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[Section 16:34]

[1]Cf. 46 U.S.C.A. § 31326(a). For the effect of a sale in bankruptcy see *In re Millenium Seacarriers, Inc.*, 419 F.3d 83, 45 Bankr. Ct. Dec. (CRR) 34, Bankr. L. Rep. (CCH) P 80344, 2005 A.M.C. 1987 (2d Cir. 2005).

[2]*Vandewater v. Mills, Claimant of Yankee Blade*, 60 U.S. 82, 19 How. 82, 15 L. Ed. 554, 1856 WL 8745 (1856); *Osaka Shosen Kaisha v. Pacific Export Lumber Co.*, 260 U.S. 490, 499, 43 S. Ct. 172, 67 L. Ed. 364, 1923 A.M.C. 55 (1923).

[3]See *Vestoil, Ltd. v. M/V M PIONEER*, 2005 A.M.C. 1035, 2005 WL 3675960 (M.D. Fla. 2005), aff'd in part, 148 Fed. Appx. 898, 2005 A.M.C. 2404 (11th Cir. 2005). See also *Dresdner Bank AG v. M/V OLYMPIA VOYAGER*, 446 F.3d 1377, 2006 A.M.C. 1256 (11th Cir. 2006); see also *Trans-Tec Asia v. M/V HARMONY CONTAINER*, 437 F. Supp. 2d 1124,

no maritime lien for bunkers.[4] In an effort to achieve uniformity, there have been three international conventions on maritime liens and mortgages (1926, 1967, 1993). The 1926 convention has been adopted only by civil law countries, e.g. Greece; the 1967 convention was acceded to only by the Scandinavian countries; the 1993 International Convention on Maritime Liens and Mortgages, entered into force on 5 September 2004.[5]

The priority of a lien vis-à-vis other liens is dependent upon the type of claim which gave rise to the lien. The law accords priority to liens which arose prior in time to the recording of a mortgage or which arise from an essential service rendered to the vessel which the law seeks to encourage or protect. For example, the salvage lien is a high ranking lien because the law wishes to encourage owners and salvors to come to the aid of a distressed vessel. The seamen's wage claim is given a high priority because, traditionally, seamen have been the wards of the court and have needed the protection of the court. Indeed, a 1898 U.S. Supreme Court decision calls seamen's wage claims "sacred liens, and, so long as a plank of the ship remains, the sailor is entitled, against all other persons, to the proceeds as security for his wages."[6]

§ 16:35 Maritime liens for "necessaries"

Maritime liens arise from a variety of sources and in a number of contexts. A person who provides "necessaries" to a ship has a maritime lien against the ship by operation of law. In the U.S., the law relating to "necessaries" is codified

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2006 A.M.C. 1011 (C.D. Cal. 2006), aff'd in part, rev'd in part on other grounds, 518 F.3d 1120, 2008 A.M.C. 684 (9th Cir. 2008) which held that the Federal Maritime Lien Act does not apply to a foreign vessel and supplier where provisions were delivered in a foreign port.

[4]*Bominflot, Inc. v. The M/V HENRICH S*, 465 F.3d 144, 2006 A.M.C. 2510 (4th Cir. 2006).

[5]The following countries were parties to this convention as of September 5, 2004: Brazil, China, Denmark, Ecuador, Estonia, Finland, Germany, Guinea, Monaco, Morocco, Nigeria, Norway, Paraguay, Russian Federation, Saint Vincent and the Grenadines, Spain, Sweden, Syrian Arab Republic, Tunisia, Ukraine, and Vanuatu.

[6]*The John G. Stevens*, 170 U.S. 113, 119, 18 S. Ct. 544, 42 L. Ed. 969, 2005 A.M.C. 2389 (1898).

in the Federal Maritime Lien Act[1] (the Lien Act). Under the Lien Act, a maritime lien is granted upon proof that the person (1) provided "necessaries" (2) to a vessel (3) on the order of the owner or a person authorized by the owner.[2] A holder of a maritime lien based upon "necessaries" furnished to a ship may commence an action in rem against a ship in the district court where the vessel is located. While it is clear that such items as fuel, water, bunkers, repairs, food for the crew and services for the ship such as pilotage, tug services and wharfage qualify as "necessaries," in recent years, a number of other types of claims have been urged upon the courts as qualifying as "necessaries."

A non-traditional category of claim that has been considered by our courts relates to hull and P&I insurance—arrears and back calls. By the time a shipowning company gets into financial difficulties, there usually are substantial, unpaid premiums. Most P&I clubs do not require immediate payment and may let the owner go for some period of time before terminating coverage. After all, the shipowners are "members" of the P&I club and deductibles may be reasonably high and on a per occurrence basis. Furthermore, a P&I club has a right to set off unpaid premiums against recoveries. Passenger vessels may have a number of personal injury cases with very substantial claims for damages. If these personal injury claims, which are in tort and therefore have priority to the mortgage, are not covered by insurance, the mortgagee's security can be seriously eroded. Claims for outstanding premiums for a fleet or a passenger shipowning company can involve several million dollars. Under some recent cases, unpaid insurance premiums have been given maritime lien status.[3]

Another series of cases deals with the question of whether unpaid container lease payments give rise to maritime liens on container vessels. A number of courts have wrestled with

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[Section 16:35]

[1]46 U.S.C.A. §§ 31341 to 31343.

[2]See *Integral Control Systems Corp. v. Consolidated Edison Co. of New York, Inc.*, 990 F. Supp. 295, 1998 A.M.C. 1905 (S.D. N.Y. 1998).

[3]See, e.g., *Equilease Corp. v. M/V Sampson*, 793 F.2d 598, 1986 A.M.C. 1826 (5th Cir. 1986). But see *In re Millenium Seacarriers, Inc.*, 292 B.R. 25, 2003 A.M.C. 1185 (S.D. N.Y. 2003), aff'd, 96 Fed. Appx. 753 (2d Cir. 2004) where club rules called for application of Norwegian law and arbitration and the court found that there was no maritime lien for necessaries under Norwegian law.

the question and generally have come to the conclusion that container lease payments do not meet the requirements of the Federal Maritime Lien Act if the containers were leased in bulk and used on a fleet wide basis. Under such circumstances, it is not possible to connect the lease charges to any particular vessel and it cannot be shown that a container is an appurtenance of a particular vessel.[4]

All claims for necessaries should be carefully scrutinized to determine the nature and amount of the claim, whether they qualify as a "necessary" under the Federal Maritime Lien Act or case precedent, in the country where the "necessary" was provided,[5] and if provided abroad, whether the law of the country where provided recognizes the particular claim as giving rise to lien, status.[6]

§ 16:36 Priorities in admiralty in the U.S.

Once the vessel has been through a judicial sale in rem by a court of competent jurisdiction sitting in admiralty, the liens that creditors holding in rem claims had against the vessel attach to the proceeds of the sale, and the vessel is transferred free and clear to the purchaser. Like scraping off barnacles, the liens are removed from the ship and attach to the proceeds of the sale, which substitutes for the ship. The mortgagee, crew, and trade creditors are no longer able to assert any claims against the vessel. All claims must be prosecuted against the proceeds of the sale as the "res." The court will distribute the fund in the order of priority accorded under the law of the forum to specific types of claims. The proceeds of the judicial sale are generally not sufficient to satisfy all claimants, so the priority of a particular claim is very important.

The time from arrest to sale varies. Two months would be

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[4]See *Silver Star Enterprises, Inc. v. Saramacca MV*, 82 F.3d 666, 1996 A.M.C. 1715 (5th Cir. 1996); *Redcliffe Americas Ltd. v. M/V Tyson Lykes*, 996 F.2d 47, 1993 A.M.C. 2294 (4th Cir. 1993); *Itel Containers Intern. Corp. v. Atlanttrafik Exp. Service Ltd.*, 982 F.2d 765, 1993 A.M.C. 609 (2d Cir. 1992); *Foss Launch & Tug Co. v. Char Ching Shipping U.S.A., Ltd.*, 808 F.2d 697, 1987 A.M.C. 913, 91 A.L.R. Fed. 873 (9th Cir. 1987). But see *Triton Container Intern. Ltd. v. M/S Itapage*, 774 F. Supp. 1349, 1991 A.M.C. 2319 (M.D. Fla. 1990).

[5]*Mobil Sales and Supply Corp. v. Panamax Venus*, 804 F.2d 541, 1987 A.M.C. 305 (9th Cir. 1986).

[6]*Lion de Mer, S.A. v. M/V Loretta D*, 1998 A.M.C. 1410, 1998 WL 307077 (D. Md. 1998); *Garcia v. M/V Kubbar*, 4 F. Supp. 2d 99, 1998 A.M.C. 893 (N.D. N.Y. 1998).

very favorable. Determination of priorities can take considerably longer particularly if there are a number of competing claimants. The normal ranking of claims in the U.S. is as follows:[1]

1. Expenses of justice[2]
2. Preferred maritime liens,[3] which are maritime liens arising before a preferred mortgage was filed or arising out of a maritime tort, general average, or salvage or for wages of the crew[4] of the vessel
3. A valid preferred mortgage on a U.S. flag ship or a preferred mortgage on a foreign vessel whose mortgage has been guaranteed under Title XI of the Merchant Marine Act of 1936
4. The claims of suppliers who furnished necessaries, repairs, and the like to the vessel in the U.S.
5. A valid preferred mortgage on a foreign flag ship
6. State created liens of a maritime nature.
7. Maritime liens for penalties and forfeitures for violation of federal crimes.
8. Preferred non-maritime liens including tax liens.
9. Other non-lien maritime claims in causes of action within the admiralty and maritime jurisdiction (foreign attachment).
10. Liens in bankruptcy.

A creditor might attempt to have its claim, which would otherwise be subordinate to the mortgage, ranked ahead of the mortgage. For example, a cargo claimant might argue that, for various reasons, its claim qualifies for recovery in tort with priority to the mortgage rather than in a contract

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[Section 16:36]

[1]46 U.S.C.A. § 31326; See also *Cargill, Inc., Skibsassuranceforening v. M/T Pacific Dawn*, 876 F. Supp. 508, 1995 A.M.C. 2146 (S.D. N.Y. 1995).

[2]"Expense of Justice" would include marshal's expenses, monies advanced by the mortgagee in compliance with a court order authorizing such advances, costs of advertising the sale, Marshal's poundage per 28 U.S.C.A. § 1921(c)(i) and other expenses reasonably incurred pending the auction as approved by the court.

[3]46 U.S.C.A. § 31301(5).

[4]Penalty wages do not have priority to a preferred mortgage. See *Governor and Co. of Bank of Scotland v. Sabay*, 211 F.3d 261, 2000 A.M.C. 1532 (5th Cir. 2000).

where cargo claims would normally be categorized.[5] The priority of claims set forth in the preceding list can vary, depending on the law of the non-U.S. forum in which the mortgage is foreclosed.

§ 16:37 Maritime attachment under Supplemental Rule B

A maritime arrest pursuant to Supplemental Rule C to enforce an in rem claim against a vessel, when executed by a court sitting in admiralty, results in the sale of a vessel free and clear of all liens, claims and encumbrances. The liens, etc. then attach to the proceeds of sale.

A maritime attachment pursuant to Supplemental Rule B, is a quasi in rem remedy which is used in connection with and ancillary to an in personam action. The judicial sale of a vessel pursuant to a writ of maritime attachment, does not clear the vessel of liens etc. It only clears the vessel of for the claim for which it was attached.

Maritime attachment has a dual purpose: the primary purpose is to obtain jurisdiction of the respondent in personam through his property; the secondary purpose is to obtain security so as assure satisfaction of any judgments in favor of the attaching creditor. Two attributes are necessary to support a maritime attachment: (1) the defendant is not present in the district and (2) the claim is maritime in nature.

If the defendant appears in the action, and the eventual judgment favors plaintiff, the judgment may be executed against all of the defendants' property whenever found. If the defendant fails to appear, judgment is limited to the value of property attached. Maritime attachment has been used to commence supplemental security proceedings in the U.S. in conjunction with U.S. or foreign arbitration proceedings or in conjunction with proceedings in other U.S. jurisdictions or in other countries, even where the parties had agreed on a foreign forum or an arbitration clause requiring the dispute to be resolved elsewhere.

Maritime attachment can be used to seize bank accounts as well as sister ships and bunkers. Since the recent decision of the U.S. Court of Appeals for the Second Circuit in *Winter*

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[5]See *Associated Metals and Minerals Corp. v. ALEXANDER'S UNITY MV*, 41 F.3d 1007, 1995 A.M.C. 1006 (5th Cir. 1995).

Storm Shipping, Ltd. v. TPI[1] there has been a flood of maritime attachments in New York. *Winter Storm* altered the prevalent use of maritime attachments from a procedure to attach tangible assets (such as vessels, chattels, real property and bank accounts) to a procedure to attach intangible assets (electronic fund transfers). With electronic fund transfers now fair game in the wake of *Winter Storm*, the frequency of maritime attachments filings in the U.S. District Court from the Southern District of New York has increased dramatically. Attachments of electronic fund transfers can be vacated only in limited circumstances.[2]

§ 16:38 Filing for bankruptcy[1]

During the course of a workout or finding itself in financial difficulties, the distressed shipowner might consider filing for protection under the applicable bankruptcy laws.[2] Historically, a bankruptcy proceeding has not been an effective way to maximize recovery on the assets of a failing shipping enterprise engaged in worldwide trade for several reasons. Yet, it has been effective for some owners seeking to reorganize where owners were financed by high yield debt.

First, a substantial number of important creditors and a substantial part of the assets of the shipping enterprise may be outside of the effective control of a particular bankruptcy

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[Section 16:37]

[1]*Winter Storm Shipping, Ltd. v. TPI*, 310 F.3d 263, 2002 A.M.C. 2705, 48 U.C.C. Rep. Serv. 2d 1255 (2d Cir. 2002).

[2]*Aqua Stoli Shipping Ltd. v. Gardner Smith Pty Ltd.*, 460 F.3d 434, 2006 A.M.C. 1872 (2d Cir. 2006).

[Section 16:38]

[1]This discussion is restricted to a bankruptcy filing under U.S. Bankruptcy Code, 11 U.S.C.A. §§ 101 et seq. (2005). As a general matter, the U.S. bankruptcy laws are more favorable to a reorganization than the laws of other jurisdictions, although a number of other countries, have now enacted laws which to a greater or lesser extent track Chapter 11 reorganization under U.S. law.

[2]An involuntary bankruptcy case can also be commenced against a debtor by creditors who hold uncontested unsecured claims. See 11 U.S.C.A. § 303 (2005). However, since creditors most likely to file an involuntary petition are trade creditors who probably hold maritime liens, involuntary petitions filed against shipping companies are almost unknown, and, to the author's knowledge, have never been commenced against a major shipping company. In addition, since most international shipping companies are not U.S.-based, there are substantial jurisdictional impediments to an involuntary U.S. filing.

court. For example, an unpaid foreign creditor with no assets in the U.S. that has an in rem claim against a vessel in Singapore is not likely to pay much attention to the "automatic stay" in a bankruptcy case in New York,[3] even though the New York Bankruptcy Court asserts it has worldwide jurisdiction over the bankruptcy assets.[4]

Second, unless the shipowner has an assured source of revenue or financing, the institution of bankruptcy proceedings is likely to cause suppliers to withdraw credit terms and demand immediate payment.[5] Since the expenses in connection with the ships for crew, insurance, bunkers, and maintenance continue, the debtor will very quickly be in a situation where it cannot obtain sufficient funds to continue to operate.

A further difficulty is the uncertainty of whether maritime liens will attach to the vessel while it is operating in reorganization. If the traditional doctrine of "in custodia legis" is applied to a vessel operating in reorganization, then such liens would not attach. Although liens might be administrative claims in the reorganization proceeding, such status does not give the same protection as it would if they were liens. Suppliers aware of this uncertainty would likely require cash payments in advance of providing services and supplies to the vessel, thus increasing the cash needs of the debtor.[6]

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[3]*In re McLean Industries, Inc.*, 76 B.R. 291, 17 Collier Bankr. Cas. 2d (MB) 415, 1987 A.M.C. 1721 (Bankr. S.D. N.Y. 1987).

[4]In the case *In re Lykes Bros. S.S. Co., Inc.*, 207 B.R. 282, 30 Bankr. Ct. Dec. (CRR) 749 (Bankr. M.D. Fla. 1997), the bankruptcy court held a creditor with no assets in the U.S. who had arrested a Lykes vessel in Hamburg, Germany to have violated the automatic stay, finding that there were sufficient contacts with the U.S. to support personal jurisdiction.

[5]The Bankruptcy Code also prohibits non-debtor contract parties from either terminating or modifying contracts because of the bankruptcy of the debtor. See 11 U.S.C.A. § 365. Thus, if services or supplies are being provided pursuant to an unexpired contract, the vendor is prohibited from changing the terms. See § 16:44.

[6]Although not addressing the in custodia legis issue, the court in *U.S. v. ZP Chandon*, 889 F.2d 233, 19 Bankr. Ct. Dec. (CRR) 1601, Bankr. L. Rep. (CCH) P 73153, 1990 A.M.C. 316 (9th Cir. 1989) held that maritime liens for wages attached to a vessel postpetition in spite of the provisions of the automatic stay imposed by 11 U.S.C.A. § 362. Because this case does not properly analyze the issues, including whether a vessel operated by a debtor in Chapter 11 is being operated in custodia legis,

The advent of high-yield financing for shipowners has however changed this general rule. See § 16:50.

§ 16:39 Impact of a bankruptcy proceeding in the U.S.

There are two kinds of bankruptcy cases under the Bankruptcy Code that can involve a maritime business debtor: a straight liquidation under Chapter 7[1] and a reorganization under Chapter 11.[2]

§ 16:40 Liquidation under Chapter 7

In a liquidation under Chapter 7, a bankruptcy trustee is appointed immediately following the filing of the petition that commences the proceeding or, if the bankruptcy is commenced by the filing of an involuntary petition, following the entry of an order for relief by the bankruptcy court. The trustee's job is to liquidate the assets of the debtor, to review and, as necessary, to object to claims, and then to distribute the assets to the claimants in the priority set forth in the Bankruptcy Code. In very limited circumstances, a trustee may continue to operate the business of a debtor.[1] For the most part, however, the only operations that a trustee is likely to undertake with respect to vessels are those necessary to put the vessels in the best possible condition for sale, to move them to another location for sale, or, conceivably, to complete a voyage in order to maximize revenues and minimize claims against the estate.

§ 16:41 Reorganization under Chapter 11

Under Chapter 11, the debtor is permitted to continue to operate its business while it seeks to reorganize its debts. Claimants against the debtor or its assets are stayed from enforcing such claims unless they obtain appropriate relief from the bankruptcy court.

Generally, a Chapter 11 debtor, including a shipowner,

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this case is weak authority for the general proposition that maritime liens attach postpetition.

[Section 16:39]

[1]11 U.S.C.A. §§ 701 to 27 (2005).

[2]11 U.S.C.A. §§ 1101 to 45 (2005).

[Section 16:40]

[1]See 11 U.S.C.A. § 721.

must be able to generate cash in its Chapter 11 proceeding sufficient to pay for its current expenses. This necessity presents the greatest difficulty in a maritime Chapter 11 reorganization.

§ 16:42 The automatic stay

Upon the filing of a bankruptcy petition, the so-called automatic stay becomes effective.[1] In general, the stay operates to preclude any actions by a creditor to enforce its claim against the debtor, the debtor's assets, or assets in the possession of the debtor (such as leased equipment). Violations of the stay can be punished as a contempt of court and can result in significant monetary sanctions. The filing of the petition does not eliminate maritime liens, which continue to attach to the vessel. It does, however, preclude enforcement action by the lienor.

For the debtor, a central problem posed by a bankruptcy filing is the lack of willingness of foreign courts to recognize the automatic stay. For example, a ship's agent supplying food or fuel that does business and has assets only in Nigeria and is able to arrest the vessel there or in some other foreign jurisdiction is not likely to be particularly threatened by the prospect of a contempt judgment in New York because of its failure to honor the automatic stay of the bankruptcy court in New York. Nor is it likely that a court will enforce a foreign bankruptcy stay to the prejudice of a local maritime lienor. However, a lienor that has assets or does business in the U.S. and arrests a vessel elsewhere in violation of the automatic stay does so at the peril of being found in contempt.[2]

§ 16:43 Relief from the automatic stay

A secured creditor, including a lienholder, that believes its interest is being adversely affected by the automatic stay (e.g., because the vessel is depreciating rapidly in value) can apply to the bankruptcy court for relief from the automatic

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[Section 16:42]

[1]See 11 U.S.C.A. § 362. See also 11 U.S.C.A. § 362(b)(12) and (13) re special 90-day exceptions to the automatic stay in respect of enforcement of a mortgage held by the Secretary of Transportation or a security interest in a fishing vessel held by the Secretary of Commerce.

[2]See *In re McLean Industries, Inc.*, 76 B.R. 291, 17 Collier Bankr. Cas. 2d (MB) 415, 1987 A.M.C. 1721 (Bankr. S.D. N.Y. 1987).

stay. Such relief might be granted if the interest of the secured creditor or lienor is not adequately protected or if the debtor does not have equity in the vessel (for example, liens and mortgages exceed the value of the vessel) and the property is not necessary for an effective reorganization. As an alternative, the court might require the debtor to adequately protect the interest of the lienholder or secured creditor. Adequate protection is often made through periodic cash payments.

The Bankruptcy Code requires that motions for relief from the stay be heard promptly (within 30 days), but whether the moving party will receive quick relief depends on the jurisdiction in which the case is proceeding. In certain jurisdictions, the case backlog or applicable local rules have been such that secured creditors have been seriously delayed in their efforts to obtain relief from the stay.

§ 16:44 Executory contracts

Under section 365 of the Bankruptcy Code, a debtor may either assume or reject certain types of contracts, including vessel's charter, at any time up to the confirmation of a plan of reorganization. (In a Chapter 7 proceeding, a trustee has sixty days from the filing of the petition to assume or reject a contract, unless that time is extended by the bankruptcy court.) In order to assume a contract or charter, the debtor must cure or provide for the cure of all monetary defaults and provide adequate assurance of future performance. A debtor also has the right to assign a lease or charter, even if there is a nonassignment provision in the lease or charter, upon a demonstration of adequate assurance of future performance. If a lessor is seriously harmed by a delay in the determination of whether to assume or reject a lease, it can move the court to require the debtor to assume or reject by a specified date.

Section 365(d)(5) of the Bankruptcy Code requires a debtor to "timely perform all of the obligations of the debtor . . . first arising from or after 60 days after the order for relief in a case . . . under an unexpired lease of personal property (which would include a vessel charter) . . . unless the court, after notice and a hearing and based on the equities of the case, orders otherwise." Thus, following a 60-day "grace" period, a charterer must commence making charter payments unless the court determines that the equities dictate otherwise. Thus far, it appears that courts have been

reluctant to vary the terms of the lease to permit payments of a different amount.

At the time this section was added to the Bankruptcy Code, the Code was also amended so that a lessor also loses its ability to seek relief from the stay and is restricted to obtaining adequate protection under section 363(e) of the Code. As a matter of procedure, a lessor is presumably now dependent on a court's willingness to enforce via contempt or otherwise an order granting adequate protection or directing the debtor to comply with section 365(d)(5), since the lessor no longer has available to it the right to get relief from the stay and then exercise its remedies under the lease or charter.

§ 16:45 Special considerations

If the shipowner becomes subject to a bankruptcy proceeding, a creditor should take immediate action to review its alternatives and to be sure that its rights are protected. At a minimum, it should determine the information discussed in Checklist § 16:46.

§ 16:46 Ship sales

During the course of the bankruptcy, the trustee or debtor might seek to sell some or all of its property in the proceeding. While a sale by the bankruptcy court should be sufficient to transfer the vessel free and clear of liens, which liens then attach to the proceeds of a bankruptcy sale, such sale is of doubtful validity abroad.[1] The general practice, therefore, has been to conduct any sales of vessels pursuant to an order of the U.S. District Court, sitting in admiralty. Since the bankruptcy court is part of the U.S. District Court, it is relatively simple to have the matter heard by the district court sitting in admiralty.

§ 16:47 Checklist: matters to consider in a bankruptcy

1. Are any actions necessary to perfect the claim against the debtor? If such actions are necessary, they should

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[Section 16:46]

[1]See *Morgan Guar. Trust Co. of New York v. Hellenic Lines Ltd.*, 38 B.R. 987, 10 Collier Bankr. Cas. 2d (MB) 1156, Bankr. L. Rep. (CCH) P 69752, 1984 A.M.C. 1074 (S.D. N.Y. 1984).

be taken immediately and it should be determined whether relief from the automatic stay is necessary in order to take such actions.

2. Does the creditor have a right of reclamation under the UCC or any applicable law? Such rights typically need to be asserted immediately, however, recent amendments to the Bankruptcy Code grant powerful reclamation rights to creditors.[1]
3. Is the creditor entitled to adequate protection? Since there is a lower threshold for adequate protection than for lifting the stay, the creditor should consider making a motion for adequate protection early in the case.
4. Is the creditor's position eroding? If it is, the secured creditor should probably make an immediate motion for relief from the automatic stay to foreclose on its maritime lien or alternatively a motion for adequate protection.
5. Should a proof of claim be filed? It is nearly always advisable to file a proof of claim early, and it is usually necessary to do so if a creditor wishes to participate in the distributions from the bankruptcy, unless their claim has been properly scheduled. Filing a proof of claim, however, subjects the creditor to the jurisdiction of the bankruptcy court. In certain circumstances, a creditor might wish to avoid that jurisdiction. If a case converts from a Chapter 11 to a Chapter 7, the creditor should usually re-file the proof of claim in the Chapter 7.

§ 16:48 Foreign bankruptcy proceedings

Foreign bankruptcy proceedings can be given effect in the U.S. by means of an ancillary proceeding. Recently-enacted Chapter 15 of the U.S. Bankruptcy Code permits the representatives of a foreign bankrupt to enlist the aid of the U.S. Bankruptcy Court in administering assets of a foreign bankrupt which are located in the U.S.[1] Filing under Chapter 15 is relatively easy and only requires proof that the ap-

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[Section 16:47]

[1]In 2005, the Bankruptcy Code was amended to provide for an administrative expense priority claim for all goods sold to the debtor within 20 days of the bankruptcy filing. See 11 U.S.C.A. § 503(b)(9).

[Section 16:48]

[1]See 11 U.S.C.A. §§ 1501 to 1532 (2005).

plicant has been appointed by a foreign court of competent jurisdiction. Chapter 15 also imposes new restrictions on the ability of a foreign representative to seek other relief in the U.S. courts, by prohibiting a representative of a foreign bankrupt from seeking injunctive or other relief in a nonbankruptcy U.S. court until and unless it has been granted relief under Chapter 15.

§ 16:49 Cooperation of courts in different countries

Because the insolvency/bankruptcy of a shipping enterprise may result in litigation being conducted in numerous jurisdictions, the cooperation of courts in different countries may become critical to an orderly resolution of claims and distribution of assets. In response to this need for transnational cooperation, there have been a number of international initiatives and treaties including those proposed by the United Nations Commission on International Trade Law (UNCITRAL). UNCITRAL has developed a set of model laws called the "UNCITRAL Model Law on Cross-Border Insolvency" (hereinafter, the Model Law). The Model Law was designed to: (i) foster cooperation between and among courts in different countries where the debtor's assets may be located, (ii) provide access to local courts for representatives of foreign insolvency proceedings and creditors, and (iii) grant recognition to orders issued by foreign courts. The Model Law is the basis for Chapter 15 and also has been enacted, in some form, in Eritrea, Japan, Mexico, Poland, Romania, South Africa, Montenegro the UK and Northern Ireland. In addition, Model Law-related legislation is either pending or has been proposed in Spain, Australia, and New Zealand. Similarly, in May 2002, the EU (except Denmark) adopted the European Union Regulation on Insolvency. The primary purpose of the Regulations is to improve the efficiency and effectiveness of insolvency proceedings by providing a jurisdictional framework to determine where insolvency proceedings can be initiated and, subject to certain exceptions, the law that will apply.

§ 16:50 High yield debt

Commencing with Eletson Holdings in 1993, many foreign shipping companies have raised funds by accessing the U.S. high yield market. Of these companies, some have sought to reorganize under Chapter 11, and a number of others have restructured their debt in a nonbankruptcy setting. Workouts

or restructurings of shipping ventures funded through the capital markets raise special concerns and problems. Unlike shipping loans, where relations between the shipowner/borrower and the lender, or in the case of a syndicated loan, the lead banks, are well-established, such close relations between the shipowner and the bondholders typically do not exist in capital markets financing. Capital markets financing is characterized by free trading of the shipowner's securities in the market place. Thus, at any point in time, the shipowner may not know who its bondholders are or how many bondholders there may be. In nearly all cases, the underwriters involved in bringing the shipowner's securities to market sell those securities at the time of initial funding and have no ongoing responsibilities or interest in the venture.

The Indenture Trustee that acts for the bondholders has very limited responsibilities and is not a real party in interest during the course of the transaction. While the Indenture Trustee may have responsibility to send and receive communications between the shipowner and the bondholders, it is not in a position to make commercial decisions or exercise discretion, all such authority residing with the bondholders.

From the shipowner's viewpoint, communication with the bondholders is, at best, difficult. Formal requests through the Indenture Trustee are the subject of a solicitation or tender offer and can be time-consuming and expensive. Thus, what might be a simple request for a waiver that could easily be handled by a bank requires a solicitation and polling of bondholders, an expensive and time-consuming process.

In the context of a troubled financing or a workout, then, the normal concerns attending such matters, described elsewhere in this chapter, can be greatly exacerbated by the inability of the parties to communicate readily with each other and easily effect waivers, or amendments to their original agreements.

Bondholders themselves may also be hampered in taking action by their own structure. For example, some bondholders are investment vehicles that by their nature have no independent means of obtaining funds necessary to conduct a workout or a restructuring. Other investment vehicles have the ability to agree to a compromise of claims, but not the ability to fund the prosecution of claims. Such circumstances make action by bondholders difficult, since the bondholders' ability to fund attorneys, accountants, liquidators and trustees, and to provide appropriate indemnities to trustees and

liquidators, are necessary adjuncts to any successful workout or restructuring.

An "informal committee of bondholders" may be established to deal with the troubled shipping company. This committee, which is comprised of the holders of a substantial portion of the issued securities, will typically retain counsel and other professionals. The fees of these professionals are usually paid by the debtor during the course of the negotiations.

It is frequently the case that by the time the restructuring process starts, a substantial portion of the bonds will, be held by so-called "vulture" investors, who specialize in buying distressed debt. This can render the process more difficult, because of limitations imposed on the committee members by the shipowner. Thus, typically the committee members will receive information from the shipowner pursuant to an agreement whereby they are restricted from trading so long as confidential information is being provided or discussions are being held. An investor, of course, may not wish to be restricted, as it will impede his ability to cut his losses in a falling market or take a profit in a rising market.

However, absent such an agreement, a bondholder may find itself without access to important information. The reporting requirements imposed by most indentures are substantially less comprehensive than those required under a typical bank loan agreement, which indeed is one of the attractions to a shipowner of the issuance of bonds as opposed to obtaining financing via bank financing.

Bondholders involved in troubled shipping issues most certainly need to retain specialists who have industry knowledge of the shipping markets in the particular area in question as well as expertise in insurance, maritime accounting, and legal and enforcement issues. Unlike major shipping banks, which have industry experience, bondholders probably do not have such expertise in-house and thus are well advised to obtain outside assistance at the first sight of trouble.

A Chapter 11 bankruptcy filing may become necessary for the shipowner, even if it has reached an agreement on a restructuring with the majority of its bondholders. Under Chapter 11, the shipowner can bind dissenting bondholders

and thus force them to agree to the terms of the restructuring supported by the requisite majority of the bondholders.[1]

Many of the companies which have issued bonds in the U.S. high yield market have no connection with the U.S. except for the bonds themselves. However, because of the minimal jurisdictional requirements for a Chapter 11 filing in the U.S., the shipowner may nonetheless be able to avail itself of the U.S. bankruptcy system. Thus, for example, in the case of *In re Global Ocean Carriers Ltd.*,[2] the bankruptcy filing was attacked on the grounds that the debtor did not have the requisite jurisdictional contacts with the U.S. and, in particular, with the state of Delaware. The court upheld the filing, finding that the existence of bank accounts, without more, was sufficient to permit the bankruptcy court to exercise jurisdiction over the debtor, even though the funds in those accounts were not significant compared with the assets and liabilities of the debtor.[3]

§ 16:51 Sale in bankruptcy

In appropriate circumstances a secured holder of high yield debt may be able to make affirmative use of bankruptcy to dispose of the company's entire fleet in the bankruptcy court's auction proceeding without the expense, delay and complications of arresting individual vessels where they may be found worldwide. Secured lenders considering such actions will need to take into account that some maritime liens may remain unadjudicated in bankruptcy proceedings; nevertheless, the commercial risk of such unadjudicated claims may be deemed outweighed by the efficiency of the bankruptcy process and resulting saving in time and costs of pursuing individual vessel arrests in several jurisdictions around the world.

The litigation surrounding the Millenium Seacarriers, Inc. bankruptcy is seminal in this approach. Millenium Seacarriers defaulted on secured high-yield bonds that it issued in

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[Section 16:50]

[1]A class of claims has accepted a plan if such plan has been accepted by directors, . . . that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors." 11 U.S.C.A. § 1126(c).

[2]*In re Global Ocean Carriers Ltd.*, 251 B.R. 31 (Bankr. D. Del. 2000).

[3]See *In re Global Ocean Carriers Ltd.*, 251 B.R. 31, 38 (Bankr. D. Del. 2000).

the capital markets, and filed for bankruptcy protection for itself, along with all of its vessel-owning subsidiaries in January 2002. Twenty-one maritime lien claimants filed claims in the bankruptcy court against the various vessels. A number of the claims were settled but others were litigated, testing the scope of admiralty and bankruptcy jurisdiction of the U.S. federal courts. Significantly, the U.S. Courts allowed the sale of the fleet without requiring the arrest of the vessels on a worldwide basis.

During the course of the bankruptcy proceedings, at the request of the secured bondholders, the bankruptcy court ordered the sale of the fleet in accordance with bankruptcy law and procedure, which transferred the titles to the vessels free and clear of liens, except for those not adjudicated by the court. The secured bondholders "bid in" their mortgages and acquired the vessels in the bankruptcy court auction proceeding.

In *In re Millenium Seacarriers, Inc.*,[1] several of the maritime lien claimants challenged the bankruptcy court's sale of the Millenium fleet, arguing that only a U.S. District Court could conduct such a sale and adjudicate maritime liens. The Second Circuit Court of Appeals referred to the long history of bankruptcy courts adjudicating the validity and priority of maritime assets but acknowledged that the issue of a bankruptcy court enforcing and foreclosing maritime liens had not been determined.[2] The Court of Appeals held that the adversary proceeding which had been established to rank the priority of the maritime liens was a core proceeding under bankruptcy law.[3] Among the reasons the Court held the adversary proceeding to be core, was a determination that the lien claimants had rendered the proceeding core by actively litigating their claims in the adversary proceeding.[4] Furthermore, the Court held that by submitting their maritime lien claims to the bankruptcy court for adjudication, the lien claimants had "submitted themselves to the bank-

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[Section 16:51]

[1]*In re Millenium Seacarriers, Inc.*, 419 F.3d 83, 45 Bankr. Ct. Dec. (CRR) 34, Bankr. L. Rep. (CCH) P 80344, 2005 A.M.C. 1987 (2d Cir. 2005).

[2]*Millenium Seacarriers*, 419 F.3d at 95.

[3]*Millenium Seacarriers*, 419 F.3d at 96–97.

[4]*Millenium Seacarriers*, 419 F.3d at 98.

ruptcy court's equitable jurisdiction."[5] Having placed their claims before the bankruptcy court, the bankruptcy court as a matter of admiralty law, properly extinguished the liens field with the bankruptcy court when the vessels were sold through the bankruptcy court.

What the Court of Appeals did not determine was whether the bankruptcy court's sale extinguished all liens on the vessels, not just those before the bankruptcy court. The Court of Appeals did note, however, in dicta, that unlike an admiralty sale in the District Court, the bankruptcy court sale probably did not have the same reach.

The Second Circuit agreed with the earlier decision of Judge Haight, in the Southern District of New York, in which Judge Haight refused to withdraw the reference to the bankruptcy court to allow a lien claimant to proceed in the District Court.[6] According to Judge Haight, such a withdrawal would have "interfere[d] with the Bankruptcy Court's ability to marshal and deal with all Millenium's property."

In a later decision, the Second Circuit held that another adversary proceeding, which had been commenced to determine which of two charter parties had been assumed and assigned under the court's sale order, was a core proceeding.[7]

§ 16:52 Drilling rigs

In the U.S., as well as many other countries, drill ships, jack-up drilling rigs and semisubmersible drilling rigs are considered vessels for the purpose of registration as well as the creation and enforcement of security interests. However, there are some important differences in working out loans on rigs as compared to loans on traditional types of watercraft. These differences result primarily from the fact that rigs are employed for long periods of time in the search for oil and gas in the seabeds of the world's oceans and do not often come into port.

Ships travel from port to port carrying cargoes and passengers. Rigs are designed to remain drilling at remote locations, often on the high seas hundreds of miles from land

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[5] *Millenium Seacarriers*, 419 F.3d at 102.

[6] *In re Millenium Sea Carriers, Inc.*, 275 B.R. 690, 2002 A.M.C. 1343 (S.D. N.Y. 2002).

[7] *In re Millenium Seacarriers, Inc.*, 458 F.3d 92, 2006 A.M.C. 2376 (2d Cir. 2006).

and outside of the jurisdiction of the courts of any country. After a contract for drilling in a specific area is completed, it is typical for a rig to be "mobilized" directly to the next drilling site. Unless it requires repair or inspection that cannot be carried out at sea or unless it is laid up or "stacked" in a protected location, it is unlikely that a rig will enter port for a protracted period. The fact that drilling rigs seldom come to port makes the enforcement of a mortgagee's remedies, particularly the remedy of arrest and judicial foreclosure, problematic and raises jurisdictional issues.

The procedure for commencing a mortgage enforcement proceeding against a rig is the same as that against a vessel.[1] However, the jurisdiction of the marshal extends only to the three-mile limit. Thus, a drilling rig either working or stacked beyond the three-mile limit is effectively beyond the jurisdictional reach of the particular U.S. district court.

Alternatives to the traditional means of commencing a mortgage foreclosure action have been tried. In a rig foreclosure proceeding in Louisiana, a federal court allowed the parties to stipulate that the court had in rem jurisdiction although the rig was not within the jurisdiction. The efficacy of this type of stipulation to jurisdiction has not been tested in a situation where a third party challenged the court's jurisdiction. More importantly, the validity of a court-ordered auction and sale of a vessel following such a stipulation, has not been decided.

Another alternative may be found in the UCC. Section 9-503, the self-help remedy statute of the UCC, provides that the security agreement may require the debtor to assemble the collateral upon default and move it to a site that is mutually agreeable to the parties. These clauses can be general, requesting only that the debtor move the rig to an acceptable location or very specific, identifying in advance a port or mooring or stacking location. Similar clauses involving non-rig collateral have received judicial approval and have been used to require a debtor to move collateral located in several states to the state where suit was filed. Further, if such a clause is contained in the security documents and the court has personal jurisdiction over the debtor, the remedy of specific performance might be available. This remedy requires the debtor to move the collateral into the district

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[Section 16:52]

[1]See § 16:29.

where the collateral can be seized by the U.S. marshal. This action would be a personal action against the debtor.

Faced with an asset that is out of reach by conventional judicial means, a lender that has decided to take enforcement action against its security may decide to utilize self-help remedies provided for in the mortgage. State law must be consulted prior to exercising self-help remedies. For example, Texas law requires that any exercise of self-help remedies be accomplished without a breach of the peace. Texas courts have defined a breach of the peace as any breaking and entering, any use of physical force, or any threatened use of force. Louisiana law appears to prohibit the use of self-help remedies unless there is consent of the debtor. English law is similar to Texas law in its limitations on self-help remedies, whereas Scottish law falls between the Texas and Louisiana approaches.

A mortgagee that decides to exercise self-help remedies must carefully plan how and when remedies are to be exercised and must retain individuals experienced in rig operation, mobilization, and stacking to supervise and conduct the operation. Once a rig is under arrest or in the possession of a creditor, the creditor must consider the safe control and maintenance of the rig. Although a vessel might be relatively safe docked at a pier with a U.S. marshal's guard at the gangway, a jack-up drilling rig or a semisubmersible drilling rig cannot lie safely at a dock. A deep water, anchorage is usually required. A rig might have complex stabilization systems that require considerable maintenance in order to insure that it remains safely in one place. Finally, the drilling equipment, supplies, and other equipment on board the rig will require attention, perhaps even expensive preservation work, if the value of the rigs is to be maintained.

Before any action is taken to enforce remedies against a rig, a qualified custodian should be retained. This custodian may be another rig operator, a marine service company, a shipyard with experience building or repairing rigs, or one of several companies that specialize in the care of stacked rigs. The creditor should seek to obtain the services of someone with practical experience in caring for and preserving the value of rigs.

The mortgagee and the chosen company often enter into a custodial services agreement. This detailed agreement specifies services to be performed, fees to be charged, responsibilities of the custodian for care and custody of the rig, and rights of the mortgagee to direct or supervise the custodian.

The custodial services agreement should also state who is responsible for insuring the rig during the custodial period. If the mortgagee is enforcing its mortgage by judicial foreclosure, it is necessary to have the custodian formally appointed as such by the court by means of a motion to appoint a substitute custodian. If this order is granted by the court at the same time as the warrant for arrest, the mortgagee can put the rig in professional hands immediately upon its arrest by the U.S. marshal.

Among other issues that should be carefully evaluated before a lender exercises its remedy are whether the rig is performing a drilling contract, the ramifications of any arrest on this contract, any possibility of damage to the contractor's drilling hole or the contractor's equipment on board the rig, and environmental damage that might occur in a takeover.

§ 16:53 Special issues—The U.S. Maritime Administration

The U.S. Maritime Administration (MarAd), a division of the Department of Transportation, is the agency of the federal government charged with promoting the U.S. Merchant Marine and also with administering certain statutes governing U.S. flag vessels. In a workout involving U.S. flag vessels, MarAd's dual role as both a promoter and a regulator must be kept in mind. As a promoter, MarAd has in the past guaranteed and continues to guarantee the debt used to build vessels in U.S. shipyards and, as security for such guaranties, has been granted first preferred ship mortgages on such vessels. MarAd is thus often a senior creditor in transactions involving U.S. flag vessels.

On the other hand, MarAd as a regulator is responsible for considering applications under section 9 of the Shipping Act of 1916[1] for the approval of the transfer of U.S. flag vessels to non-U.S. citizens and to foreign flags. Thus, in any workout involving the sale of a U.S. flag vessel to a purchaser that does not meet the citizenship tests imposed by the Shipping Act of 1916, MarAd's prior written approval must be

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[Section 16:53]

[1]Shipping Act of 1916 § 9, 39 Stat. 728 (1916) (codified at 46 U.S.C.A. app. § 808 (1994)).

obtained.[2] This approval is almost never withheld, but MarAd has the statutory authority and usually exercises such authority to impose conditions on its approvals of such transfers. These conditions may include the requirement that any future transfers of the vessel (even from one non-U.S. citizen to another) be subject to MarAd approval and restrictions on the future use of the vessel, and even restrictions on the identity of future users or purchasers of the vessel.

These conditions are usually contained in either an approval notice and agreement, which is a contract between MarAd and the purchaser of the vessel, or a transfer order, which is the written evidence of MarAd's approval under section 9. The obligation of any non-U.S. citizen purchaser of a U.S. flag vessel to comply with the MarAd-imposed restrictions must often be secured by a surety bond or letter of credit in favor of MarAd; this is usually required by MarAd before it will issue its transfer order approving the transfer of a U.S. flag vessel to a non-U.S. citizen or to a foreign flag. Since MarAd can and has placed continuing restrictions on the transferability and operation of U.S. flag vessels upon their initial sale to non-U.S. citizens or their transfer to foreign flags, it is necessary in a vessel workout to check to see if the vessel is affected by such restrictions even if it is not presently under the U.S. flag.

As a practical matter, in addition to insuring that all necessary applications are made to MarAd, any agreement that contemplates the sale of a U.S. flag vessel to a non-U.S. citizen or its registration under a foreign flag or that involves the sale of a foreign flag vessel still covered by a MarAd restriction must be made specifically subject to MarAd approval.

§ 16:54 Judicial sale of U.S. flag vessels

At a foreclosure auction conducted by a U.S. district court of a U.S. flag vessel, including fishing vessels, only a person eligible to document a U.S. flag vessel or the mortgagee may purchase the vessel. If the mortgagee is not qualified to document the vessel under U.S. flag (i.e., is not a U.S. citizen), the mortgagee will be prohibited from operating the vessel except in limited circumstances, such as to move it to a place

[2]MarAd has preapproved certain transfers to purchasers that do not meet the citizenship test. See 46 C.F.R. §§ 221.11 to 19.

of safety or to have repair work done on it. A foreign mortgagee may purchase a U.S. flag vessel at foreclosure auction and hold it for resale to a qualified purchaser. If the mortgagee as owner subsequently proposes to sell the vessel to a non-citizen, MarAd's permission must be obtained. Foreclosures involving U.S. vessels with foreign lenders consequently require careful planning, which may include setting up an entity to purchase the vessel at auction that meets U.S. citizenship requirements for documenting the vessel under U.S. flag. In the event the vessel qualifies for the U.S. coastwise trade, thus having a greatly enhanced value for that reason alone, great care must be taken that title not pass to an entity that is not qualified to own a vessel engaged in the coastwise trade.

§ 16:55 Syndicated loans

Syndicated and participated ship loans give rise to special problems in workouts. To maximize recovery, a lender must be willing to make additional advances to protect its investment, to act quickly to free a ship from arrest, and to take advantage of sale opportunities. Getting all members of a syndicate to agree to act and to agree quickly enough is often impossible. Furthermore, because of pressure from syndicate members or concerns about potential liability to syndicate members for failing to pursue all possible avenues of recovery, a lead bank may make decisions that are not in fact in the best interests of maximizing recovery.

§ 16:56 Conclusion

Credibility is a sine qua non to any successful workout. The maintenance of good communication aids in reaching a mutually acceptable resolution of a troubled shipping loan. The lender must have confidence in the representations made to it by the debtor and vice versa. If credibility is lost, attempts to work out a shipping loan will quickly deteriorate into global war games. When a lender loses confidence in a shipowner, be it in the shipowner's financial or operational credibility, prompt proceedings should be taken against vessels in the best available jurisdictions. Vessels are seldom in the best jurisdictions from the point of view of the lender, and a good deal of forum shopping by and gamesmanship among the lender, the shipowner, and third-party creditors can ensue. It is in these situations that the workout team finds its greatest challenges.

