Expert Q&A on Maritime Bankruptcies and the Intersection of Admiralty and Bankruptcy Laws

PRACTICAL LAW BANKRUPTCY

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An Expert Q&A with Ilana Volkov of Cole Shotz P.C. discussing the unique aspects of maritime bankruptcy cases and providing practical tips for restructuring professionals when addressing the conflicts between admiralty and bankruptcy law.

Maritime bankruptcies pose unique and often complicated issues for restructuring professionals because of the interplay between the Bankruptcy Code and maritime laws. Chapter 11 is designed to:

- Offer the debtor a breathing spell from creditor enforcement actions.
- Preserve the value of a debtor's assets for the benefit of its estate and creditors.
- Give the debtor an opportunity to reorganize its business through a section 363 sale or confirmation of a plan.

Because of these protections and benefits, US bankruptcy law is generally recognized as a debtor-friendly system. In contrast, maritime law typically favors creditors, particularly maritime lien holders. The purpose behind this preference is to promote the smooth flow of worldwide commerce and international finance "while not allowing [ships] to escape their debts by sailing away" (*Equilease Corp. v. M/V Sampson*, 793 F.2d 598, 602 (5th Cir. 1986)). The conflicting interests of debtors and creditors often collide in bankruptcies involving maritime matters, creating challenging cases.

Many shipping companies operate US and foreign flag vessels that provide domestic and international transportation services. A maritime debtor's assets move through international waters and can dock at foreign ports at any given time. It is therefore crucial to the maritime debtor's operations and successful reorganization efforts that, after the bankruptcy filing:

- The debtor's assets are not seized.
- Maritime liens are not imposed or enforced.
- Contracts and leases are not terminated.

Practical Law asked Ilana Volkov of Cole Schotz P.C. to explain the unique aspects of maritime bankruptcy cases and provide practical tips for restructuring professionals when addressing the conflicts between admiralty and bankruptcy law.

DOES THE AUTOMATIC STAY APPLY TO THE GLOBAL ASSETS OF A CHAPTER 11 SHIPPING DEBTOR?

The automatic stay provided by section 362 of the Bankruptcy Code is one of the most important protections and powerful tools available to a debtor in bankruptcy. Triggered immediately on filing a bankruptcy petition, it automatically stops substantially all acts and proceedings against the debtor and its property, worldwide, including:

- The exercise of remedies regarding collateral.
- Enforcement of prepetition judgments.
- Litigation.
- Collection efforts.
- Acts to create, perfect, and enforce liens granted before the date the bankruptcy petition was filed.

Because of its importance to a debtor's reorganization efforts, courts have construed the automatic stay broadly and have recognized its extraterritorial reach. In addition to the automatic stay, section 365(e)(1)(B) of the Bankruptcy Code protects a debtor from a counterparty cancelling an executory contract or unexpired lease because of the debtor's insolvency, financial condition, or bankruptcy filing, even if a contract allows a counterparty to do so by its terms (known as an ipso facto clause).

Although the automatic stay bars international parties from seizing the debtor's assets, foreign vendors who transact with international shipping debtors often do not understand or feel compelled to observe the automatic stay or the invalidation of ipso facto clauses. For example, an Asian-based supplier of fuel or other necessaries to ships that has no ties to the US may choose to arrest a debtor's vessel during a voyage outside the US, regardless of the bankruptcy laws.

To avoid these occurrences, multinational shipping debtors should seek comfort orders from the Bankruptcy Court restating and enforcing the automatic stay regarding all assets, no matter where they are located, to mitigate any disruption to their postpetition operations. For an example of a motion seeking this relief, see Standard Document, Chapter 11 Motion to Enforce the Automatic Stay (SDNY) (W-004-9910).

When an international shipping company commences its main insolvency proceeding in a foreign jurisdiction, it may also need to file a Chapter 15 proceeding to protect its US assets. If filing an ancillary Chapter 15 proceeding becomes necessary, counsel should be mindful that the automatic stay:

- Only applies to assets located within the territorial jurisdiction of the US.
- Does not take effect until the ancillary proceeding is recognized under section 1517 of the Bankruptcy Code.

The foreign representative must therefore obtain emergent injunctive relief by seeking a temporary restraining order to protect a shipping company's assets from arrest or other creditor enforcement actions pending the recognition hearing.

WHAT IS A MARITIME LIEN?

A maritime lien is a non-possessory property right in a vessel that attaches to the vessel the moment the debt arises (see *Dresdner Bank AG v. M/V Olympia Voyager*, 465 F.3d 1267, 1272 (11th Cir. 2006)). The vessel itself becomes indebted for the obligation and may be sold to satisfy the debt. Without maritime liens, vendors and suppliers would be reluctant to provide materials or services to a vessel that may sail out of port.

The Commercial Instruments and Maritime Lien Act (CIMLA) states that a person providing "necessaries" to a privately owned vessel on the order of the vessel's owner or a person authorized by the owner:

- Holds a maritime lien on the vessel.
- May bring a civil action in rem to enforce the lien.
- Is not required to allege or prove that credit was given to the vessel.

(46 U.S.C. § 31342.)

The CIMLA defines necessaries to include "repairs, supplies, towage, and the use of a dry dock or marine railway" (46 U.S.C. § 31301(4)). This definition has been interpreted broadly to include any item reasonably needed for the venture engaged by the vessel. However, despite the broad construction of the term necessaries, alleged maritime liens should be reviewed carefully and challenged where appropriate. A common ground often raised for contesting a maritime lien focuses on whether the underlying good or service was in fact provided to the vessel on the order of the owner or a person authorized by the owner.

SECRET LIENS

Other than preferred ship mortgages (see Practice Note, Security Interests: Aircraft, Vessels, and Rolling Stock: Vessels (2-519-3295)), maritime liens do not have to be recorded or filed to be valid or perfected. This means that if a vessel is sold to an innocent purchaser who is not aware of the lien's existence, the lien remains valid and enforceable. Lenders providing debtor-in-possession (DIP) financing must also conduct meticulous diligence of a maritime debtor's liabilities. Unknown maritime liens, which attach the moment the debtor incurs the obligation, may survive the Chapter 11 case and have priority over DIP liens granted by the court.

PRIORITY OF MARITIME LIENS

Different parties may hold maritime liens against the same vessel. The rules regulating priorities of maritime liens are complicated and vary from country to country. In the US, the rules are based in common law and CIMLA. Competing maritime liens are ranked according to class (for example, type of claim) and the time incurred. Unlike other security devices under US commercial law, more recent maritime liens have priority over maritime liens incurred at an earlier date. This "last in time, first in right" rule is grounded in the principle that a later provider of goods or services keeps the vessel in service for the benefit of earlier-in-time lienholders.

ENFORCEMENT OF MARITIME LIENS

In the US, a maritime lien may only be enforced by an in rem action in a court having admiralty jurisdiction (for example, a US District Court) against the vessel itself. Because of the mobility of the asset and the speed with which vessels can move in and out of ports, time is of the essence in arresting a vessel to enforce a maritime lien.

For more information on maritime liens in the US, see Practice Note, Maritime Attachment and Vessel Arrest in the US (W-001-8160).

WHAT ACTIONS CAN MARITIME LIENHOLDERS AND OTHER SECURED CREDITORS TAKE TO ENFORCE THEIR LIENS AFTER A SHIPPING COMPANY FILES FOR BANKRUPTCY?

Maritime lienholders and other secured creditors may seek relief from the automatic stay. Section 362(d) of the Bankruptcy Code provides that the bankruptcy court must lift the automatic stay and allow a creditor to exercise its remedies outside bankruptcy if either:

- Cause exists, including the lack of adequate protection.
- The debtor retains no equity in its property and the property is not necessary for an effective reorganization.

A bankruptcy court is generally reluctant in the early stages of a case to grant stay relief because it is mindful of affording the maritime debtor an opportunity to demonstrate its prospect of reorganizing. However, because maritime assets are likely to depreciate in value over time, a secured creditor may ask the bankruptcy court to adequately protect its interest. Adequate protection is tailored to the specific facts of the case.

To prevent maritime lienholders from filing an onslaught of stay relief motions or refusing to provide postpetition goods and services, shipping company debtors should seek first day relief allowing them to pay prepetition claims of critical and foreign vendors (see Practice Note, Critical Vendor Status in Bankruptcy (1-518-9996)).

HOW MAY A PURCHASER ENSURE THAT IT ACQUIRES A MARITIME ASSET FREE AND CLEAR OF LIENS, CLAIMS, AND INTERESTS?

A judicial foreclosure, by order of a court of competent jurisdiction sitting in admiralty, is the most certain way to extinguish all liens against a vessel. The foreclosure sale enables the purchaser to obtain title to the vessel free and clear of all liens, claims, and encumbrances**,** and all recorded mortgages and unrecorded secret liens and claims are transferred to the sale proceeds.

A sale under section 363 of the Bankruptcy Code may not accomplish the same result. While a debtor's books and records typically reflect all debt obligations of the vessel, it is possible that not all secret maritime liens will be identified when a maritime debtor chooses to sell its assets under section 363(f) of the Bankruptcy Code. In that situation, the unknown lienholders may not receive notice of a sale seeking to eliminate the lien from title of the asset. Without proper notice of the requested adverse relief, the buyer will not be assured of clean title.

HOW DO EXECUTORY CONTRACTS PLAY A ROLE IN A MARITIME DEBTOR'S BANKRUPTCY?

Most shipping companies do not own their vessels. Instead, they lease vessels from third-party owners under charter agreements. There are different kinds of charter agreements, but the two charter agreements that are frequently litigated in bankruptcy cases are:

- **Time charters.** A time charter entails hiring a vessel for a specific period of time. The owner continues to manage the vessel but the charterer selects the ports and directs the vessel where to go. The charterer pays the owner of the vessel for:
  - all fuel the vessel consumes;
  - port charges and fees; and
  - a daily hire.
- **Bareboat charters.** A bareboat (or demise) charter entails hiring a vessel where the owner gives possession of the vessel to the charterer and provides no administration or technical maintenance. The charter period often ends with the charterer obtaining title to the vessel.

The terms of a bareboat charter are akin to ownership of the vessel. Lienholders therefore have a difficult time relying on the argument that the automatic stay does not apply to the enforcement of their claim against the vessel. Lienholders may believe that a time charter provides them with more leeway from the application of the automatic stay.

However, it is generally accepted that the automatic stay bars a lienholder from seizing a vessel in which the debtor has any legal or equitable interest, including a vessel under a time charter to the debtor (see, for example, *In re Am. Trading & Shipping, Inc.*, 24 B.R. 32 (Bankr. S.D. Fla. 1982); *In re Hanjin Shipping Co., Ltd.*, 2016 WL 6679487, at *6, (Bankr. D.N.J. 2016) ("[w]hile it is true that the [time] chartered vessels are not owned by the Debtor, the claims against these vessels are based in part upon liabilities of the Debtor. And, so as long as these vessels are under [time] charter by the Debtor, its property rights are impacted. In order to achieve the practical objective of moving cargo from the Debtor's vessels to intended destinations in the United States (and limit harm to the [beneficial cargo owners], it was necessary to extend the stay to vessels [time] chartered by the Debtor")).

CAN CHARTER AGREEMENTS BE ASSUMED OR REJECTED?

Charter agreements have generally been treated as executory contracts. To assume a charter agreement, the debtor has to satisfy section 365(b) of the Bankruptcy Code. A burdensome charter agreement may be rejected under section 365(a) of the Bankruptcy Code. Rejection gives rise to a general unsecured claim for damages. It is possible for a bareboat charter agreement to provide that on occurrence of an event of default (for example, insolvency, bankruptcy filing, rejection, or confirmation of a plan), the lessor is entitled to recover a stipulated loss value (SLV) as liquidated damages.

However, in the case of *Tidewater Inc.* the Honorable Brandon L. Shannon, US Bankruptcy Judge in Delaware, held that an SLV provision is an unenforceable penalty (Case No. 17-11132 (Bankr. D. Del., Aug. 30, 2017 (BLS)). Judge Shannon further ruled that an evidentiary hearing is needed to determine the non-debtor counterparty's actual and appropriate damages from rejection of a bareboat charter agreement. On that issue, Judge Shannon found that the Third Circuit's holding in *In re Montgomery Ward Holding Corp.* (268 F.3d 205 (3d. Cir. 2003)) governs the appropriate calculation of damages for breach due to an event of default, which includes the sum of:

- The amount of any unpaid rent.
- The present value, at the time of breach, of the monthly rentals for the then-remaining term of the lease.
- The present value, when the lease terms began, of the anticipated aggregate residual value of the leased equipment at the scheduled termination of the lease.

HOW DOES SECTION 1110 OF THE BANKRUPTCY CODE APPLY IN MARITIME BANKRUPTCY CASES?

Section 1110 of the Bankruptcy Code applies to vessels constructed in the US that are subject to a security interest granted by, leased to, or conditionally sold to a water carrier debtor. It provides a 60-day reprieve to debtors from the enforcement by a secured party, a lessor, or conditional vendor of the vessel of any of its contractual rights or remedies to sell, lease, or otherwise retain or dispose of the vessel. Section 1110 provides that these actions are stayed under section 362 of the Bankruptcy Code if:

- Within 60 days of the petition date, the debtor agrees to perform all of its obligations under the security agreement, lease, or conditional sale contract.
- The debtor cures any default, other than a default specified in section 365(b)(2) (an ipso facto default).

The debtor and the secured party, lessor, or conditional vendor may agree to extend the 60-day period, subject to court approval. The debtor must also seek approval from the court to enter into any agreement to continue performance of its contractual obligations and to cure any non-ipso facto defaults.

WHAT IS THE JONES ACT AND HOW DOES IT APPLY IN MARITIME BANKRUPTCY CASES?

The Merchant Marine Act of 1920, commonly known as the Jones Act, is a federal statute enacted for the purpose of promoting and maintaining the American merchant marine. The law also regulates maritime commerce in US waters and imposes four primary requirements on vessels carrying goods between US ports:

- The vessels must be owned by US companies that are controlled by US citizens with at least 75 percent US ownership.

- At least 75 percent of the crew must be US citizens.
- The vessel must have been built or rebuilt in the US.
- The vessel must be registered in the US.

A plan of reorganization that proposes a change of control involving foreign ownership of the reorganized company must comply with the Jones Act. Companies have successfully employed certain techniques to assure the continuing ability of shipping companies to engage in US coastwise trade, including:

- Separating the fleet management and other operations into one entity that can be owned by non-US citizens or entities, while ensuring that the Jones Act compliant assets are held in a US entity owned by US citizens or entities
- Limiting the aggregate ownership of common stock by non-US citizens to no more than 25 percent of the company's outstanding common stock and providing warrants or subscription rights, provided that any acquisition of reorganized equity pursuant to the warrants or subscription rights would itself have to comply with the Jones Act.

LOOKING AHEAD, DO YOU SEE AN INCREASE OF RESTRUCTURINGS FOR THE SHIPPING INDUSTRY?

A material recovery for the global shipping industry in 2018 continues to be uncertain as the balance of international supply and demand remains imperfect. Many shipping companies have overleveraged balance sheets with elevated debt that cannot be sustained by stagnant, let alone decreasing, revenue. These shipping companies will need to implement corrective measures to ensure their businesses can survive the persisting headwinds. Some shipping companies may have to resort to formal, in-court restructuring proceedings to reorganize their business and financial affairs. It is imperative for restructuring professionals to fully understand the types of unique issues that may arise in a shipping company's Chapter 11 or Chapter 15 case and to know how to address those issues.