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Don't Go Down With The Shipping Bankruptcy

Law360, New York (February 26, 2013, 6:16 PM ET) -- Bankruptcies of international shipping companies are on the rise. These bankruptcies involve unique legal and practical issues given the transitory nature of ships, the foreign domicile of most shipping companies, and the awkward intersection of bankruptcy and admiralty law. With the shipping industry depressed, and the number of major shipping insolvencies increasing, lawyers should realize that there are traps for the unwary where bankruptcy and admiralty intersect.

Policy Differences

The U.S. bankruptcy laws have objectives that are, in many respects, inconsistent with the objectives of admiralty law. U.S. bankruptcy laws give the debtor a "breathing spell" and the opportunity for a "fresh start," and ensure equitable treatment of creditors. In contrast, admiralty law is creditor-oriented, generally permitting aggressive individual creditor remedies such as the seizure of assets. Under admiralty law, creditors possessing liens are generally able to seize vessels or other property, actions expressly prohibited under the Bankruptcy Code once a bankruptcy proceeding is commenced and the automatic stay is in place.

The Bankruptcy Code permits debtors to recover assets seized by or transferred to creditors, as well as obtain the nonconsensual release of liens granted or obtained, near the bankruptcy filing date. The ability of a debtor to recover assets or get the release of liens received by creditors in the time leading up to the bankruptcy filing discourages creditors from racing to the courthouse or taking other action that could worsen the debtor's financial position or disadvantage other, less aggressive creditors. In contrast, admiralty law rewards creditors for aggressive enforcement of their claims against the debtor.

Bankruptcy courts have broad jurisdiction to consider claims against and relating to a debtor and its assets. Depending on the degree to which a dispute or claim arising under admiralty law is related to a given bankruptcy proceeding, the bankruptcy court may determine the issue or decide that it should defer to another court or tribunal.

For instance, a bankruptcy court will give consideration to applicable admiralty law in determining the validity and priority of any claims (including lien claims) with respect to the debtor's vessels, including the distribution of the sale proceeds to lien creditors, and rarely would yield jurisdiction to an admiralty court to determine such issues. In order for a bankruptcy court to abstain from hearing a given dispute, the proceedings must typically hinge on substantive nonbankruptcy issues of law and have only the most tangential connection to the bankruptcy case (e.g., an insurance dispute).

Conflicts Over Liens

Shipping creditors that file claims in a bankruptcy case are deemed to consent to the equitable jurisdiction of the bankruptcy court, such that the bankruptcy court will assume jurisdiction to adjudicate (or even extinguish) those claims.

One U.S. appellate court decision indicates that, even where an arrest of a ship occurred outside the U.S., when shipping lienholders submit their claims in the bankruptcy proceeding, they consent to the bankruptcy court's jurisdiction, and the bankruptcy court may order the sale of vessels free and clear of such liens (albeit with the liens attaching to the proceeds of the sale and distribution thereof to be determined by the bankruptcy court).

Even so, for the reorganized debtor or purchasers of the debtor's assets relying on a bankruptcy court's order, the risk remains that foreign courts may not recognize that certain maritime liens have been extinguished by a U.S. bankruptcy court sale of a vessel (as opposed to a U.S. admiralty court). Admiralty court sales, unlike bankruptcy court sales, are universally recognized as cleansing a ship of liens.

U.S. commercial law requires transparency with regard to the interests creditors may hold in a debtor's property. It therefore requires that security interests be recorded in order to be effective against other creditors. Generally, the first creditors to record their security interests against the property of the debtor enjoy the primary right to payment from the proceeds of such property — a "first in time, first in right" system. This system makes it easy for bankruptcy courts to make determinations as to the nature, extent, validity and priority of liens.

Preferred ship mortgages are also recorded under a first-in-time, first-in-right system; thus, they are easy for bankruptcy courts to address. Maritime liens, on the other hand, are secret liens that arise by operation of law. Maritime liens, which may arise, among other ways, in connection with the provision of necessaries to a vessel (crew wages, repairs, towage, maintenance, etc.), need not be recorded. Such secret liens are often prioritized in the opposite manner of typical U.S. commercial liens — a "last in time, first in right" basis.

Consequently, it is possible that an unrecorded maritime lien can be recognized as valid and senior to all other liens, and be unknown to all creditors except the one creditor holding the lien and the debtor. The lack of transparency of maritime liens creates a host of problems in a bankruptcy proceeding. Additionally, caution must be taken by lenders negotiating post-petition financing with a maritime debtor, as unknown maritime liens may survive the bankruptcy and enjoy priority to the security interests granted to such lenders as part of the bankruptcy proceeding.

Executory Contracts

Under the Bankruptcy Code, a debtor has the right to assume or reject executory contracts and unexpired leases (those contracts/leases under which both the debtor and the nondebtor counterparty continue to have material performance obligations). Vessel charters generally have been treated as executory contracts under the Bankruptcy Code.

Consequently, a debtor charterer (or a debtor ship owner) under a charter may decide that the terms of a charter are unfavorable and reject the charter, resulting in a claim for damages arising from the breach of the charter in favor of the nondebtor counterparty. Generally, outside of the bankruptcy context, a breach of a charter by the ship owner will result in a maritime lien in favor of the charterer.

As indicated above, this would typically enable the charterer to attach and arrest the vessel as security for payment. Consequently, it has been suggested by one court that a damages claim arising from the debtor's rejection of a charter in bankruptcy may constitute a maritime lien, which might be entitled to higher priority than certain other lien claims coming into existence after commencement of the charter and before rejection of the charter.

In addition, certain types of charters (e.g., "bareboat" charters) are often used in the shipping industry in connection with sale lease-back transactions as a means of vessel financing. If a charterer under such an arrangement files for Chapter 11 protection, the bankruptcy court may be asked to evaluate whether the charter represents a true lease or a disguised financing.

If the charter is recharacterized as a financing, the bankruptcy court may deem the vessel the property of the debtor charterer, not the owner. Under such circumstances, the charterer would be able to retain possession of the vessel without performing its obligations under the relevant charter, and claims by the ship owner against the charterer would be treated as general unsecured claims.

Chapter 15

Shipping is an international business. It is common for a shipping debtor to have creditors and assets in a number of jurisdictions. As noted above, this may present any number of complications, as separate nations have different legal regimes relating to insolvency, reorganization and asset seizure. Thus, it is increasingly necessary that a shipping debtor globally coordinate its insolvency proceedings to enhance the likelihood of a successful reorganization. The Bankruptcy Code seeks to facilitate coordinated foreign filings through Chapter 15, which enables the bankruptcy court to recognize and aid foreign insolvency proceedings.

Chapter 15 of the United States Bankruptcy Code is based on a U.N. model law on cross-border insolvency that has been adopted by many, but not all, jurisdictions where a shipping insolvency may occur. Chapter 15 provides that if the foreign proceeding is located in the country where the debtor has the center of its main interests, then the proceeding is dubbed a "foreign main proceeding." Shipping companies have frequently commenced Chapter 15 proceedings to stay asset seizure in the United States.

Unlike Chapter 11, the benefits of Chapter 15 do not commence immediately upon the filing of a petition. Typically, such relief is only granted upon the actual recognition of the foreign main proceeding by the bankruptcy court. The foreign representative may, however, seek emergency relief during the gap period between filing date and date of recognition, including a stay of actions against the debtor's assets, the suspension of third parties' rights against the debtor's property, or the turnover of the debtor's property in the U.S. to the foreign representative.

A bankruptcy court will grant the foreign representative such gap period protections if the representative demonstrates that the standards for a preliminary injunction are met. Generally, this requires a showing by the representative, among other things, that the debtor or its property will suffer irreparable injury if the requested protections are denied. In Chapter 15 cases involving shipping companies, this relief has been routinely granted.

Conclusion

Shipping bankruptcies can be anything but routine. For the bankruptcy attorney unfamiliar with maritime law, or for the maritime attorney unfamiliar with the bankruptcy process, caution must be the watchword in handling such cases either for debtors or creditors.

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