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Shipping bankruptcies and their unique issues

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Shipping bankruptcies have been in the headlines throughout 2012 and 2013, with the likes of Overseas Shipholding Group, Excel Maritime and TMT Group currently in US Chapter 11 proceedings. Distressed investors have flocked to the sector. But shipping bankruptcies have special challenges in light of the movable nature of ships, foreign vendors and ship arrest risk, the foreign domicile of most shipping companies, and at times the uncomfortable intersection of bankruptcy and admiralty law. Yet the US bankruptcy regime remains the best chance at reorganisation (if an out of court resolution is not possible).

Access to the US Bankruptcy Court

Shipping companies (and other types of companies) can utilise Chapter 11 even if they are not formed in or based in or have no offices or material assets in the US. Although there have been challenges, judges have allowed minimal operations or assets (even unapplied retainers paid to professionals (e.g., bankruptcy lawyers)) to satisfy jurisdictional requirements. Likewise, challenges

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to foreign debtors' Chapter 11 filings as being made in bad faith (e.g., to stymie a foreign admiralty court sale, and with no meaningful connections to the US) have failed time and again. In other words, the US bankruptcy court is an open port for international shipping companies.

Automatic stay

The most immediately felt benefit of a Chapter 11 filing is the imposition of the Bankruptcy Code's automatic stay that on its face purports to have worldwide effect and prohibits creditors from commencing or continuing legal actions against the debtor or its assets anywhere in the world. For a shipping debtor that would include arresting ships, freezing accounts or commencing a proceeding in a foreign court.

The automatic stay is practically limited to the bankruptcy court's ability to enforce its orders (i.e., impose punishment for noncompliance), which generally is limited to parties in or with property in the US. With respect to foreign banks, this generally should work (and, therefore, they are likely to honour the automatic stay); however, foreign vendors or even some foreign courts may ignore the stay. For instance, an Asian or African-based supplier of fuel or other necessaries to ships may have no ties to the US and not fear the automatic stay and feel free to arrest a vessel during a voyage outside the US.

Critical vendors

Maritime creditors have rights to arrest ships to satisfy debts in most ports worldwide. Because of the risk of arrest by even small foreign vendors, it is common for a shipping debtor at the time of the bankruptcy filing to seek special authority to pay its critical vendors for their pre-bankruptcy claims. The intention is both to limit arrest risk and stabilise daily operations. The ability to obtain fuel, address manning, port and agent fees, repair costs and the like is critical to the debtor and the very chance at a successful restructuring. Notwithstanding such authority, the debtor may not pay all vendors or all that they are owed; rather, the debtor will use its own business judgment.

Liens

Secured creditor liens are generally respected in Chapter 11, subject to a number of caveats, including that during the Chapter 11 case, the debtor is not required to service the secured creditor's debt (yet the secured creditor typically will be prohibited by the automatic stay from exercising remedies) and may challenge the secured creditor's liens and may use cash collateral (subject to certain protective requirements).

One issue that comes up in shipping cases is the matter of unrecorded maritime liens that can be recognised 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.

Cash collateral and DIP financing

A Chapter 11 debtor typically requires some form of financing to continue its operations while in bankruptcy and to pay for the bankruptcy process itself (i.e., for its professionals and the professionals for an official creditors committee). The debtor will need to obtain bankruptcy court approval for its borrowings which are usually in the

form of use of a secured creditor's cash collateral and/or new borrowings. Financing is critical to maintain critical vendor relationships and avoid ship arrests.

A debtor cannot use cash collateral unless the secured creditor consents or the bankruptcy court authorises such use over the secured creditor's objection if the court finds that the secured creditor is adequately protected by its overall collateral package or the provision of current payments or additional liens.

New money borrowing to continue operations and finance the Chapter 11 case (known as DIP financing) is often provided by the debtor's existing lenders, but can be provided by a new lender. Such lenders can obtain a lien senior to pre-existing liens (often not a problem if it is the same lender, although some difficulty if a new lender).

Executory contracts

Under the Bankruptcy Code, a debtor has the right to assume (i.e., perform) or reject (i.e., terminate) executory contracts and unexpired leases (where both parties continue to have performance obligations). Vessel charters generally have been treated as executory contracts so that a debtor is able to reject non-market charters and limit any breach claim to the equivalent of a pre-bankruptcy general unsecured claim. In contrast, generally, outside of the bankruptcy context, a shipowner's breach of a charter would result in a maritime lien in favour of the charterer. In practice, in Chapter 11 cases it does not appear that this has occurred, leaving the non-debtor party with only an unsecured claim. This power can be a valuable negotiating tool for a debtor.

Conclusion

Shipping bankruptcies present unique challenges, yet also unique opportunities. Chapter 11 cases to date have shown that they can be successful where all parties recognise that the operation is valuable (although they may disagree on how that value is distributed and on who should be in control); with creditors all over the world, obtaining such consensus can be challenging. However, if the parties are in strong disagreement about the business itself, the case is likely destined for failure. ■