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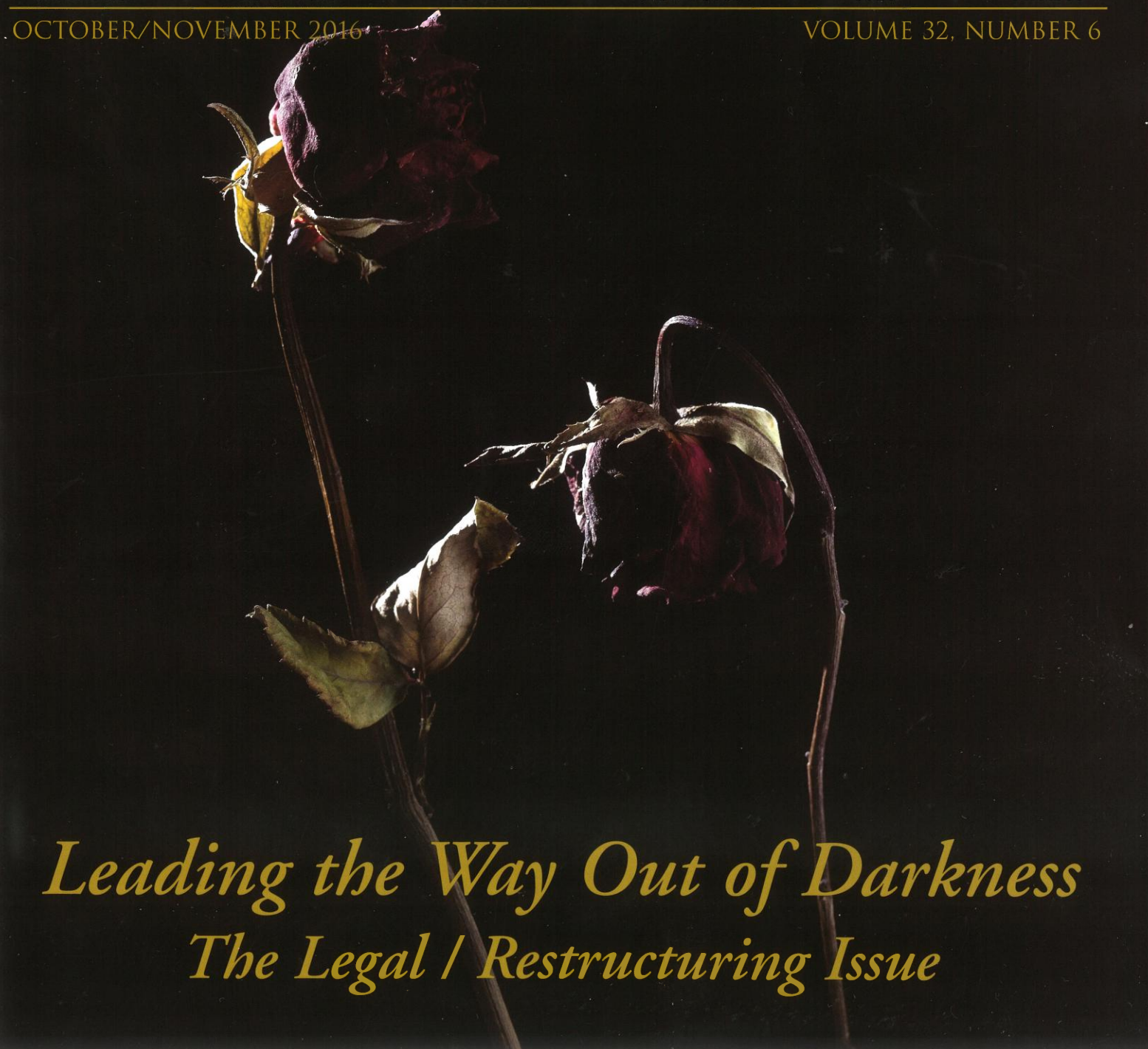

Leading the Way Out of Darkness

The Legal / Restructuring Issue

CHAPTER 11: A RESTRUCTURING TOOL FOR FOREIGN SHIPPING COMPANIES

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INTRODUCTION

A company (a "debtor") that files for protection under Chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code") obtains significant protections and tools to restructure its debts. In recent years, several shipping companies based outside of the United States have utilized Chapter 11 to reorganize their businesses and emerge as going concerns. Despite these precedents and Chapter 11's many advantages, foreign companies are often reluctant to use Chapter 11. This may be due to a misunderstanding of the barriers to filing a Chapter 11 petition in the United States, the protections available, or even the belief that a foreign company could become a US taxpayer if it filed for Chapter 11 protection.

This article is intended to provide the reader with a high-level understanding of the accessibility to, and benefits of, Chapter 11, which non-US entities should view as a viable and powerful restructuring tool.

WHO CAN FILE CHAPTER 11?

The eligibility requirements for filing under Chapter 11 are not substantial. Additionally, once a foreign debtor files under Chapter 11, it is very difficult for creditors to dismiss the case.

Eligibility

The Bankruptcy Code permits a Chapter 11 filing by a person (defined to include a corporation) "that resides or has a domicile, a place of business, or property in the United States …." 11 U.S.C. § 109(b) (emphasis added). Courts that have considered the "property" requirement with respect to foreign corporations have found it satisfied by even a minimal amount of property located in the United States. For example, in *In re Global Ocean Carriers Ltd.*, a shipping company headquartered in Greece filed Chapter 11 petitions in Delaware. In that case, the court held that a few thousand dollars in a US bank account and the unearned portions of retainers provided to local US counsel constituted sufficient property to meet the requirements of section 109. Numerous other courts have reached the same conclusion on similar facts.

Potential Dismissal

Notwithstanding the Bankruptcy Code's very broad eligibility standards, a United States bankruptcy court has the authority to dismiss a case. One section of the Bankruptcy Code provides that a court may dismiss or suspend a case if "the interests of creditors and the debtor would be better served by…dismissal or suspension," 11 U.S.C. § 305(a)(1), while another section says that a court may dismiss a case for "cause," 11 U.S.C. § 1112. However, the fact that a court has the ability to dismiss or suspend (i.e., abstain from hearing) a particular case does not mean it will exercise that power. For instance, courts have noted that the test under section 305(a)(l) requires that both creditors and the debtor would be better served by dismissal or suspension of the Chapter 11 case. Additionally, courts routinely recognize that dismissal or suspension under section 305(a) is a form of "extraordinary relief." Similarly, while section 1112(b) of the Bankruptcy Code permits a party in interest to move to dismiss a bankruptcy case for cause, the moving party bears the initial burden of demonstrating "cause." This might require the creditor to demonstrate the absence of a reasonable likelihood of rehabilitation or the gross mismanagement of the estate — both difficult and

typically expensive standards to meet.

In recent years, courts considering the dismissal of cases involving foreign companies have adopted a practical approach, and have generally focused on the debtor's (and the court's) ability to effectuate a restructuring. If it is reasonably (maybe even remotely) possible that a restructuring can be implemented, courts have generally denied dismissal and abstention motions. Indeed, some recent shipping Chapter 11 cases demonstrate this approach. For example, in *In re Marco Polo Seatrade B.V.,* two of the debtors' principal lenders sought dismissal of the debtors' bankruptcy cases. These lenders cited the debtor's lack of United States contacts, among other things, as a basis to dismiss the case. The court denied the lenders' request, finding that "the interests of the creditors are better served by maintaining the case as a fully active Chapter 11 case, not dismissing it." A similar result was reached in the *In re TMT Procurement Corporation, et al.,* bankruptcy case, which involved a Taiwanese shipping company with very minimal contacts to the United States.

WHAT ARE SOME OF THE BENEFITS OF CHAPTER 11?

The many benefits that Chapter 11 offers a debtor include, among other things, the automatic stay, the ability to reject executory contracts, the power to avoid certain prepetition transfers, the ability to sell assets free and clear of liens and encumbrances, the ability to obtain financing, and the ability to restructure debts — all of which are briefly described below.

The Automatic Stay

The "automatic stay" is triggered upon the filing of a bankruptcy petition. The automatic stay provides for a broad stay of litigation, lien enforcement and almost all other actions that are attempts to enforce or collect prepetition claims against the debtor. The stay is intended to give the debtor a "breathing spell" so that it can try to formulate a plan of reorganization or implement an orderly liquidation process, preventing the proverbial "run on the bank" (or creditors attempting to gain an advantage through first action).

In the shipping context, the stay would (in theory) prohibit the arrest of any of the debtor's vessels located worldwide. However, in practice, a United States bankruptcy court's ability to enforce the automatic stay is generally limited to (i) actions taken against the debtor's assets within United States territory or (ii) actions taken against foreign assets which were initiated by either US creditors or foreign creditors with meaningful assets in the United States (which could be subject to a judgment for violation of the stay). Despite the practical limitations, the stay remains a significantly broad protective measure — particularly against banks (and other financial institutions) that, generally, will avoid violating the stay even if they exist wholly outside the United States.

The Rejection of Contracts

Under the Bankruptcy Code, a debtor has a right to assume (maintain and perform) or reject (terminate) executory contracts and unexpired leases up until the time that its Chapter 11 plan is confirmed. A contract is an executory contract when both sides have material performance obligations remaining. This power allows debtors to retain favorable contracts while terminating those that are disadvantageous.

In this regard, charter-parties have been treated as executory contracts under the Bankruptcy Code. While a terminated charter-party would result in a claim for damages in favor of the non-debtor counterparty, such a damage claim generally would be treated as an unsecured claim in the bankruptcy case, which are often repaid under a Chapter 11 plan at mere pennies on the dollar.

Avoidance Actions

In Chapter 11, the debtor is able to commence "avoidance" actions (lawsuits) that allow the debtor to unwind certain transfers that were made to or for the benefit of a non-debtor party prior to the bankruptcy filing. These avoidance powers gener-

ally extend to transfers that were made prior to the bankruptcy and that had the effect of "preferring" certain creditors over others, or were made in exchange for less than "reasonably equivalent value." Certain defenses exist against these avoidance actions, but their applicability depends on the particular circumstances. If a transfer is avoided, the debtor can recover the property transferred or the value of such property to supplement the assets in the bankruptcy estate available for the benefit of all creditors. This can also include the avoidance of liens or guarantees granted to lenders as part of pre-bankruptcy restructuring transactions or forbearance arrangements.

Asset Sales

A Chapter 11 debtor generally can sell some or all of its assets free and clear of existing liens on the assets (with any security interest usually shifting to proceeds of the sale). This process allows the debtor to realize value for its assets in an expedited fashion, with the entire process generally taking only two to four months (sometimes less). The brief timeframe is significant, particularly when the assets to be sold are declining in value rapidly or the sale is a convenient way to deal with difficult creditors. Importantly, the consent of secured creditors is not required.

Certain purchasers actually prefer a sale in bankruptcy court to an out-of-court sale because they receive the comfort provided by a formal bankruptcy court order approving the sale (limiting post-hoc challenges to a sale by a distressed seller). While a sale of vessels free and clear in the Chapter 11 context is similar to an admiralty sale, it is not as commonly understood, and there are some reasonable buyer-side concerns about the enforceability of the bankruptcy court order in foreign jurisdictions against foreign lien creditors. However, more shipping companies are utilizing this tool as part of their efforts to address their debts.

Ability to Restructure Debts

Through a Chapter 11 plan of reorganization, a debtor is able to restructure its debts, both secured and unsecured. A Chapter 11 plan must provide for the payment of a secured claim up to the value of the collateral securing the claim. A Chapter 11 plan may split a secured creditor's claims into two pieces: a secured claim to the extent of the value of collateral securing the claim; and an unsecured claim to the extent the amount of the claim exceeds the value of the collateral. When a payment plan is proposed over a secured creditor's objection, it is typically referred to as a "cram-down plan." In a cram-down plan, the payment of the secured portion of the claim can be stretched out, provided that the secured lender retains its lien securing its claim, and the present value of the payment stream equals the value of the secured creditor's claim (i.e., the value of the collateral securing the claim).

Under a Chapter 11 plan, the treatment of unsecured creditors' claims is generally based on the value, if any, remaining after distributions to secured creditors. Oftentimes, that can be pennies on the dollar. Furthermore, subordination agreements often dictate the priority of distributions on unsecured debt in a Chapter 11 case (particularly public debt).

Other Selected Benefits of Chapter 11

Chapter 11 may appeal to a distressed shipping company for a variety of other reasons. For instance, in Chapter 11, the management of the debtor generally stays in possession of the company's assets and in control of its operations. Also, a Chapter 11 debtor has access to the US capital markets where debtor in possession financing ("DIP financing") may be available to help fund the debtor's bankruptcy and exit from bankruptcy. The debtor is required to obtain bankruptcy court approval for such borrowings, which are often provided by the debtor's existing lenders (although DIP financing can be provided by a third-party). DIP financing may be available to a debtor even if it could not obtain new financing outside of bankruptcy. This is generally because the Bankruptcy Code allows the lender to obtain senior liens approved by the bankruptcy court, which are therefore not subject to challenge.

DOES FILING CHAPTER 11 MAKE A FOREIGN SHIPPING COMPANY A US TAXPAYER?

A foreign shipping company which is not doing business in the United States, but which establishes eligibility to file for Chapter 11 by paying an advance retainer to US bankruptcy professionals and/or opening a US bank account with de minimis funds ($50,000, for example), should not be treated as a US taxpayer.

TAKEAWAY

Chapter 11 of the United States Bankruptcy Code is a powerful tool that can be used to restructure the debt of foreign corporations, including shipping concerns, that is often misunderstood. When faced with a distressed situation, a foreign shipping company should consult counsel and consider the possibility of employing a Chapter 11 process to reorganize. Most entities would likely be eligible, as the perceived bars to securing the many benefits of the process are often non-existent or are able to be overcome.

If you have any questions concerning this article, please feel free to contact John R. Ashmead (212-574-1366), Michael S. Timpone (212-574-1342), or Robert J. Gayda (212-574-1490).