

C.M.I.

COMITE MARITIME INTERNATIONAL

COLLOQUIUM ON
PROTECTION AGAINST INSOLVENCY
IN MARITIME LAW

TULANE
1987

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ON

PROTECTION AGAINST INSOLVENCY
IN MARITIME LAW

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TULANE LAW SCHOOL — MARITIME LAW CENTER

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OF THE UNITED STATES AND

THE MARITIME LAW CENTER OF THE TULANE LAW SCHOOL

FOREWORD

Maritime law is both the result of conflicting private interests and a powerful influence on the resolution of those conflicts. A substantial part of it consists of a search for a harmony between individual interests in relationships such as between owner and charterer or carrier and shipper. From early days, however, institutions like general average and liens and hypothèques concentrated upon the community of creditors either by creating legal ties among creditors without their express consent or, in the opposite direction, by allowing an individual creditor to assert a stronger individual right enabling him to leave the general creditors' unsafe raft.

But whatever detailed provisions maritime law may have to offer to those engaged in the maritime industry, the moment may come when the possibility of having to apply the general law of insolvency looms ahead. In a period when renowned non-maritime companies and conglomerates startle the public with bleak notices about their financial condition, the shipping community has not been immune – on the contrary.

The purpose of the Colloquium which the Comité International Maritime has organised in New Orleans in November 1987 is to enable those engaged in maritime law to try not only to have their individual clocks chime together, but perhaps more importantly, to discuss solutions which increasingly force themselves on creditors in non-maritime insolvencies as well: although the traditional remedy of bankruptcy, if indeed it is one, has to an ever-growing extent been supplanted by moratoria, surseance or Chapter 11 solutions, practice has shown the importance of other more pragmatic devices allowing problems to be solved without the interference of state appointed officials such as trustees or liquidators.

Even so, the bankruptcy or moratorium hypotheses remain of the utmost practical importance, although they often raise acute questions of difference of treatment between creditors within or outside the country of bankruptcy.

Whatever comes out of the Colloquium, the discussion can hardly fail to be absorbing, if not passionate. This bundle of papers prepared by experts from various fields and countries sets out to prepare the participants for those discussions to an even greater degree than emanates already from their own experience.

Jan C. Schultz
September 1987

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BIOGRAPHIES

Richard B. Barnett, B.A. J.D., partner in Haight, Gardner, Poor and Havens, New York, attorneys, is no stranger to writing and lecturing. He is author of the chapter on maritime financing in "Asset Based Financing" (published by Matthew Bender) and has lectured on ship financing for Seatrade seminars and on the same subject and on "doing business with China" for the Practising Law Institute. He is chairman of the Committee on Marine Finance of the Maritime Law Association of the United States.

Francesco Berlingieri, President of the CMI, was an officer in the Italian Navy during the War. He graduated in Law in 1944 and started his career in his father's office in Genoa in 1946. He took part in all the CMI conferences, becoming a titular member of CMI in 1955, a member of the Executive Council in 1972 and President in succession to Mr. Lilar in 1976. He assisted the English Government in reviewing the functioning of the Commercial Court, and was elected Honorary Member of the U.S. Maritime Law Association and of the Canadian Bar Association. He is the author of numerous books and articles.

Graeme Bowtle, who acknowledges invaluable assistance from Stephen Hoffmeyr (Barrister at Law) and Rob Merkin (Director of Research at Richards Butler) in the preparation of his paper, is himself a partner of some seniority in that firm, which he joined in 1965. Before that he read Jurisprudence at New College, Oxford. He has specialised in asset financing, in particular, ship financing.

Emery W. Harper, attorney and partner in the law firm of Lord Day and Lord, New York, collected a B.A. cum laude from Amherst College in 1958, and thereafter a LL.B. from Yale University in 1961. He started practice in New York in 1962. Since then he has written, lectured and advised internationally making maritime liens and mortgages and maritime financing his speciality. His most recent publication is "The Hybrid Lien – Maritime Liens giving rise to causes of action in contract and tort" (*Il Diritto Marittimo*, 1986).

John Honour M. A. (Oxon), Westminster School and Christchurch, joined the management of the West of England P. and I. Association in 1955 and is now consultant to West of England Services. He was Director there from 1982 to 1986. His long association with that firm followed active war service in the Far East when he was made Captain, and six years practice at the English Bar. He was joint editor with Sir William McNair of one of the earlier editions of Temperley's "Merchant Shipping Acts".

Takeo Kubota, following his graduation from the Law Course at Chuo University in 1960 and from the Legal Institute of the Supreme Court in 1963, joined the Tokyo law firm of Braun, Moriya, Hoashi and Kubota of which he is now a partner. He immediately started to practise in the maritime field and in the same year became registered as a Marine Proctor to act in Marine Enquiry Board hearings. He was appointed as maritime arbitrator to the Japan Shipping Exchange, Inc. (Tokyo) in 1984.

Ole Lund, is a graduate of Oslo University, which awarded him the Scientific Degree Lic. Juris in 1958 for a comparative study of maritime law. He was assistant professor in the Faculty of Laws from 1961 to 1965, and since 1969 he has been attorney at the Supreme Court of Norway. He started his own law firm in 1986, and holds or has held official positions in a wide range of shipping and financial concerns. Perhaps his longest association has been with Nordisk Skibsrederforeningen, from 1965 to 1975, and again as President from 1978 to 1986. He is Chairman of the Maritime Law Association of Norway.

Ralf Richter, professor of Maritime and Commercial Law at Wilhelm – Pieck University, Rostock, took his first degree at the University of Leipzig. He holds Doctorates from the Martin Luther University at Halle-Wittenberg (1968) and from the Academy of State and Legal Science at Potsdam-Babelsberg (1977). He is an arbitrator and a member of the Board of the International Court of Arbitration of Marine and Inland Navigation at Gdynia. He is also President of the Maritime Law Association of the G.D.R.

Jan Schultsz has been involved with maritime law throughout his professional life. His Doctorate was awarded in 1955 by the University of Amsterdam where he is now professor of maritime law, for a thesis on the Transfer of Property in Comparative Law and Conflict of Law. In the same year he became an attorney. He is a partner in the law firm of Blackstone Rueb and Van Boeschoten and president of the MLA of the Netherlands. He serves on the CMI Executive Council and, as an arbitrator, on the board of Nederlands Arbitrage Instituut and on the CMI-ICC arbitration facility.

Roger Wilman, has more than twenty years commercial and merchant banking experience, the last fifteen dealing exclusively with the shipping industry, particularly advising on and arranging ship financing packages for major shipowning and shipbuilding companies. He is currently Director of Lloyds Export and Project Finance Ltd. where his responsibility is to tailor financing packages to take account of particular problems relating to ship ownership, registration, operation, crewing and chartering. He is an associate member of the Institute of Bankers and holds the Institute's Diplomas in Taxation and Investment.

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PART I
PRELIMINARY PAPERS

THE PROTECTION OF MORTGAGEE BANKS IN ENGLISH LAW

Graeme Bowtle*

INTRODUCTION

The primary objective of a mortgagee bank when advancing a loan to an owner on the security of a ship is to make certain that the loan is repaid in full with interest by the owner and that if the loan is not repaid that the loan documents enable the mortgagee to enforce the mortgage and recover all amounts due to it in priority to all other creditors of the owner.

In order to protect its position therefore the mortgagee has to ensure that it obtains valid and enforceable charges on the assets of the owner and that those charges will be recognised and enforced by the courts of all states where the mortgagee may have to enforce them.

This paper describes the security documents required by a mortgagee in a ship finance transaction governed by English law and the methods of enforcement open to it.

SECURITY

There are three principal assets over which a mortgagee normally obtains a charge. First, there is the ship herself, second, there are the insurances on the ship and third, there are the earnings of the ship.

In addition there are often alternative or secondary security documents like personal and corporate guarantees, share pledge agreements, sale options and repurchase options which are not peculiar to ship finance transactions and will not be discussed here.

1. Mortgage on the ship

In English law the registration of ships and mortgages is governed by the Merchant Shipping Act, 1894 ("the Act") and this act still applies in many Commonwealth countries either in its original form or in a re-enacted form (see appendix 1). Section 1 of the Act provides:

* Nos. 1-9 referred to in the text relate to Notes on Italian Law. They have been provided by Francesco Berlingieri and may be found at the end of this article. Prof. Berlingieri has also kindly supplied a brief summary of mortgages in Civil Law which has been printed as Appendix 5.

"A ship shall not be deemed to be a British ship unless owned wholly by persons of the following description (in this Act referred to as persons qualified to be owners of British ships) namely (a) British subjects (b) bodies corporate established under and subject to the laws of some part of Her Majesty's Dominions and having their principal place of business in those Dominions".

Section 2(1) of the Act provides

"Every British ship shall unless exempted from registry be registered under this Act".

Accordingly all British ships exceeding fifteen net registered tons have to be registered under Part I of the Act. There are two further registries, the Fishing Boats Register maintained under Part IV of the Act and the Small Ships Register maintained under the Merchant Shipping Act, 1983 and the Merchant Shipping (Small Ships Register) Regulations, 1983. However it is possible to register mortgages only against a ship which is registered under Part I of the Act and therefore the Fishing Boat Register and the Small Ships Register are not relevant for the purposes of this paper.

In order to register a mortgage against a British ship the owner has to execute a statutory mortgage in the form provided in section 31(1) of the Act and set out in the first schedule thereto. There are two principal forms of statutory mortgage; a mortgage to secure an account current and a mortgage to secure principal and interest. The form generally used is the form to secure an account current since it secures all amounts from time to time due and owing to the mortgagee from the owner. The forms of the statutory mortgage are set out in appendix 2. The statutory mortgage is executed only by the owner and on execution is registered with the Registrar of British Ships at the port where the ship is registered. Under section 33 of the Act mortgages rank in priority of the date of registration.

The form of statutory mortgage itself (as can be seen) does not set out any covenants or undertakings but merely grants a charge on the ship to secure the repayment of all amounts due to the mortgagee ¹⁾. Accordingly the invariable practice is for the mortgagee to require the owner to enter into a deed of covenants with the mortgagee which is collateral to the statutory mortgage and which sets out in detail the owner's duties and liabilities.

In summary, in a deed of covenants the owner undertakes:

- to repay to the mortgagee the amount advanced together with interest;
- to insure the ship in accordance with the terms set out;
- to maintain the UK or British registry of the ship;
- to pay and discharge all the debts and liabilities incurred in the operation of the ship;
- to maintain and repair the ship;

not to mortgage or charge the ship or the insurances;

not to charter the ship for terms longer than the limits specified;

not to permit any charge or lien (including a possessory lien) to be incurred on the ship, and to discharge any which are so incurred.

The deed of covenants lists the events of default, that is those occasions when the mortgagee may enforce its security, and also sets out in detail the rights and powers which the mortgagee may exercise on the occurrence of an event of default ²⁾.

According to the wording in the form of the statutory mortgage the property charged is the "Ship.....her boats and appurtenances....." In the deed of covenants this is generally extended to all equipment, fuel etc which is the property of the owner. Since *nemo dat quod non habet* the owner cannot validly charge property to which it has no legal title such as containers which are on lease or charterer's fuel and equipment: (see *The "Honshu Gloria"* (No. 2) [1986] 2 Lloyd's Rep. 67.)

If the ship is demise chartered the mortgagee generally requires the demise charterer to be a party to the deed of covenants for two reasons: first so that the demise charterer undertakes directly to the mortgagee to perform and discharge the duties and liabilities imposed on the owner in the deed of covenants but which are to be performed by the charterer under the demise charter (such as insurance or repairs) and second, so that the demise charterer expressly subordinates its rights against the ship to those of the mortgagee ³⁾.

The deed of covenants is not registrable with the Registrar of British Ships but if the owner is a limited company registered under the Companies Act then the statutory mortgage and the deed of covenants are registerable under section 395 of the Companies Act (section 410 in Scotland) with the Registrar of Companies ⁴⁾. If the statutory mortgage and deed of covenants are not so registered within 21 days then they will be void against the creditors and any liquidator of the owner ⁵⁾. There are provisions similar to section 395 of the Companies Act in those Commonwealth countries whose legislative provisions are based on the UK Companies Acts of 1929 and 1948 (see Appendix 1).

A statutory mortgage and deed of covenants entered into by an owner which is incorporated outside the United Kingdom but which is registered in the United Kingdom under section 691 of the Companies Act 1985 or has an established place of business in the United Kingdom should also be registered under section 395 Companies Act 1985. (see also: *N.V. Slavenburg's Bank v Intercontinental Natural Resources Ltd & Ors.* [1980] 1 All E.R. 955)

No certificate of registration is issued by the Registrar of Ships in relation to the statutory mortgage but the Registrar may issue a transcript of register which sets out full details of the registered owner, the dimensions of the ship and the mortgages

registered against the ship. It is possible for anyone to inspect the register book maintained by the Registrar of Ships at the port of registry on payment of the statutory fee and also to obtain a transcript of registry ⁶⁾.

A certificate of registration is issued by the Registrar of Companies in respect of registrations under sections 395 and 410 of the Companies Act, 1985 and it is possible for anyone to inspect this register too ⁷⁾.

2. Insurances

Insurance requirements

Perhaps equally important with the charge on the ship is the mortgagee's charge on the insurances taken out on the ship by the owner. It is essential that the mortgagee ensures that the ship is fully insured against hull and machinery marine and war risks and P. & I. risks in accordance with the mortgagee's requirements and that either the mortgagee is named as joint assured or that the insurances are effectively assigned to the mortgagee.

If the ship is insured at Lloyds or by insurance companies then the relevant insurance document is the policy to which are attached the clauses setting out the risks covered and the special conditions of the insurance e.g. the Institute Clauses. If the ship is insured in a mutual insurance association then the relevant documents are the certificate of entry and the rules of the association which set out the terms of the cover.

Insurance in joint names

The insurances can be effected in the joint names of the owner and the mortgagee so that they are joint assureds. If the owner and the mortgagee are joint assureds then they are jointly liable for the premiums and any claims will be paid to them jointly or as otherwise required by the loss payable clause. Furthermore any breach by one assured, which gives the underwriters the right to avoid liability on the policy, gives the underwriters the right to avoid the policy as against both assureds. If however the policy is a "composite" policy so that the several interests of the owner and the mortgagee are insured (see *General Accident Co. Ltd. v Midland Bank Ltd.* [1940] 2 KB 388) then a breach of warranty by the owner does not affect the mortgagee's rights against the underwriters (*Samuel & Co. Ltd. v Dumas* [1924] AC 431). However if as in *Samuel & Co. Ltd. v Dumas* the cause of the loss is the wilful misconduct of the owner and not an insured peril then of course neither the owner nor the mortgagee will be able to recover under the policy.

Requirements of assignment under English law

In English law an assignment is either legal or equitable.

Section 136(1) of the Law of Property Act, 1925 provides:

Any absolute assignment by writing under the hand of the assignor (not purporting to be by way of charge only) of any debt or other legal thing in action of which express notice in writing has been given to the debtor, trustee or other person from whom the assignor would have been entitled to claim such debt or thing in action is effectual in law (subject to equities having priority over the right of the assignee) to pass and transfer from the date of such notice:

- (a) the legal right to such debt or thing in action;
- (b) all legal and other remedies for the same; and
- (c) the power to give a good discharge for the same without the concurrence of the assignor.

To the extent that the assignment does not comply with the statutory requirements it may be effective as an equitable assignment. Assignments generally rank in order of the priority of the date on which notice is given to the debtor (*Dearle v. Hall* (1828) 3 Russ.1) and the assignee (the mortgagee) cannot acquire a better right than the assignor (the owner) Snell's *Principles of Equity* 28th Ed. p.82. The debtor can plead against the assignee any defence which he would have had against the assignor, provided the defence had accrued before the debtor received notice of the assignment.

This is the position under the general law but there are further specific provisions relating to marine insurance.

Section 50 of the Marine Insurance Act, 1906 provides:

- (1) A marine policy is assignable unless it contains terms expressly prohibiting assignment. It may be assigned either before or after loss.
- (2) Where a marine policy has been assigned so as to pass the beneficial interest in such policy the assignee of the policy is entitled to sue thereon in his own name; and the defendant is entitled to make any defence arising out of the contract which he would have been entitled to make if the action had been brought in the name of the person by or on behalf of whom the policy was effected.
- (3) A marine policy may be assigned by endorsement thereon or in other customary manner.

The terms of the insurance policy or rules of the association further influence the question of assignment.

Clause 5 of the Institute Time Clauses Hulls (1983) provide as follows:

"No assignment of or interest in this insurance or in any monies which may be or become payable thereunder is to be binding on or recognised by the Underwriters unless a dated notice of such assignment or interest signed by the Assured and by the Assignor in the case of subsequent assignment, is endorsed on the Policy and the Policy with such

endorsement is produced before payment of any claim or return of premium thereunder”.

The rules of protection and indemnity associations generally require the consent of the association before an assignment can validly be granted. For example, rule 15 of the United Kingdom Mutual Steamship Assurance Association (Bermuda) Limited provides:

“No insurance given by the Association and no interest under these Rules or under any contract between the Association and any Owner may be assigned without the written consent of the Managers who shall have the right in their discretion to give or refuse such consent without stating any reason or to give such consent upon any such terms or conditions as they may think fit. Any purported assignment made without such consent or without there being due compliance with any such terms and conditions as the Managers may impose shall, unless the Managers in their discretion otherwise decide, be void and of no effect.

Whether or not the Managers shall expressly so stipulate as a condition for giving their consent to any assignment the Association shall be entitled in settling any claim presented by the assignee to deduct or retain such amount as the Managers may then estimate be sufficient to discharge any liabilities of the assignor to the Association whether existing at the time of the assignment or having accrued or being likely to accrue thereafter.”

Under the rules of most protection and indemnity associations there is rather a draconian rule of cesser of cover on the granting of a mortgage. Rule 29(b)(ii) of the United Kingdom Steamship Assurance Association (Bermuda) Limited provides:

“Unless otherwise agreed in writing by the Managers an Owner shall forthwith cease to be insured by the association in respect of any ship entered by him or on his behalf or upon the happening of any of the following events in relation to such ship . . . upon the mortgaging or hypothecation of the ship or any part of the Owners interest in that ship.”

In order to complete the assignment the mortgagee must serve a notice of assignment in the proper form: in the case of the marine policies the notice is to be served on the underwriters and in the case of the protection and indemnity association, subject to having obtained the association’s prior consent it will be served on the association ⁹⁾, or on the managers as agents.

Assignment of reinsurances

In certain cases an owner may have insured all or part of the risk through a “captive” insurance company (an insurance company controlled by the owner or the holding company of the owner); in this case a mortgagee is likely to require a direct right against the reinsurers by an assignment of the primary insurer’s rights against the reinsurer’s.

Loss payable clauses

Although the insurances stand in joint names or are assigned to the mortgagee, the mortgagee and the owner generally agree the terms of a loss payable clause which is endorsed on the policy and which sets out to whom claims under the policies are to be paid. All claims for total loss, all claims exceeding a specified amount and all claims arising after an event of default will be payable to the mortgagee while other claims may be paid direct to the owner as and when the liabilities arise.

The loss payable clause does not of itself create any interest in the insurance but merely evidences the agreement between the mortgagee and the owner: it qualifies the effect of the notice of assignment since certain claims may still be paid direct to the owner.

Letters of undertaking

Since the hull policies are usually held by the brokers, a mortgagee generally obtains a letter of undertaking from them. The Lloyds' Brokers' Association has issued a standard form letter of undertaking (see appendix 3) which is generally acceptable to mortgagees. Amendments are frequently requested in particular, to require the brokers to give the mortgagee prior notice of non-renewal of the policies at the end of the policy year without a specific request.

The protection and indemnity associations also issue letters of undertaking in standard form (see appendix 3).

In the letters of undertaking the brokers or association agree to endorse the loss payable clauses on the policies or the certificates of entry and undertake to give to the mortgagee notice of non-renewal or cancellation of the policy or entry. A letter of undertaking constitutes a contract between the broker or the association and the mortgagee and is legally enforceable against the broker by the mortgagee (but see *Amalgamated General Finance Co. v Golding* [1964] 2 Lloyd's Rep. 163).

Broker's lien and set off

In law brokers have a lien on the policy for the premium and commission and may also have a lien on the policy for amounts due to them on a general insurance account (see Arnould on Marine Insurance 16th Ed. para. 195). It is therefore important to restrict the broker's lien to premiums due in respect of the particular ship on which the mortgagee holds a mortgage.

A broker's lien on the policy does not extend to the proceeds collected under it, but in practice, as no claim can be collected without production of the policy the lien on the policy constitutes a *de facto* lien on the proceeds. (See clause 22 of the Institute Time Clauses Hull, and also *Fairfield Shipbuilding & Engineering Co. Ltd. v Gardner Mountain & Co. Ltd.* 104 (1911) LT 288.)

The mortgagee's rights as assignee are subject to the broker's lien, since the owner cannot assign its rights under the policy free of the restriction of the broker's lien, unless the broker has expressly waived his rights.

The broker's lien, in so far as it relates to the proceeds of insurances, is a right of set off, rather than a lien.

Protection and indemnity associations also have the right to set off against any amounts payable by them to the mortgagee amounts due to them from the owner at the time of the receipt of the notice of assignment unless the mortgagee agrees otherwise (*The "Evelpidis Era"* [1981] 1 Lloyd's Rep. 54).

Mareva injunctions: third parties' claims

In certain circumstances in England a third party may claim against the insurances effected on the ship. If the insurances are placed in London then claims under those insurances form one of the assets of the owner: the third party may obtain a *Mareva* injunction against the insurances or any claims under the insurances. A *Mareva* injunction is an order of the court prohibiting the payment out of the jurisdiction of any funds which may be payable to the owner. (*Mareva Comp. Nav. S.A. v International Bulk Carriers S.A.* [1975] 2 Lloyd's Rep. 509 (C.A.).)

If this happens, and assuming that the insurances have been assigned to the mortgagee, then the mortgagee can apply to the court for an order varying the *Mareva* injunction, so that claims under the insurances up to the amount of the mortgage debt shall nevertheless be paid to the mortgagee in accordance with the terms of the assignment of insurances.

On occasion, a third party with a claim against a ship has alleged that it has legal rights against the insurances under a lien clause in a charter. The courts have held that no such claim exists: Mr. Justice Goff in *The "Lancaster"* [1980] 2 Lloyd's Rep. 497 held "the proceeds of insurance upon a chattel neither represent the chattel nor constitute the product of the chattel" when he dismissed a claim by the charterer that the lien clause in the charter gave the charterer the right to claims against the hull insurances. See also *The "Panglobal Friendship"* [1978] 1 Lloyd's Rep 368 and, *Rayner v. Preston* [1881] 18 Ch. D. 1.

In English law the only way a party can obtain a direct right against the insurances is by contract; the only exception is in the case of liability insurance when upon the insolvency of the assured a third party may make a claim under the Third Party (Rights against Insurers) Act 1930 %.

Breach of warranty clauses and mortgagee's interest insurance

Section 33(3) of the Marine Insurance Act, 1906 provides:

"(1) A warranty, in the following sections relating to warranties, means a promissory warranty, that is to say, a warranty by which the assured undertakes that some particular thing shall or shall not be done, or that some condition shall be fulfilled or whereby he affirms or negatives the existence of a particular state of facts.

(2)

(3) A warranty, as above defined, is a condition which must be exactly complied with, whether it be material to the risk or not. If it be not so complied with, then, subject to any express provision in the policy, the insurer is discharged from liability as from the date of the breach of warranty, but without prejudice to any liability incurred by him before that date."

Section 55 provides:

"(1) Subject to the provisions of the Act, and unless the policy otherwise provides, the insurer is liable for any loss proximately caused by a peril insured against, but, subject as aforesaid, he is not liable for any loss which is not proximately caused by a peril insured against.

(2) In particular,--

(a) The insurer is not liable for any loss attributable to the wilful misconduct of the assured, but, unless the policy otherwise provides, he is liable for any loss proximately caused by a peril insured against, even though the loss would not have happened but for the misconduct or negligence of the master or crew;"

Accordingly if there is a breach of warranty, wilful misconduct or want of good faith on the part of the owner, the underwriters can avoid liability as against the owner (the assured) and the mortgagee either as joint assured or as an assignee of the insurances: (*The "Litsion Pride"* [1985] 1 Lloyd's Rep. 437). It is, of course, critical for the mortgagee to ensure that the insurances will be valid notwithstanding any breach of warranty by the owner and this protection can be obtained in two ways. First, the mortgagee may require the owner to include a breach of warranty clause in the primary policies so that notwithstanding any breach of warranty by the owner the underwriters remain liable to the mortgagee to the extent of its interest. However this will not be effective if the underwriters avoid liability for want of good faith. Second, the mortgagee may take out a separate mortgagee's interest insurance, generally with separate underwriters and generally through separate brokers. Mortgagee's interest insurance originated with insurance provided by the Swedish Club and the earliest forms of mortgagee's interest insurance were known as "the Swedish wording". Subsequently in the 1970's the mortgagee's interest insurance was written in the London market and various brokers drafted their own terms. In May 1986 the Institute Mortgagee's Interest Clauses were published, and it is intended that all future mortgagee's interest insurance in London is written on the Institute Clauses.

It had long been understood by mortgagees that if the underwriters under the primary policy avoided liability, then the underwriters on the mortgagee's interest insurance would pay to the mortgagee the lesser of the insured value of the ship or the amount of the loan. However, in *The "Captain Panagos D.P."* [1985] 1 Lloyd's Rep. 625 Mr. Justice Mustill held that on the Intersure terms, the total amount recoverable under the terms of the mortgagee's interest policy was the sound value of the ship immediately before the casualty.

Although the Institute Clauses differ from the Intersure terms the arguments that were put forward by the underwriters in *The "Captain Panagos D.P."* could still be put forward against a claim under the Institute Clauses. It is important therefore for a mortgagee who is arranging for mortgagee's interest insurance to ensure:

- First: if a claim arises under the primary policies, which are then avoided by the underwriters for any reason, the mortgagee's interest underwriters will pay either the amount of the claim under the primary policies or the amount of the loan outstanding whichever is less: and
- Second: that the amount payable will be paid within twelve months of the claim being submitted to the primary underwriters and remaining unpaid.

3. Assignment of earnings

Assignment and payment

It is also important for the mortgagee to take an assignment of the earnings of the ship. "Earnings" includes all the revenue of the ship, all payments of hire and freight under the charters, salvage awards, remuneration under towage contracts, general average recoveries, requisition for hire and all other amounts that are receivable by the owner arising out of or in connection with the use of the ship.

The assignment of earnings may be included in the deed of covenant or alternatively may be contained in a separate document. The assignment is generally drafted in terms of an absolute assignment of earnings but with provision for the earnings to be paid in a specified way until an event of default occurs. There are three principal ways in which the earnings of the ship can be applied:

- First: all the earnings can be paid to the mortgagee who releases to the owner sufficient funds for the operational costs of the ship, and retains the balance against debt service payments etc.;
- Second: all earnings may be paid into a bank account with the mortgagee but the owner may apply the funds in that account in accordance with its own requirements;
- Third: the mortgagee may permit the owner to retain all the earnings and have them paid in accordance with its directions.

On the occurrence of an event of default all the earnings should become payable, and be paid, to the mortgagee.

In many cases the mortgagee may require the owner to include a term in all charters that the hire is to be paid to the owner's account with the mortgagee.

The general rules of English law regarding assignment apply also to the assignment of earnings that is, notice of the assignment has to be given to the payer. Additionally, the mortgagee generally requires the payer, usually the charterer, to acknowledge the notice of assignment and confirm that the earnings will be paid in accordance with the assignment.

Set off

Again an assignee takes subject to equities and if a charterer has a right to set off against the hire any claim which had accrued when he received notice of the assignment, he can exercise the right against the mortgagee, subject to one important limitation: in English law no set off is permitted against freight: *Mondel v Steel* (1841) 8M&W 858; *The "Aries"* [1977] 1 Lloyd's Rep. 334; *The "Dominique"* [1987] 1 Lloyd's Rep. 239: although set off may be permitted against hire; *The "Nanfri"* [1978] 2 Lloyd's Rep. 132 (C.A.) [1979] 1 Lloyd's Rep. 201 (H.L.).

Assignment of charter

Where there is either a demise charter or a long term time charter the mortgagee may require the charterer to enter into a charter assignment agreement with the owner and the mortgagee. The charterer then undertakes to pay all charter hire to the mortgagee. In default of payment the mortgagee may be granted a direct right against sub-charters so that the mortgagee may claim freights and hire payable under them. The charter assignment agreement may also provide that if the owner defaults under the mortgage the mortgagee can either sell the ship subject to the charter or terminate the charter and sell the ship free of the charter.

Owner's lien on sub-freights

The mortgagee may in certain cases take an assignment of the owner's rights of lien in a time charter, since if the charterer fails to pay the hire then the owner may have a right to lien sub-freights (see clause 18 of the New York Produce Form, clause 18 of the Baltimore Form and clause 20 of the Linertime Form). In English law this right of lien itself operates as an equitable assignment or charge on the sub-freights granted by the charterer to the owner (see *The "Cebu"* [1983] 1 Lloyd's Rep. 302 and *The "Ugland Trailer"* [1985] 2 Lloyd's Rep. 372: notice of lien has to be given to the payer of the freight to make it effective.

Companies Act registration

In English law an assignment of earnings is a charge on the book debts of the owner. If the owner or other assignor is a limited company, the assignment is registerable under section 395 of the Companies Act. 1985. This also applies to a lien clause in a charter and such a lien will not be valid against other creditors or a liquidator of the charterer unless registered under section 395 of the Companies Act. 1985 (*The "Ugland Trailer"*).

Retention account and set off

Loan documents often provide for the retention of earnings received by the mortgagee and the right of the mortgagee to set off money due to it against money held in a retention account. It was assumed by many mortgagees that such a provision was valid but in the *In re Charge Card Services Limited* [1986] 3 All E.R. 289, it was held by the Court that it was not effective in law because a customer could not charge a credit balance in favour of the mortgagee which held the account. The set off provisions are effective as a matter of contract, but if the owner is in liquidation the set off provisions can be effective only to the extent permitted under the Insolvency Rules. Accordingly if a mortgagee is to be fully protected it should ensure that the earnings are held in an account of an associate bank, whereupon the owner can validly charge the credit balances in that account to the mortgagee.

ENFORCEMENT OF SECURITY

On the occurrence of an event of default the mortgagee can enforce the rights that it has in law and those contained in the security documents. In relation to the ship, the mortgagee has four separate rights which he can exercise: the right to foreclose, the right to apply for a judicial sale, the right to take possession and effect a sale, and the right to procure the sale of the ship by the owner.

A mortgagee of a British ship has a statutory power of sale under section 35 of the Merchant Shipping Act 1894. Otherwise the rights and powers of a mortgagee in the English Courts are the same whatever the country of registry of the ship, subject always to the terms of the mortgage.

1. Foreclosure

At common law the right of foreclose was a procedure whereby the owner's equitable right of redemption was declared by the Court to be extinguished. In mortgages on real property the mortgagee might apply to the Court for an order for foreclosure but on the application of the owner or another interested party such as a subsequent mortgagee the Court would generally order the sale of the property rather than foreclosure. The same principles would be applied by the Admiralty Court in an action for foreclosure on a ship's mortgage, so it is improbable that an action for foreclosure would ever come before the Admiralty Court.

2. Judicial Sale

Procedure for arrest and sale

The Admiralty Court in England has power to arrest ships of any port of registry (except those protected by sovereign immunity) which are within its jurisdiction (i.e. territorial waters of the United Kingdom but not inland waterways: *The "Goring"* [1987] 2 W.L.R.1151) and thereafter to sell the ship under its inherent jurisdiction and under the provisions of sections 20–22 of the Supreme Court Act, 1981. The formal procedure is laid down in Order 75 of the Rules of the Supreme Court. In outline the procedure is that the mortgagee issues a writ *in rem* against the ship and then applies for the issue of a warrant of arrest which is executed by the Admiralty Marshal at the port or place where the ship is.

The actual arrest is usually carried out by officers of H.M. Customs & Excise who can prevent the ship from leaving the port.

In most actions commenced by a mortgagee there is no defence and the mortgagee can apply to the court for judgment either in default of notice of acknowledgement to the writ or in default of defence (Order 72 rule 21).

However even before obtaining judgment it is possible for the mortgagee to apply for an order for sale *pendente lite* and because of the expense of maintaining a ship under arrest such an order is generally granted by the Admiralty Court: *The "Mytro"* [1977] 2 Lloyd's Rep. 243, but see also *The "Alexandros Tsavliris"* [1987] LMLN 202.

After the court makes an order for sale, a Commission for Appraisement and Sale is lodged with the Admiralty Registry and the Admiralty Marshal's brokers value the ship, which is then advertised for sale on the Admiralty Marshal's conditions of sale (Appendix 4). The normal procedure is that a prospective purchaser completes the printed form of tender which he lodges with the Admiralty Marshal's brokers. The highest bid is accepted provided it is higher than the appraised value. If no bids are received above the appraised value then it is open to the Admiralty Marshal to apply to the Admiralty Court for the highest bid to be accepted notwithstanding. Normally tenders are made in pounds sterling but it is open to the court to order the ship to be sold in foreign currency. (*"The Halcyon the Great" (No. 1)* [1975] 1 Lloyd's Rep. 518 and *The "Halcyon the Great" (No. 2)* [1975] 1 Lloyd's Rep. 525).

When a bid has been accepted, the Admiralty Marshal executes the bill of sale which transfers the legal title in the ship to the purchaser free of all encumbrances including maritime liens, mortgages and other liens or charges on payment of the purchase price. These claims then attach to the sale proceeds which are paid into court pending an order for the determination of priorities and payment out.

A mortgagee who arrests a ship is liable for all the costs of the arrest whilst the ship (see RSCO 75 rule 23) is under arrest although such costs are recoverable from the proceeds of sale after the ship has been sold (see *The "World Star"* [1987] Lloyd's Rep.

192) in priority to all other claims other than the Admiralty Marshal's costs.

If the mortgagee has not continued the insurances he should insure the ship for the period between the arrest and the sale (see Practice Direction 1970) since it is no longer done by the Admiralty Marshal.

If the ship has been arrested by another claimant then the mortgagee should lodge a caveat against release and payment of the proceeds of sale in the Admiralty Court. If the claimant who has arrested the ship lifts the arrest then it is open to the mortgagee to arrest the ship and make an application for sale.

All claimants who have claims against the ship must obtain judgment and it is then for the Court to decide, at the hearing for the determination of priorities, the order in which the claims should rank.

Priority of Claims

In summary, the order of priority of claims against the fund in court is as follows:

- First: Admiralty Marshal's expenses, costs of the arrest and the costs of the arresting claimant in relation to the arrest (but not the costs of the substantive action).
- Second: Claims secured by a possessory lien and certain statutory claims of harbour authorities which give them the right to detain and sell the ship. (*The "Queen of the South"* [1968] 1 Lloyd's Rep. 182 and *The "Freightline One"* [1986] 1 Lloyd's Rep. 266).
- Third: Maritime liens: in English law these claims are as follows:
 - A. Collision damage (including personal injury see: *The "Tolten"* [1946] P. 135)
 - B. Salvage
 - C. Officers' and crew's wages (including the master's wages under section 18 of the Merchant Shipping Act 1970)
 - D. Respondentia and bottomry (in practice obsolete).
- Fourth: Mortgages: in order of priority.
- Fifth: Statutory liens, that is claims under section 20 of the Supreme Court Act, 1981 in respect of which *in rem* actions have been commenced. *In re "Aro"* [1980] W.L.R. 453.

It is a matter for the *lex fori* to determine the juridical nature of any claim and whether or not a claim is a maritime lien (see *The "Halcyon Isle"* [1980] 2 Lloyd's Rep. 325 (P.C.)). Accordingly the claim of a foreign claimant may rank as a maritime lien, in the country where the claim arose (*lex causae*) but may not so rank in the United Kingdom. It then ranks with other lienors who have liens under section 20 of the Supreme Court Act, 1981 and therefore subordinate to a mortgage.

Crew

If the crew (as is generally the case) is on board the ship when the ship is arrested it is improbable that they will agree to leave without being paid. Accordingly it is often advisable for the mortgagee to pay the officers and crew all amounts due to them. The mortgagee should first obtain an order of the Admiralty Court, so that it is subrogated to the maritime lien of the officers and crew. If the mortgagee does not pay then the Admiralty Marshal may pay them and arrange for their repatriation. The costs would be claimed from the mortgagee who would be reimbursed from the proceeds of sale when they become available. (*The "World Star"* [1987] Lloyd's Rep. 192).

Cargo on board Ship

Often when a ship is arrested there is cargo on board which may not itself be subject to the arrest. The Admiralty Marshal generally permits the cargo interests to remove the cargo at their cost (Admiralty Practice Direction 3.) If they do not do so then the Admiralty Marshal may remove the cargo and charge the cargo interests with the costs of so doing (*The "Jogoo"* [1981] 1 Lloyd's Rep. 513; *The "Myrto"* [1978] 1 Lloyd's Rep. 11 (C.A.); *The "Myrto" No. 2* [1984] 2 Lloyd's Rep. 341)

Bunkers on board Ship

Bunkers on board the ship usually belong to the owners and are subject to the charge of the mortgage. They are therefore sold by the Admiralty Marshal under the Order for Sale (but see *The "Honshu Gloria" (No. 2)* [1986] 2 Lloyd's Rep. 67). However if a charterer can establish that the bunkers are his and not the owner's then he can arrange for the bunkers to be redelivered to him.

Classification Society fees

In order to sell the ship it is important that the class is maintained and therefore the Admiralty Marshal may pay any outstanding Classification Society fees in order to effect the sale: (*The "Honshu Gloria"*).

Charterer's right of intervention

A charterer has certain rights to prevent the arrest and sale of the ship if such action would interfere with his contractual rights. A mortgagee should therefore carefully consider whether an arrest to enforce its mortgage will procure a breach of contract between the owners and a charterer. In *The "Myrto"* [1977] 2 Lloyd's Rep. 243, Mr. Justice Brandon set out in detail the relevant principles. If the owner is willing and able to complete the contractual voyage and if the security of the mortgage is not prejudiced, then on the application of the charterer the Court will prevent the mortgagee from enforcing its rights until the termination of the charter. However the exception to this rule, and one which invariably applies, is that if the owner is insolvent and incapable of paying his bills then the Court will not stop the sale of the ship. The principles laid down by Mr. Justice Brandon in *The "Myrto"* have not been questioned in any subsequent reported decision although it has been argued that the authorities on which he relied did not wholly support the principles which he laid down.

3. Mortgagee's power of sale

Mortgagee's possession

In English law a mortgagee may take possession of a ship after an event of default either by giving orders directly to the master or by taking physical possession and replacing the owners's officers and crew with its own officers and crew. In practice the mortgagee takes possession simply by giving notice to the master of the exercise of its power to take possession. The master acknowledges the notice and agrees to act in accordance with the mortgagee's directions. When the owner is in default it is often, if not invariably, the case that there are wages due to the officers and crew and therefore the officers and crew are generally willing to co-operate with the mortgagee on terms that the arrears of wages are paid. The mortgagee on taking possession of the ship becomes responsible for the payment of the future wages: *Keith v Burrows* [1877] 2 A.C. 636; and for all other liabilities incurred after it takes possession.

Power of sale

The rights and powers of the mortgagee are set out in detail in the security documents. However under section 35 of the Merchant Shipping Act. 1894 the mortgagee in possession has a statutory power of sale, in addition to any contractual power of sale conferred by the mortgage.

If the mortgagee sells the ship as mortgagee in possession then the effect of the sale is to discharge all subsequent mortgages on the register. However the purchaser takes the ship subject to pre-existing maritime liens and subject to any claims under section 20 of the Supreme Court Act, 1981 in respect of which proceedings have been commenced against the ship before the transfer of title (see *The "Monica S"* [1967] 2

Lloyd's Rep. 113).

Implied warranties

When a mortgagee sells as mortgagee in possession warranties of title (section 12 of the Sale of Goods Act, 1979) are implied into the contract unless specifically excluded. The mortgagee should therefore ensure that there are no claims *in rem* which may be enforceable against the ship after the sale. It is not always possible for the mortgagee to obtain this information easily short of investigating the owner's books of account to see what claims are outstanding against the ship. The mortgagee should always carry out a writ search in the Admiralty Registry before completing a sale to ensure that no writs *in rem* have been issued (which would be enforceable after the sale has been completed) although again this is not conclusive since the writs *in rem* may have been issued out of a District Registry or a County Court.

If such a writ has been issued or if a claimant is threatening proceedings, then the mortgagee either has to reach a compromise with the claimant or alternatively has to withdraw from the agreed sale and apply to the court for an order for sale.

Although the mortgagee is not a trustee of the power of sale, it has a duty to obtain a reasonable price: (*The "Calm C"* [1975] 1 Lloyd's Rep. 188, Canadian Court of Appeal.)

The mortgagee is under no obligation to exercise its power of sale and may simply retain possession and operate the ship, assuming all liabilities, perhaps awaiting a change in the market to obtain a higher price.

Finally in relation to the question of possession, a mortgagee may take constructive possession of a ship by giving orders to the owner which are complied with by the owner. Therefore, unless the mortgagee intends to take possession of the ship, it should be very careful as to the orders it gives to the owners pursuant to its powers in the security documents and as far as possible should give only negative orders, prohibitions rather than positive orders.

4. Sale by mortgagee as attorney for owner

In many cases a mortgage includes a provision appointing the mortgagee as attorney in fact for the owner. Upon a default, it is possible for the mortgagee to execute all documents necessary to transfer the ship, in the name of the owners. *Prima facie* this is a sale by the owner. If there is a breach of warranty, for instance, as to title to the ship or as to its condition then the purchaser can have recourse only against the owner. However in these circumstances the purchaser could well require a guarantee or an indemnity from the mortgagee before accepting the owner's bill of sale as in certain cases the purchaser may be able to show the real seller was the mortgagee, and that the owner was merely a nominee, and that the mortgagee should be liable for any breach of the terms of the contract of sale.

5. Insolvency Act, 1986

In the United Kingdom the provisions of the Insolvency Act, 1986 may affect the enforcement of a mortgagee's security. If the owner has granted a debenture on its assets and if an administrative receiver has been appointed then the administrative receiver has the right under section 43 of the Insolvency Act, 1986 to apply to the Court for an order to sell the ship notwithstanding that it is subject to a mortgage. This section applies only if the debenture under which the administrative receiver was appointed has priority over the security of the mortgage. The proceeds of the sale by the administrative receiver must be applied towards discharging the sum secured by the mortgage. It is unlikely that the Companies Court would make an order under this section in respect of a ship if proceedings in the Admiralty Court were pending.

Under section 8 of the Insolvency Act 1986 an owner or a creditor of the owner may apply to the Court for the appointment of an administrator of the owner: if the application is granted, the mortgagee cannot enforce its security without leave of the Court, while the administrator, with leave of the Court, can sell the ship notwithstanding it is subject to mortgage although the administrator must account to the mortgagees for the proceeds of sale. However an administrator cannot be appointed if a debenture holder has already appointed an administrative receiver, unless the debenture holder consents to such appointment.

Section 130(2) of the Insolvency Act, 1986 provides:

“When a Winding up Order has been made... no action or proceedings shall be proceeded with or commenced against the company or its property, except by leave of the Court and subject to such terms as the Court may impose”.

If a winding up order has been made against the owner it is necessary for the mortgagee to obtain leave of the court to proceed with its action. This is invariably given in the case of a secured creditor such as the mortgagee or in the case of a claimant having a lien on the ship: (see *In re Aro Co. Limited* [1980] 2 W.L.R. 453).

The English Courts do not give effect to the provisions of foreign insolvency proceedings. If such proceedings are pending against the owner (e.g. Chapter 11 of the US Federal Bankruptcy Code) then the Court is not prevented from exercising its jurisdiction as if no such order had been made. In *Felixstowe Dock and Railway Co. v US Lines Inc.* [1987] 2 Lloyd's Rep. 76 the Court dismissed an application by United States Lines Inc. to set aside a *Mareva* injunction obtained against them on the basis that a restraining order under Chapter 11 of the U.S. Federal Bankruptcy Code had been obtained. The Court held that such an order did not prevent or limit the court's jurisdiction in this country to grant an injunction against the assets of the United States Lines Inc.

FORUM SELECTION

When an owner is in default a mortgagee obviously prefers to make an agreement with the owner as to how the owner's assets can be realised in the manner most advantageous to both of them. In many cases agreement can be reached, especially in cases where there are personal guarantees when it is in the owner's interest to ensure that the mortgagee maximises its recovery provided that the owner does not commit a fraudulent preference (section 239 Insolvency Act. 1986).

However where the owner's co-operation is not possible then the mortgagee is left no alternative but to enforce its right *in rem* against the ship; to enforce its legal title to all insurance claims outstanding which may involve bringing proceedings against underwriters if these claims are disputed or not paid; and to enforce its legal title to the earnings which may involve bringing proceedings against charterers and others who are indebted to the owner.

The mortgagee may have no discretion as to where proceedings are commenced. Proceedings on a claim against London underwriters have to be commenced in London: if there is a claim against a U.S. charterer under a charterparty which provides for New York arbitration then the claim would have to be brought in New York under the arbitration clause.

However in relation to the ship which is trading the mortgagee has a limited discretion as to where it will enforce its security. In some countries the only remedy open to the mortgagee is to apply to the Court for arrest and sale, whereas in others the mortgagee can enforce all the rights and powers granted to it in the mortgage, in particular the right to take possession of the ship. The mortgagee's decision is usually irrevocable and can have an important effect on its recovery.

The factors which a mortgagee has to take into account are:

1. What is the procedure for arrest and sale?
2. Does the mortgagee have to provide counter security?
3. What is the period between arrest and sale of the ship and the payment out of the sale price?
4. How is the ship sold: is it by auction or tender?
5. Can the proceedings be withdrawn at any time?
6. What is the order of priorities applied by the Court in paying out the sale proceeds? If maritime liens rank in priority to the mortgage, what claims constitute maritime liens?

7. Can the mortgagee purchase the ship? If so, can the mortgage debt be "set off" against the price?
8. Are there any exchange control regulations in effect limiting the right of the mortgagee to repatriate the proceeds of sale?
9. Can a charterer or other third party intervene to prevent the sale?

It is to the mortgagee's advantage to arrest the ship in a jurisdiction where the procedure is relatively simple and a sale of the ship can be effected within a defined limited period of time and where the mortgage will be accorded priority to all claims other than maritime liens. If there is an outstanding repair yard claim for repairs done in the United States (which there carries a right to a maritime lien) it is clearly to the advantage of the mortgagee to arrest the ship and enforce its security in a jurisdiction which decides whether a claim is a maritime lien by the *lex fori* rather than in a jurisdiction which does so on the basis of the *lex causae*.

In practice English admiralty law is applied in many common law jurisdictions outside the United Kingdom. Decisions of the English courts are binding in the British Colonial courts of Hong Kong and are of persuasive authority in Commonwealth countries such as Australia, Canada and New Zealand.

Occasionally a Commonwealth court will not follow a decision of the English Court. In the three related decisions of *The "Ioannis Daskalelis"*, *The "Christine Isle"* and *The "Halcyon Isle"*, the question was whether or not a U.S. repairer's lien constituted a maritime lien and therefore ranked in priority to the mortgage. In *The "Ioannis Daskalelis"* [1974] 1 Lloyd's Rep. 174 the Canadian Supreme Court held that whether a claim constituted a maritime lien or not was to be decided by the *lex causae* and not by the *lex fori*. In taking this decision the Court purported to follow the English decision in *The "Colorado"* (1923) 13 L.L.R. 310; [1923] P.102. The matter came for decision in Bermuda in *The "Christine Isle"* [1974] AMC 331. The Bermuda Court decided that it should apply the *lex fori* rather than the *lex causae* in deciding the nature of the lien. This decision was followed in the case of *The "Halcyon Isle"* [1980] 2 Lloyd's Rep. 325 which was an appeal from the Singapore Court. The Law Lords in the Privy Council were divided three to two; three Law Lords held that the nature of the claim should be determined by the *lex fori* whereas two Law Lords held that the decision in *The "Ioannis Daskalelis"* was correct and the matter should be determined by the *lex causae*.

The arguments for and against the *lex fori* and the *lex causae* are clearly set out in the judgments in *The "Halcyon Isle"* by Lord Diplock (*lex fori*) and Lord Salmon and Lord Scarman (*lex causae*).

Lord Diplock held that on the basis of the authorities the English Courts had always applied the *lex fori* to determine whether or not a claim constituted a maritime lien:

“in their Lordships’ view the English authorities upon close examination support the principle that in the application of English rules of conflict of laws, maritime claims are classified as giving rise to maritime liens which are enforceable in actions *in rem* in English Courts where *and only where* the events on which the claim is founded would have given rise to a maritime lien in English law, if those events had occurred within the territorial jurisdiction of the English Court.”

However, Lord Scarman and Lord Salmon considered the matter to be one of private international law:

“in England the *lex fori* decides the priority of the rights which exist against a ship, e.g. the rights conferred by a maritime lien taking precedence over the rights of a mortgagee. The question is – does English law, in circumstances such as these, recognise the maritime lien created by the law of the U.S.A. i.e. the *lex loci contractus* when no such lien exists by its own internal law. In our view the balance of authorities, the comity of nations, private international law and natural justice all answer this question in the affirmative. If this be correct then English law (the *lex fori*) gives a maritime lien created by the *lex loci contractus* precedence over the appellant’s mortgage.”

On this point Canadian law and English law differ although of course it would be open to the Canadian Supreme Court in another case not to follow the decision in *The “Ioannis Daskalelis”* just as (in theory) it would be open to the House of Lords not to follow the majority Privy Council decision in *The “Halcyon Isle”*. From the mortgagee’s point of view the decision in *The “Halcyon Isle”* is to be preferred in that the mortgagee can tell precisely which claims will rank in priority to his mortgage: if the decision of the minority of the Privy Council in *The “Halcyon Isle”* were adopted there would clearly be a degree of uncertainty since whether or not a claim took priority to the mortgage would depend not on the *lex fori* but on the law of the country where the claim arose: in certain countries it may be that all maritime claims constitute maritime liens which would therefore take priority to the mortgage. This from the mortgagee’s point of view would be wholly unacceptable. The primary purpose of the law should be to protect the mortgagee as secured creditor.

The majority decision in *The “Halcyon Isle”* has been subject to some criticism, in particular by Professor Tetley in his book on *Maritime Liens and Claims* (1985) (see also the Australian Law Reform Commission Report on Admiralty Jurisdiction (No. 33) 1986).

However the decision of the Privy Council although not binding on English Courts, would almost certainly be followed by the House of Lords, and indeed was followed by the South African Courts in 1987 in the cases of *The “Andrico Unity”* and *The “Calantido”*.

Neither the United Kingdom nor any Commonwealth country has ratified either the 1926 or the 1967 Conventions for the Unification of Certain Rules relating to Maritime Liens and Mortgages and therefore the position in common law countries is governed by Admiralty Law and not by Convention.

SUMMARY

When agreeing to lend money to an owner, a mortgagee should ensure that it has a valid and enforceable charge on the ship, that the ship is properly insured, that the insurance has been effectively and validly assigned to the mortgagee and that the earnings of the ship have also been effectively assigned to the mortgagee. It should ensure that as far as possible the security documents give the mortgagee priority to all other creditors and that all documents that require registration or filing under relevant statutory provisions have been so filed and registered and that all notices such as notices to insurers or to charterers have been given.

Enforcement is often multi-jurisdictional. A mortgagee may have no choice where to enforce its claim against insurances and earnings since the jurisdiction is determined by the relevant contract, such as the insurance policy or a charterparty. If the owner has assets other than those charged to the mortgagee then the latter may endeavour to attach those assets as well by obtaining a *Mareva* injunction or by a similar procedure often called "*saisie conservatoire*", wherever the assets may be found. However, the mortgagee generally has some discretion to select a *forum* when enforcing the mortgage against the ship. The mortgagee must ensure that the jurisdiction selected accords due priority to the claim of the mortgagee since once action has been commenced against the ship it is often difficult, it not impossible, to withdraw the action or change *forum*. The correct selection of jurisdiction may therefore make the difference between a deficit and a surplus at the end of the day.

The mortgagee therefore at all times – whether at the documentation stage or the enforcement stage – must always have as its prime objective the validity and enforceability of its security in priority to all other possible claimants.

NOTES ON ITALIAN LAW

- 1) There is no special *form* required for the execution of a *hypothèque*.
- 2) The minimum information which must be set out in an application for the registration of a *hypothèque*, and which therefore, must be set out in the deed of hypothecation. Article 569 of the Navigation Code includes full details of both creditor and debtor of the ship charged and of the loan.

It is now usual practice to insert in the deed most of the provisions of the loan agreement and certain covenants which are usually included in the British deed of covenant. There are not, therefore, two documents as in England.

- 3) The demise charterer could be a party to the deed of hypothecation and undertake directly with the holder of the hypothec to perform and discharge the duties and liabilities imposed on the owner. However, this is unusual; normally the demise charterer (which are not common) enters into a separate agreement with the holder of the hypothec.
- 4) Since the covenants are included in the deed of hypothecation, they are registerable. In fact, the minimum information set out in Art. 569 of the Navigation Code may be expanded. It is customary to include in the application for registration a *résumé* of the most important covenants included in the deed. What is registered in the ship's register is the information contained in the application for registration, and not the whole deed, though a certified copy of the deed is enclosed with the application and is kept by the registrar.

The deed of hypothecation is registered only in the ships' register, and it cannot be registered with the registrar of companies.

- 5) The effect of registration is to make public the information which is registered and so it is valid against any third party. The information which is contained in the deed and not in the application for registration, is not registered, and is not valid against third parties.
- 6) The registrar notes the date and time of the application (made in duplicate) in a daily register and thereafter registers the full contents of the application in the ships' register. He returns to the applicant one of the two documents, certifying that the hypothec has been registered in the ships' register. In order

to obtain evidence of the priority a transcript of register may be requested from the registrar.

- 7) The register and the deed of hypothecation kept in the archives of the port authority are open to public inspection at any time.
- 8) In Italian law, there is a distinction between an assignment of a contract and the assignment of credits. Although an insurance contract may be assigned, the normal practice in providing collateral securities for a hypothec, is to assign the insurance contract, and the credit of the owner in respect of the insurance indemnities. The assignment of a credit is valid and enforceable against the debtor when he has been notified of it. By Art. 1265 of the Italian Civil Code the first of two assignments to be notified even though it was created later, prevails.
- 9) Third parties may attempt to attach or seize insurance indemnities as security for or satisfaction of their claims against the owner. If there is a loss payable clause in the insurance policy, or if the owner has in some other way assigned his indemnities to the holder of the hypothec giving notice of such assignment to the insurers, the attachment or seizure has effect only to the extent that the indemnity is still payable to the owner.

Country	Equivalent to U.K. Merchant Shipping Act	Equivalent of S.395 Companies Act, 1985
Australia	Registration of Ships covered by Shipping Registration Act 1981 which repeals Part I Merchant Shipping Act	s.199-215 Companies Code provides that, although a charge not registered within 30 days is not void against the creditors, a charge not so registered will be void against the liquidator. s.205 applies to charges created by companies incorporated in the jurisdiction and charges over property within the jurisdiction (including that of foreign companies registered in the jurisdiction)
Bahamas	Merchange Shipping Act, 1976, -- repealed Merchant Shipping Acts	No equivalent to s.395
Bermuda	s.5 & 41(8) Bermuda Merchant Shipping Act, 1079 applies the Merchant Shipping Acts	No equivalent to s.395
Canada	Canada Shipping Act, (re-enacts with modification UK Merchant Shipping Act)	No equivalent to s.395
Cayman Islands	Merchant Shipping Act 1894	Mortgage should be registered at the Company's own registered office. There is no equivalent to s.395
Cyprus	Merchant Shipping (Registration of Ships, Sales & Mortgages) Act 1963: re-enacts with modifications the Merchant Shipping Act 1894	s.90 Companies Law analogous to s.395 but 21 days period extended to 42 days where the mortgage is executed abroad
Gibraltar	Merchant Shipping Act 1894	s.80(2) Companies Ordinance
Hong Kong	s.117 Hong Kong Merchant Shipping Ordinance incorporates Merchant Shipping Act	s.80 Companies Ordinance the period allowed for registration is 35 days not 21 days
Malta	Merchant Shipping Act, 1973	No equivalent to s.395
New Zealand	Shipping and Seaman Act, 1952	Similar provisions to s.395
Singapore	Merchant Shipping Act, 1970	No equivalent to s.395

Prescribed by the
Commissioners of
Customs & Excise
with the consent
of the Secretary
of State for Trade

MORTGAGE (to secure Account Current, &c.)
Form No. 12A (Body Corporate) XS 81a

Official number	Name of Ship	Number, year and port of registry		Whether a sailing, steam or motor ship	Horse power of engines (if any)
Length from fore part of stem, to the aft side of the head of the stern post/fore side of the rudder stock				Number of Tons <i>(Where dual tonnages are assigned the higher of these should be stated)</i>	
Main breadth to outside of plating		Feet	Tenths	Gross Register	
Depth in hold from tonnage deck to ceiling amidships					
and as described in more detail in the Register Book					
Whereas (1)					
.....					
.....					
.....					
.....					
Now we (2)					
with the said (3)					
..... assigns, to pay to him or them or it the sums for the time being due on this security, whether by way of principal or interest, at the times and manner aforesaid. And for the purpose of better securing to the mortgagee(s) the payment of such sums at last aforesaid, we do hereby mortgage to the mortgagee(s)					
..... shares, of which we are the Owner in the Ship above particularly described, and in her boats and appurtenances.					
..... assigns that we have power to mortgage in manner aforesaid the above-mentioned shares, and that the same are free from incumbrances (4)					
In witness whereof we have hereunto affixed our common seal on19.....					
The Common Seal of the					
was affixed hereunto in the presence of (5)					
.....					
.....					

(a) Here state by way of recital that there is an account current between the mortgagee, giving the full name of the Body Corporate together with its principal place of business, and the mortgagee(s), giving full name(s), and addressed) with their description in the case of individuals and adding "as joint mortgagees" where such is the case and describe the nature of the transaction so as to show how the amount of principal and interest due at any given time is to be ascertained, and the names and time of payment. (b) Name of the Body Corporate. (c) Full name of mortgagee. (d) "His", "Their" or "its". (e) If any joint incumbrance add, "save as appears by the Registry of the said ship". (f) Signatures and description of witnesses, i.e. Director, Secretary, etc. (as the case may be)

NOTE. The prompt registration of a Mortgage Deed at the port of registry of the ship is essential to the security of a Mortgage, as a Mortgage takes its priority from the date of production for registry, not from the date of the instrument

NOTE. Registered Owners in Mortgage are reminded of the importance of keeping the Register of British Ships informed of any change of residence on their part.

MORTGAGE (to secure Principal Sum and Interest)

Form No. 11a

(Body Corporate)

XS 80a

Official number	Name of Ship	Number, year and port of registry	Whether a sailing, steam or motor ship	Horse power of engines (if any)
Length from fore part of stem, to the aft side of the head of the stern post/fore side of the rudder stock		Feet	Tenths	Number of Tons
Main breadth to outside of plating				
Depth to hold from tonnage deck to ceiling amidships				
(Where dual tonnages are assigned the higher of these should be stated)				
Register				
and as described in more detail in the Register Book				
<p>We, (a) this day lent to us by (b) in consideration of do hereby for ourselves and our successors covenant with the mortgagee(s) and (c) assigns the said sum of together with interest thereon at the rate of on the (d) day of next; and secondly, that if the said principal sum is not paid on the said day, we or our successors will, during such time as the same or any part thereof remains unpaid, pay to the mortgagee(s) or (c) assigns, interest on the whole or such part thereof as may for the time being remain unpaid, at the rate of per cent. per annum per annum, by equal half-yearly payments on the day of in every year, and for better securing to the mortgagee(s) the repayment in manner aforesaid of the principal sum and interest we hereby mortgage to the mortgagee(s) shares, of which we are the Owners in the Ship above particularly described, and in her boats and appurtenances. Lastly, we for ourselves and our successors covenant with the mortgagee(s) and (c) assigns that we have power to mortgage in manner aforesaid the above-mentioned shares, and that the same are free from incumbrances (e)</p> <p>In witness whereof we have hereunto affixed our common seal on 19.....</p> <p>The Common Seal of the</p> <p>was affixed hereunto in the presence of (f)</p>				

(a) Name in full of Body Corporate together with its principal place of business. (b) Full name(s) and address(es) of mortgagee(s) with their description in the case of individuals, and adding "as joint mortgagees" where such is the case.
(c) "his", "their" or "its". (d) Insert the day fixed for payment of principal as above. (e) If any prior incumbrance add, "save as appears by the registry of the said ship". (f) Signatures and description of witnesses, i.e. Director,
Secretary, etc. (as the case may be).

NOTE. The prompt registration of a Mortgage Deed at the port of registry of the ship is essential to the security of the Mortgage, as a Mortgage takes its priority from the date of production for registry, not from the date of the instrument.
NOTE. Registered Owners or Mortgagees are reminded of the importance of keeping the Registrar of British Ships informed of any change of residence on their part.



SEASCOPE INSURANCE SERVICES LTD.

AT LLOYD'S

Registered Number 980109 England

REGISTERED OFFICE

WOODRUFFE HOUSE,
COOPER'S ROW,
LONDON EC3N 2NLTELEPHONE: 01-488 3288
FAX 01-481 4499
TELEX: 883133

Our Ref

Your Ref

Dear Sirs,

VESSEL:

OWNER:

We confirm that we have effected insurances for the account of the above Owners as set out in Appendix "A" attached.

Pursuant to instructions received from the above Owners and/or their authorised Manager or Agents and in consideration of your approving us as the appointed Brokers in connection with the insurances covered by this letter, we hereby undertake:-

1. to hold the Insurance Slips or Contracts, the Policies when issued, and any renewals of such Policies or new Policies or any Policies substituted therefor with your consent as may be arranged through ourselves and the benefit of the insurances thereunder to your order in accordance with the terms of the Loss Payable Clause(s) set out in Appendix "B" attached; and
2. to arrange for the said Loss Payable Clause(s) to be included on the policies when issued; and
3. to have endorsed on each and every Policy as and when the same is issued a Notice of Assignment in the form of Appendix "C" hereto dated and signed by the Owners and acknowledged by Underwriters in accordance with Market practice; and
4. to advise you promptly if we cease to be the Broker for the Assured or in the event of any material changes of which we are aware effecting the said insurance; and
5. following a written application received from you not later than one month before expiry of these insurances to notify you within fourteen days of the receipt of such application in the event of our not having received notice of renewal instructions from the Owners and/or their authorised Managers or Agents, and in the event of our receiving instructions to renew to advise you promptly of the details thereof.

Our above undertakings are given subject to our lien on the Policies for premiums and subject to our right of cancellation of default in payment of such premiums but we undertake not to exercise such rights of cancellation without giving you ten days notice in writing, either by letter, telex or cable and a reasonable opportunity for you to pay any premiums outstanding. We further undertake on application from you to advise you promptly of the premium payment situation.

It is understood and agreed that the operation of any Automatic Termination of Cover, Cancellation or Amendment Provisions contained in the Policy conditions shall override any Undertakings given by us as Brokers.

Notwithstanding the terms of the said Loss Payable Clause and the said Notice of Assignment, unless and until we receive written notice from you to the contrary, we shall be empowered to arrange for a collision and/or salvage guarantee to be given in the event of bail being required in order to prevent the arrest of the vessel or to secure the release of the vessel from arrest following a casualty. Where a guarantee has been given as aforesaid and the guarantor has paid any sum under the guarantee in respect of such claim, there shall be payable directly to the guarantor out of the proceeds of the said Policies a sum equal to the sum so paid.

This undertaking is subject to all claims and returns of premiums being collected through us as Brokers.

Yours faithfully,
SEASCOPE INSURANCE SERVICES LIMITED

U.K. (Bermuda) Standard Letter of Undertaking

Dear Sirs,

.....'

We acknowledge receipt of a letter from giving notice of assignment to you of the insurances on the above ship. So far as this Association is concerned, the Managers do not consent to such assignment for the purposes of Rule 15, other than to give efficacy to the Loss Payable Clause set out below and subject always to the Association's rights under Rule 15 (B).

We do confirm however that such ship is entered in this Association for Protection and Indemnity risks on the terms and conditions set out or to be set out in the Certificate of Entry. Furthermore, in consideration of your agreeing to the entry or continuing entry of the ship to this Association, the Managers agree

- (a) that the Owner shall not cease to be insured by the Association in respect of that ship by reason of such assignment (see Rule 29(B)(i)); and
- (b) that, notwithstanding that the ship is mortgaged to you and that no undertaking or guarantee has been given to the Association to pay all contributions due in respect of such ship, the Owner does not cease to be insured by reason of the operation of Rule 29(B)(ii).

It is further agreed that the following Loss Payable Clause will be included in the Certificate of Entry.

"Payment of anyr recovery the Owner is entitled to make out of the funds of the Association in respect of any liability, costs or expenses incurred by him shall be made to the Owner or to his order unless and until the Association receives notice from that the Owner is in default under the Mortgage, in which event all recoveries shall thereafter be paid to or their order; provided always that no liability whatsoever shall attach to the Association, its Managers or their Agents for failure to comply with the latter obligation until after the expiry of two clear business days from the receipt of such notice."

The Association undertakes

- (a) to inform you if the Directors give the Owner of the above ship notice under Rule 18 that his insurance in the Association in respect of such ship is to cease at the end of the then current Policy year;
- (b) to give you fourteen days' notice of the Association's intention to cancel the insurance of the Owner by reason of his failure to pay when due and demanded any sum due from him to the Association.

Yours faithfully,

For: THOS. R. MILLER (SON),
as Agents for THOS. R. MILLER & SON (BERMUDA)

Mr,.....
of

(if the above address is not within England or Wales then the following information must be given)

whose agent(s) in England or Wales is/are

.....
of

hereby offer to purchase at the price of

£..... Say.....

the..... [name of vessel]

now lying at..... [place where ship

or craft is lying] and at present under the arrest of the High Court of Justice of England. This offer

is to purchase the said.....

on the terms of the Admiralty Marshal's Conditions of Sale printed overleaf and shall remain open for three business days after the date appointed for receiving offers. We recognise that the Admiralty Marshal is not bound to accept any offer.

Signed

Dated

Witnessed

The Admiralty Marshal's Conditions of Sale

SUBJECT MATTER OF SALE

1. In these conditions the expression "the Vessel" means the Vessel agreed to be sold with everything on board belonging to her but excluding any equipment on hire (see clause 13)
2. The Buyer shall take and pay for the unused bunker fuel and lubricants remaining on board her (if any) in accordance with clauses 5 6 and 7 below.

BASIS OF SALE

3. The Buyer undertakes that in making his offer he has not relied upon any information which he may have been given by or on behalf of the Admiralty Marshal and that he has relied solely upon his own inquiries and/or inspection.
4. The Vessel is sold as lying at the date of the sale with all her faults and all errors of description whatever. The Buyer shall not be entitled to reject the Vessel nor to any damages or diminution in price, by reason of any fault of or in the Vessel or any error of description whatever.
5. Payment shall be made by the Buyer in cash in sterling in London to the Admiralty Marshal or to C. W. Kellock & Co. Ltd., his brokers, as follows—
 - (a) immediately upon the acceptance of the offer, 10% of the price;
 - (b) within one week of the acceptance of the offer;
 - (i) the balance of 90% of the price, and
 - (ii) a sum in respect of bunker fuel and lubricants (if any) calculated in accordance with clause 6.
6. The sum (if any) payable in respect of unused bunker fuel and lubricating oil shall be calculated by reference to—
 - (i) the quantities (if any) remaining on board unused at noon on the day one week after the acceptance of the offer or on the day of the final payment whichever shall be the earlier, and
 - (ii) the current market prices ruling in the port where the Vessel is lying

The quantities and prices shall be determined by the Admiralty Marshal or his agent

DELIVERY

7. On completion of the payments referred to in clause 5 the Admiralty Marshal shall give and the Buyer shall take immediate delivery of the Vessel (together with her bunker fuel and lubricating oil).
8. If the Buyer requires delivery of the Vessel to an Agent, such Agent must produce the Buyer's written authority to that effect, signed by the Buyer and addressed to the Admiralty Marshal.
9. On delivery the Buyer shall have the Admiralty Marshal's Bill of Sale for the Vessel, together with any documents belonging to the Vessel which are in the Admiralty Marshal's possession.

RISK etc.

10. The Vessel shall be at the Buyer's risk from the time when the payments referred to in clause 5(b) are made or become due, whichever is earlier, and from that time all expenses relating to the Vessel, including dock and other dues, shall be for the Buyer's account.
11. If the Vessel is lost, destroyed or damaged in any way whatever before the risk in the Vessel has passed to the Buyer under clause 10 the Admiralty Marshal may rescind the contract of sale by notice in writing to the Buyer and repaying to the Buyer, without interest costs or compensation, any sums the buyer has paid under clause 5.

DEFAULT OF BUYER

12. If the Buyer is in default in making any of the payments referred to in clause 5, or is in any other respect whatever in breach of any of these conditions, the Admiralty Marshal may exercise all or any of the following rights—
 - (a) by notice in writing rescind the contract and/or the sale;
 - (b) if the Buyer has made the payment referred to in clause 5(a) declare it to be forfeited to him;
 - (c) Resell the Vessel by public or private sale;
 - (d) recover from the Buyer all losses, damages costs and expenses caused by the Buyer's default including, in the event of such resale, any loss suffered as a result thereof;
 - (e) If the Buyer has made any further payments besides that referred to in clause 5(a), retain in satisfaction or part satisfaction of the right of recovery given by sub-clause (d) above the whole or part of such further payments but without prejudice to any other means of enforcing such right.

EQUIPMENT ON HIRE

13. If any equipment of any kind on board the Vessel is on hire, it shall not be included in the sale but the Buyer shall make his own arrangements in respect of such equipment with its Owners, and if he fails to do so shall indemnify the Admiralty Marshal in respect of any claims arising from such failure.

MORTGAGES & HYPOTHEQUES IN CIVIL LAW

Francisco Berlingieri

The purpose of a mortgage or hypothèque is to secure the payment of a sum of money.

Both the mortgage and the hypothèque may be created by contract or by the unilateral declaration of the owner of the vessel. In some countries (e.g. Italy and the German Democratic Republic) the hypothèque comes into existence only with its registration in the ships' register.

In some countries (e.g. the Federal Republic of Germany), mortgages or hypothèques may arise by operation of law (so-called statutory mortgages or hypothèques) and the right to register a charge in the ships' register may be recognised, for example, as security for the unpaid portion of its purchase price or as security for a claim for which a vessel has been arrested. In the majority of maritime countries, there is only one type of ship mortgage or ship hypothèque. In Greece however there is an ordinary hypothèque and a preferred hypothèque. The ordinary hypothèque is created by unilateral declaration, whilst the preferred hypothèque must be created by contract.

Only the registered owner of the vessel can create the charge .

To be valid against third parties the charge must be registered in the ships' register. In most countries, it is also indorsed on the ship's papers; in some countries indorsement is a prerequisite to the validity of the charge vis-a-vis third parties whilst in others (e.g. Greece and Italy), the lack of an indorsement on the ships' papers does not affect the validity or the priority of the charge. In some countries (e.g. the Federal Republic of Germany), registration creates a presumption that the person who has registered the security is the holder of the right.

Voluntary sale does not affect the charge which continues notwithstanding the registration of the sale in the ships' register. The holder of the charge may, enforce his security at any time after the sale and the purchaser may not object to the ship being sold, to satisfy the claim of the holder of the charge. In some countries (e.g. the Federal Republic of Germany, France, Italy, Japan and the Netherlands), the purchaser has the option to release the vessel from the charge by tendering to the holder of the charge the whole of the purchase price; the holder of the charge then has the option either to accept the offer or to request the forced sale of the vessel or to purchase the vessel himself paying a higher sum than that offered by the purchaser. The minimum increase is in some countries 10%.

Upon the forced sale of the vessel the holder of the charge is entitled in most countries to share in the proceeds on the basis of the priority enjoyed by his security. However, in Spain, if the sale is conducted under the special procedure provided for by Article 131 of the "Ley Hipotecaria", the holder of the hypothèque receives the total amount of the proceeds but the charges ranking ahead of the hypothèque are not extinguished by the sale.

Where the ship is a total loss the charge is extinguished, save that, the holder of the charge may enforce his claim, always with priority, against the insurance indemnity. In some countries, the holder of the charge is entitled by statute to enforce his claim against the insurance indemnity with no change in priority. In other countries, the holder of the charge does not automatically have rights to the total loss insurance proceeds; these rights depend on steps which must be taken separately and generally depend on an assignment of the policy; the priority with respect to the insurance proceeds is not necessarily the same as the priority with respect to the vessel.

In several civil law countries the holder of the hypothèque is entitled to satisfy his claim against monies due to the owner by third parties in respect of the loss of, or damage to, the vessel, general average contribution and salvage.

In some countries (e.g. Sweden), the de-registration of the vessel cannot take place without the consent of the holder of the hypothèque. In other countries, the registrar makes an entry of the total loss in the register and the entry of the ship in question is considered closed except so far as relates to any unsatisfied security.

As a general rule, the charge may not be de-registered except with the consent of the holder or by order of court.

As a general rule, the vessel may not be de-registered except with the consent of the holder of the charge. To avoid the de-registration of a ship after her sale to an owner not qualified to keep her under her present flag, some countries (e.g. France: Article 57 of law 3 of January 1967), prohibit the sale of a hypothecated vessel to a foreign purchaser with penalties under criminal law. For the same reason, in other countries (e.g. Greece), the sale of a hypothecated vessel which would entail de-registration, is null and void.

The holder of the charge is, under some legal systems, entitled to take possession of and operate the ship on the default of the debtor. This remedy is granted in England to the mortgagee. It is not normally granted to the holder of a hypothèque, except in Portugal.

The holder of the charge has, under some legal systems, the power to sell the ship and to satisfy his claim out of the proceeds of sale. But no statutory power of sale is granted in civil law countries to the holder of a hypothèque, and it is even doubtful if it may be granted by contract. However, in Greece, the power of sale may be granted by contract to the holder of a preferred hypothèque. In any event, the power of sale cannot be exercised after proceedings for the forced sale of the ship have been

commenced.

Enforcement of the security is not equally easy and quick in the various legal systems. In principle, it seems to be faster for a mortgage than for a hypothèque. This may depend on the procedure in the various countries, rather than on the type of security. In some countries it is possible to apply for the sale of a ship under arrest even before judgment is obtained and the proceeds of the sale are distributed among the holders of securities unless an objection to their claims is made by the parties interested in the forced sale. In yet other countries, the proceeds of sale are paid into court and distributed only when judgment is available. In other countries a distinction is made between arrest as a conservative measure (now regulated by the 1952 Brussels Convention) and seizure in execution of a judgment; for example, a hypothèque does not enable the holder to seize the vessel unless a judgment has been obtained, or when an acknowledgement of the debt, notarially attested, is embodied in the instrument.

THE PROTECTION OF MORTGAGEE BANKS – THE AMERICAN LEGAL BACKGROUND

Emery Harper

I. The non-maritime basics of state law

In describing the American approach it is relevant first to consider the Uniform Commercial Code (the "U.C.C."), a statute adopted and now in force in 49 of the 50 states and, as its name indicates, a virtually uniform codification of laws governing many types of commercial relationships. In the United States, many, if not most, commercial relationships are governed by the laws of the individual states. This, of course, creates great confusion for parties from other countries because there may be no apparent reason for the laws of, say, New York or California rather than national law to govern a commercial contract or relationship. This division of authority impinges on the maritime field and very directly on maritime liens and mortgages. While there is a federal, or national, Ship Mortgage Act, there is no national law of "mortgages". The Ship Mortgage Act, in granting special priority status to "preferred mortgages", assumes and builds on the creation of a "*valid* mortgage". Since there is no national law on the component parts of a valid mortgage, courts must look to state law for guidance.

The interplay between federal and state law has also had its impact in the law of maritime liens, particularly liens for supplies and necessities. Although the "general maritime law" gives guidance with respect to certain kinds of maritime liens, supply liens since 1910 have been governed by the Federal Maritime Lien Act which grants maritime lien status to claims by persons furnishing repairs, supplies, services and other "necessaries" to vessels in the United States. Its passage was necessary to supersede the chaos resulting from a myriad of inconsistent and competing state laws on the subject. In contrast to ship mortgages, the liens created by these state statutes were recognised as maritime in character. Many of these state laws are still on the books although no longer viable because pre-empted by federal legislation.

In the United States there is historically a limit on the subjects over which a court in Admiralty may exercise jurisdiction. The principal reason for the Ship Mortgage Act was to turn a non-maritime chattel mortgage recognised under state law but "beneath the dignity of the Admiralty" into a maritime instrument recognised and enforceable in the Admiralty Courts.

Before the adoption of the Uniform Commercial Code in the early sixties, security interests in personal property were created by instruments labelled, variously, chattel mortgages, pledges, assignments, trust agreements, and other types of title retention devices. These forms, with their own special rules and intricacies provided a creditor with special rights of recourse to items of a debtor's personal property prior to other creditors. At the time the federal Ship Mortgage Act was passed in

1920 the prevailing method of securing a lender with regard to tangible personal property was the chattel mortgage, and the Ship Mortgage Act adapted the forms and procedures then in practice in the several states, added a few requirements and opened the courts of Admiralty to these “preferred mortgages”. With the adoption of the U.C.C., the chattel mortgage as a security device with rules peculiar to its form largely passed into history: thereafter there was no continuing and developing body of state chattel mortgage law, to fill in those gaps in the ship mortgage statute where such reliance had been presumed.

The Uniform Commercial Code (1)

With very limited and specified exceptions, Art. 9 of the U.C.C. applies to “any transaction (regardless of its form) which is intended to create a security interest in personal property”. Although rights governed by the Federal Ship Mortgage Act are among the exceptions, most vessel financings today include security interests in personal property other than vessels (such as hire due under charter of the vessel, or shares of capital stock in the vessel owning company). Art. 9 of the U.C.C. is very relevant to the consideration of the broader subject of vessel financing as well as useful background for the subject of mortgages.

Definition of terms

One major effect of Art. 9 was the development of a series of “generic” definitions of broad application. Under Art. 9, a “debtor” is the person who owes payment of the obligation secured. Generally, the debtor owes payment of the obligation to a “secured party”. U.C.C. §9-105(1)(d). A “secured party” is defined as a:

lender, seller or other person in whose favour there is a security interest, including a person to whom accounts or chattel paper have been sold.

(U.C.C. §9-105(1)(m))

The U.C.C. divides personal property into six categories:

1. “Goods”, generally tangible movable objects and fixtures. There are four sub-categories:

(1) As enacted in New York State

(1) "consumer goods" if they are used or bought for use primarily for personal, family or household purposes; (2) "equipment" if they are used or bought for use primarily in business; (3) "farm products" if they are crops or livestock or supplies used or produced in farming operations; (4) "inventory" if they are held by a person who holds them for sale or lease or to be furnished under contracts of service:

(U.C.C. §9-109)

2. "Account", or account receivable, defined as any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance:

(U.C.C. §9-106)

3. "Instrument", a writing evidencing the right to the payment of money, including a "negotiable instrument" and a "security" as defined in Arts. 3 and 8 of the U.C.C., respectively; typically a promissory note and a stock or bond certificate:

(U.C.C. §9-105(i))

4. "Document of Title", a writing evidencing that the person in possession of the document is entitled to receive, hold and dispose of the document and the goods it covers; typically, Bills of Lading.

(U.C.C. §9-105(1)(f));
see U.C.C. §1-201(15).

5. "Chattel paper", a writing which evidences both a monetary obligation, and a security interest in specific goods; typically, a lease, although a purchase money chattel mortgage, when accompanied by a promissory note secured by that mortgage, used as collateral by the holder, would be considered in this category.

(U.C.C. §9-105(b))

6. Finally, the catchall category of "general intangible":

"any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money."

(U.C.C. §9-106)

Examples of collateral in the form of general intangibles include goodwill, copyrights, patent rights, royalty rights or rights to performance.

In addition to providing a secured party with rights in the original collateral, a security agreement under Art. 9 also provides the secured party with rights to "proceeds", or the property which results from the sale, exchange, collection or other disposition of the original collateral. U.C.C. §9-203. Art. 9 contains elaborate "tracing" rules affecting rights in proceeds.

Creation of a security interest: attachment and perfection

There are three events which must occur before a security interest attaches: (1) a security agreement, adequately describing the collateral, must be signed by the debtor, (2) value must be given by the secured party, and (3) the debtor must have or acquire rights in the collateral. As stated by the U.C.C., a security interest does not attach unless:

(1) (a) the collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement which contains a description of the collateral... and (b) value has been given (by the secured party); and (c) the debtor has rights in the collateral.

(2) A security interest attaches when it becomes enforceable against the debtor with respect to the collateral. Attachment occurs as soon as all the events specified in subsection (1) have taken place unless explicit agreement postpones the time of attaching.

(U.C.C. §9-203)

It is important to note that the events may occur in any sequence and, thus, the traditional sequence of events in common law countries applicable to say, a mortgage has been loosened.

Mere attachment of a security interest will not protect the secured party against the world. While attachment creates an enforceable relationship between the debtor and the secured party, it does not determine the relative rights or ranking of the secured party and interested third parties. To protect the secured party against the debtor's other creditors and transferees, it is imperative that the security interest be "perfected". The concept of "perfection" is primarily Art. 9's adaptation of the principle of public or constructive notice, and generally requires some additional step beyond attachment which is deemed to constitute adequate notice of the security party's priority interest.

Under Art. 9, security interests may be perfected in two principal ways, depending upon the type of property involved.

First, security interests in all types of collateral, except "instruments", may be perfected by filing a "financing statement". There are few formalities and these are not rigorous. A financing statement is a simple form listing the names and addresses of the debtor and secured party and describing the collateral. It is signed by the debtor or, if previously authorized by the debtor, the secured party. The forms (in several counterparts) are filed in an appropriate state or county office and stamped by date and sequential numbering. The rules for determining the proper places for

filing a financing statement can be complicated, depending on the type of property involved and the location of the debtors' business offices.

Most significantly:

A financing statement may be filed before a security agreement is made or a security interest otherwise attaches.

(U.C.C. §9-402)

In other words, unlike a mortgage, a security interest can be recorded before the debtor owes the collateral and before the security agreement (the mortgage equivalent) is signed.

Secondly, security interests in goods, money, negotiable documents, instruments or chattel paper may be perfected by possession, thereby continuing the common law concept of a possessory pledge. The theory is that a secured party's unequivocal, absolute physical control over the pledged property should be sufficient to put third parties on notice of the secured party's interest. However, it is important to note that a security interest in accounts and general intangibles may *not* be perfected by transfer of possession to the secured party. Both accounts and general intangibles represent kinds of property not ordinarily evidenced by a writing, which, by delivery into the possession of a secured party, could operate to transfer the claim. In other words, a debtor's account receivable, in the hands of the secured party, does not generally transfer the right of payment to the secured party, and thus delivery of such an account to the secured party is not sufficient to put third parties on notice that possessory party's interest is that of a secured party.

The existence of a third set of security interests which are deemed perfected simply upon the attachment of the security interest must be mentioned for completeness of discussion. For example, a purchase money security interest in goods purchased primarily for personal, family or household purposes is perfected when the security interest attaches as between the debtor and the secured party. Therefore, when a consumer buys consumer goods from a merchant on credit, and the merchant reserves title to the goods until the consumer pays for the goods, the merchant's security interest is perfected upon attachment. It was felt that the merchant's financial and administrative burden in filing a financing statement is not justified by the protection thereby afforded to other possible creditors of the consumer-debtor. The likelihood of the consumer using the goods as collateral in another financing was considered unlikely.

Other forms of security interest

Notwithstanding the comprehensiveness of Article 9, it does not govern all security arrangements. As previously noted the provisions of the Ship Mortgage Act and other federal statutes are not intended to be disturbed. In addition, Article 9 does not by its terms govern liens or "security interests" in insurance policies or bank

accounts except where insurance proceeds or a bank account represents proceeds of the original collateral in which the secured party had a security interest.

It would be gratifying to be able to say that Article 9 rules have nothing to do with maritime liens, the latter being creatures of national law, i.e. the general maritime law which is considered a national law and the Federal Maritime Lien Act. It is true, as a general proposition, that state laws, such as the U.C.C., cannot abridge or regulate rights granted at the federal level. However, there are two areas where the perfected U.C.C. security interest and the maritime lien can be competing for priority. Vessel suppliers have a maritime lien against a vessel and her freight then pending for payment of the cost of supplies. A vessel owner has a maritime lien on subfreights to secure payment by a charterer or charter hire under the prime charter. The subject of these liens (freights and subfreights) are within the definition of "account" under Article 9. Should the holder of the secret maritime lien prevail over the holder of an Article 9 security interest which has duly attached and been perfected by the filing of a financing statement? The answer, for the moment, appears to be yes – not because of an inherent equity but solely because one is maritime and the other not; or alternatively, solely because one is considered a creature of federal law and the other a creature of state law. The argument has been made that the U.C.C. rules governing perfection of a security interest in accounts should apply to a maritime lien on subfreights.

Enforcement

Article 9 does not contain provisions outlining those acts which constitute a default. Rather it leaves this important issue to the parties and to what little common law on default already exists. Generally, except for the vague restrictions of unconscionability and good faith, default is "whatever the security agreement says it is". While almost every default clause in a security agreement includes a provision that non-payment constitutes default, other common provisions provide for the triggering of a default if the debtor suffers financial reverses, the debtor damages, destroys or removes goods, or the debtor fails to maintain insurance on goods.

Upon default the remedies available to a secured party are extremely broad. First the secured party is entitled to take possession of the collateral. U.C.C. §9-503 provides in part:

Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace or may proceed by action.

This ancient remedy of "self-help" is sanctioned, provided no breach of peace occurs, and, predictably, the courts have expended a substantial amount of time in defining the meaning of that phrase. Generally, if a secured party attempts to take possession of collateral despite the objection of the debtor, then the secured party's attempt will be a "breach of peace". See e.g. *Morris v. First Nat'l Bank & Trust Co.*, 21

Ohio St. 2d 25, 254 N.E.2d 683 (1970) and *Stone Machinery Co. v. Kessler*, 1 Wash.App. 750, 463 p.2d 651 (1970).

The remedy is most often availed of in consumer financing situations and there are many cases which now stand for the proposition that entry of the debtor's home or garage without the debtor's permission also constitutes a "breach of peace". See *Girard v. Anderson*, 219 Iowa 142, 257 N.W. 400 (1934). But see *Cherno v. Bank of Babylon*, 54 Misc. 2d 277, 282 N.Y.S.2d 114 (1967), *aff'd* 29 A.D.2d 767, 288 N.Y.S. 2d 862. Most successful cases of repossession occur where the collateral is not located at the debtor's premises and the debtor has neither approved nor disapproved of the secured party's attempts to take the property. Many yachts subject either to a U.C.C. security interest or a "preferred mortgage" are repossessed at yacht basins, and airplanes have been flown away to undisclosed locations by creditors' agents, in the middle of the night. Complications can arise when the debtor tries to regain possession of the property in a similar manner. Of course, if the debtor consents to the taking, the taking is not a "breach of peace".

There are sanctions applicable to overzealous creditors since a secured party's commission of a "breach of peace" may expose him to tort liability and to liability under §9-507 (discussed below) and may deprive him of his right to a deficiency judgment against the debtor.

If the debtor has defaulted and will not part with the goods, the secured party must reclaim the property through judicial action.

One important right which the secured party may exercise, but only if the security agreement so provides, is the right to require the debtor to assemble the collateral and make it available to the secured party at a place to be designated by the secured party which is reasonably convenient to both parties (U.C.C. §9-503). The secured party is also authorized to render equipment unusable without removing it, subject to the general requirement that he proceed in a reasonable manner.

Upon default and repossession, the secured creditor may accept the collateral in complete satisfaction of the debt. U.C.C. §9-505(2). This procedure is called "strict foreclosure" and when accomplished, the creditor foregoes any right to recover any deficiency from the debtor.

"Strict foreclosure" procedures require that the secured party first take possession of the collateral after default. Then, the secured party must send written notice to the debtor stating his intention to retain the collateral in satisfaction of the debtor's obligation. In addition, if the collateral is not consumer goods, the secured party must send notice of his intent to any other creditor of the debtor who has previously sent the secured party written notice to a claim of an interest in the collateral. Failure to give notice to the entitled parties can invalidate the strict foreclosure. If one of the notified parties enters a written objection during a specified period after the notice, the secured party must dispose of the collateral through the resale procedures described below.

Most secured parties have little use for repossessed collateral and attempt to dispose of the property under the provisions of U.C.C. § 9-504 which permit the secured party to “sell, lease or otherwise dispose of any or all of the collateral in its then condition or following any commercially reasonable preparation or processing”. In addition, §9-504(3) provides that “Disposition (of the collateral) may be as a unit or in parcels at any time and place and on any terms...”.

Article 9 provides liberal guidelines, not strict rules, for the disposition of collateral by the secured party. There are two principal constraints.

First, except in limited circumstances, notice must be sent to the debtor:

(U)nless the collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale or reasonable notification of the time after which any private sale or other intended disposition is to be made shall be sent by the secured party to the debtor.

(U.C.C. §9-504(3))

Second, every aspect of the sale must be commercially reasonable. §9-507(2) states that:

The fact that a better price could have been obtained by a sale at a different time or in a different method than that selected by the secured party is not *of itself* sufficient to establish that the sale was not made in a commercially reasonable manner.
(Emphasis supplied)

Despite the above language, courts have apparently invalidated sales because the resale price was simply too low. See *Mercantile Financial Corp. v. Miller*, 292 F.Supp. 797 (E.D. Pa. 1968).

Section 9-507(2) provides additional criteria of what is commercially reasonable: (1) a sale in the usual manner in any recognized market; (2) a sale at the price current in a recognized market at the time of sale; and (3) a sale in conformity with reasonable commercial practices among dealers in the type of property sold.

The order of distribution of the proceeds of a disposition is specified in U.C.C. §9-504(1). They are to be applied in the following order: (1) to the secured party's expenses of realization; (2) to the satisfaction of the indebtedness secured by the security interest under which the disposition occurs and (3) to the satisfaction of indebtedness secured by any subordinate security interests. Under §9-504(2), the debtor is generally entitled to the remaining proceeds.

In the event of such a disposition, the interests of the debtor, of the secured party disposing of the collateral, and of secured parties junior thereto are extinguished. However, a superior security interest would not be extinguished. Under §9-306(2), a superior security interest would remain attached to the collateral notwithstanding

the disposition of the collateral unless the disposition were also authorized by the secured party. That secured party also holds a perfected security interest in any identifiable proceeds received by the debtor, generally without having to take further steps to perfect the security interest.

An additional remedy is available where intangibles are concerned. The secured party is entitled, under U.C.C. §9-502, whenever it is so agreed, to require the account debtor (i.e. the third party owing money to the debtor under a contract or other instrument which is the subject of the security interest) to make payment directly to the secured party. The secured party may proceed in a commercially reasonable manner to obtain such payment and may deduct from collections his reasonable expenses of realization. This remedy is particularly important in marine financings where a long term charter of the vessel is involved and the charter hire is expected to be applied to amortize the debt.

The debtor has the right to redeem his property until one of the following events occurs:

- (1) the secured party disposes of the collateral or enters into a contract for disposition of the collateral (§9-506);
- (2) the secured party accepts the collateral in satisfaction of the debt under §9-505(2); or
- (3) the debtor agrees in writing after default not to exercise his right to redeem the collateral (§9-506).

The U.C.C. imposes sanctions upon a creditor tempted to misbehave. Section 9-507 authorizes the courts to exercise control over dispositions which would be commercially unreasonable and specifies that a secured party is liable for any loss caused by his non-compliance with the provisions of Article 9 dealing with the repossession and disposition of collateral.

When a secured party repossesses and then disposes of collateral, the purchaser takes the collateral free of all rights and interests of the secured party as well as any subordinate secured parties. This holds regardless of whether the secured party complies with the requirements of §9-504 in the resale. However, if at a public sale, the purchaser has knowledge of defects in the sale or if he buys in collusion with the secured party, other bidders, or the person conducting the sale, then he would not take the collateral free of such interests. At a private sale, the purchaser must act in good faith which is defined to mean "honesty in fact in the transaction concerned". U.C.C. 2-103(17(b)).

Summary

Article 9 of the U.C.C. can be seen as a comprehensive scheme designed to govern the entire range of activities and issues involved in the granting, perfecting and enforcing of security interests in personal property.

Where competing security interests are involved, the first to perfect (usually by filing a financing statement or taking of possession) is the first in priority. Detailed and complex rules also govern rights to proceeds.

In the context of maritime liens and mortgages, it is important to observe the role assigned to the courts by the provisions of Article 9. The key to the secured party's enforcement lies in his taking possession of the collateral and here he is accorded the right to assistance from the courts. The key to the protection of the debtor's interest is the commercial reasonableness of the secured parties' disposition of the collateral. Here, the debtor may obtain oversight by the court. In neither case, however, is recourse to the courts presented as a first option.

The purchaser of the collateral on resale by the secured party is also protected. Generally, he takes away goods unencumbered by the results of the previous owner's commercial activities.

It is strange that such a scheme does not apply to liens on vessels. The reason seems to lie in the secret nature of maritime liens and the need for the intervention of a court in admiralty to wipe the vessel clean. This conclusion is buttressed by the fact that mortgagees under preferred mortgages on commercial vessels almost never, in the United States, exercise the right to possession or the right to private sale, whereas mortgagees of preferred mortgages on a pleasure vessel seek to avoid a court ordered sale at almost any cost. In the case of a pleasure vessel there are, in practice, usually few maritime liens which attach through the vessel's operation and the time and expense of a judicial sale are not justified for the protection afforded.

II. American and English Ship Mortgages Compared

The ship mortgage in the United States and England is significantly different from the civil law hypothèque. The hypothèque is a much broader concept and probably sweeps in a variety of liens and other forms of analogous security devices known to the American and British system. The right of possession of the collateral on default of the debtor/mortgagor appears to distinguish the mortgage from the hypothèque as a security instrument. Yet the right to possession is rarely exercised; recourse to court proceedings, through arrest and forced sale, is the preferred method of enforcement. The reason for this is largely financial, since there are likely to be existing commitments, such as a charter or cargo on board; there is a crew to be paid, and arrangements to be made for insurance, port facilities and discharging cargo. In the United States, the obligations of a mortgagee assuming possession of an operating vessel are not defined by statute or otherwise clearly developed through court precedent. Ship mortgagees are accordingly reluctant to jump into these uncharted waters. Also, the Ship Mortgage Act, as has already been seen, is not a comprehensive statute. It was designed to give a common ship mortgage a maritime lien priority and to make the admiralty foreclosure action available for realising the security. Because of these factors, there is probably very little difference in practical effect between a mortgage and a hypothèque.

The original method of raising funds on the credit of the vessel in both English and American law was the Bottomry Bond. Although this device created a security interest in the vessel enforceable in admiralty *in rem*, it was not a satisfactory device, since not only the maritime lien, but the debt itself, was lost if the vessel sank. Thus, the Bottomry Bond, along with the "Respondentia Loan", a similar device pledging the cargo of the vessel, became historical relics during the nineteenth century.

Ordinary ship mortgages, before the passage of the Ship Mortgage Act in the United States in 1920 and the Admiralty Court Acts in England in 1840 and in 1861, were considered by United States and English courts to be personal contracts, unenforceable in the courts of admiralty. These early mortgages were left to rely on the common law and equity courts for their foreclosure rights and in terms of priority ranked behind all maritime lien claimants in the distribution of proceeds from the sale of the vessel. The ship mortgage was a singularly unattractive form of security.

In the United States, the Ship Mortgage Act of 1920, codified as amended at 46 U.S.C. §§911–84 (1975), created a new security device, the *preferred* ship mortgage ("preferred mortgage") and, in so doing, transformed the ship mortgage into a viable form of security. The most significant feature of the preferred mortgage is that it is of a maritime character, enforceable by an action *in rem* in the Admiralty courts, with a considerably improved level of priority. The preferred mortgage is not absolutely preferred however; it ranks behind a group of "preferred maritime liens" consisting of any maritime liens arising prior in time to its recording and endorsement on the vessel's document and to a group of maritime liens that receive priority regardless of

time of accrual. This latter group, consisting of damages arising out of torts, wages of stevedores and crew members, general average, and salvage (including contract salvage) (46 U.S.A. §953(a) (1975)), are easily correlated with the group of genuine maritime liens under English law. As already mentioned the Ship Mortgage Act is limited in scope.

“The (Ship) Mortgage Act is not a comprehensive statute. It contains the detailed provisions previously discussed on the formal requisites of a preferred mortgage and on the giving of public notice through recordation and indorsement. It has also a highly important provision regulating priorities between preferred mortgages and other maritime liens ... It contains sketchy provisions on foreclosure; the lien of the mortgage may be enforced by suit *in rem* in admiralty and the mortgage may also proceed *in personam* for the recovery of any deficiency. That is, however, about as far as the Act goes”. (Footnotes deleted) ⁽²⁾.

As early as 1840, the English Admiralty Courts began to exercise limited jurisdiction over ship mortgages under the Admiralty Court Act 1840. Today, the Admiralty Courts' jurisdiction is complete, deriving its authority under the Supreme Court Act 1981, section 20(a)(c) which provides jurisdiction over “any claim in respect of a mortgage of or a charge on a ship or any share therein” and extends to unregistered mortgages as well as foreign mortgages. This is in contrast to the United States Ship Mortgage Act which is far narrower in application and which makes admiralty jurisdiction dependent on adherence to formal requisites of recordation.

Formalities of recordation

Access to the Admiralty Courts of the United States for enforcement of a preferred mortgage depends upon the proper recordation of the mortgage in the office of the U.S. Coast Guard Documentation Office (formerly office of the Collector of Customs) at the vessel's port of documentation (46 U.S.C. §§921–22 (1976)) and endorsement by the Documentation Officer of certain information respecting the mortgage on the vessel's document. Section 926 of the Ship Mortgage Act requires several preconditions to the recording of the mortgage. It must state the interest of the grantor or mortgagor in the vessel and the interest mortgaged, and the signature of the mortgagor must be acknowledged before a notary public in the jurisdiction where executed. There also must be filed with the mortgage an affidavit of good faith, to the effect that the mortgage is made without any intent to hinder, delay or defraud any existing or future creditor or lienor of the vessel (46 U.S.C. §922(a)(3)). The act requires but not as a condition to “preferred” status that a certified copy of the mortgage be placed on board the vessel by the mortgagor and be exhibited by the Master to any person also having business with the vessel (46 U.S.C. §923).

(2) G. Gilmore & C. Black, *The Law of Admiralty* 718 (2d ed. 1975)

The legal mortgage in England is created by complying with the statutory requirements of the Merchant Shipping Act 1984, notably section 31(1). This section provides that only registered ships can be subject to legal mortgages. Mortgage registration must take place at the ship's port of registry. Often, the mortgage instrument refers to a collateral agreement in which the parties have set forth their agreement on such terms as time for repayment, interest, insurance, and conditions constituting default.

Mortgages on ships which are not registered under the Merchant Shipping Act, or which are not capable of being registered because they are granted on ships under construction or foreign-owned ships, are not legal mortgages but are described as equitable mortgages and have low priority ranking.

Like the United States system, the formal requirements of registration and recordation must be closely followed to create a legal mortgage. However, even if the formal requirements are not met, an equitable mortgage is created.

Under the Companies Act 1948, certain mortgages must be registered with the Companies Register, and failing proper registration will fall into the equitable mortgage status. These include mortgages on ships owned by companies registered in England and which have established places of business there. Unless the mortgages on such ships are registered within 21 days of their creation, they will not prevail over liquidators or creditors of such companies.

Registered mortgages may be transferred to third parties, but the instrument of transfer must be in the proper form and it must be properly registered to take priority over third parties.

Subject of the security

To constitute a preferred mortgage in the United States, the subject must cover the "whole" of a United States vessel, other than a towboat, barge, scow, freighter, car float, canal boat, or tank vessel, of less than twenty-five gross tons (46 U.S.A. §992(a)). Vessels which are not documented cannot be subject to a preferred ship mortgage.

Mortgages on foreign flag ships may also attain "preferred" status (i.e. they may be enforced in the Admiralty Courts) provided that the mortgage was validly executed and duly registered in accordance with the laws of that ship's flag. It must be remembered, however, that the value of such mortgages when enforced in the United States Admiralty courts is diminished by the fact that they rank after maritime liens for necessities supplied in the United States.

Where a mortgage includes property other than a vessel – also called mixed mortgage – preferred status will be denied "unless the mortgage provides for separate discharge of the other property by a payment of a specified portion of the mortgage indebtedness" (46 U.S.C. §922(e)). Such a rule is designed to ensure the

jurisdictional and constitutional integrity of the admiralty proceedings by avoiding the "entangling alliance" with non-maritime property: *The Emma Giles*, 15 F.Supp. 502, 506 (D.Md. 1936).

Preferred mortgages may include more than one vessel. The provision of the act governing these "fleet mortgages" grants to the maker the option of providing "for the separate discharge of each vessel by the payment of a portion of the mortgage indebtedness". If so provided, this amount must be endorsed on each vessel's documents. If not so provided, a court may release a vessel from the mortgage upon payment of part of the mortgage debt proportional to the values of the vessels covered by the mortgage, plus 20%.

The mortgage must cover the whole of the vessel; one that covers only the ship's equipment cannot attain preferred status. It is generally understood that the mortgage covers the freight earned by the ship, and the mortgagee can require in the mortgage instrument the freight to be paid directly to him.

Property that has been acquired for the vessel's use after the creation of the preferred ship mortgage may be included in the security interest of the mortgage. Most mortgages contain what is commonly known as an "After-Acquired-Property" clause. In the absence of such a clause, courts usually ask whether the property or equipment is necessary to the accomplishment of the particular voyage, or has become an essential part of the *res*. If so, it will further inquire into the property's ownership. Where title is held by the owner-mortgagor, or where a supplier holds title as a security device only, courts extend the lien to that property.

Only a United States citizen may hold a mortgage on a United States ship. Corporations are considered citizens of the United States when the controlling interest is owned by United States citizens, its president, chief executive officer, and chairman of the board of directors are United States Citizens, no more than a minority of the number of directors constituting a quorum are aliens, and the corporation is organised under the law of the United States or one of the states.

In English Law, a legal mortgage can be granted on any ship not exempted from registry under the Merchant Shipping Act, 1894. Exempted are ships not exceeding 15 tons and which sail only in the rivers and coasts of the United Kingdom or some British possession. Under the Act, ships are defined to include vessels which are not self-propelled, such as various types of barges and floating oil tanks, as well as submersibles and jack-up rigs ⁽³⁾.

(3) Hamilton, Douglas *England and Wales, Handbook on Maritime Law*, Vol. III, 137-138 (1983).

Only British subjects or companies established under and subject to the laws of Her Majesty's Dominions and which have a principal place of business in those Dominions may own a British vessel. The nationality of the shareholders of the company is immaterial.

A mortgage covers the vessel and the appurtenances thereto. This includes all articles necessary to the navigation of the vessel which were on hand at the time of the mortgage or which were brought on board to substitute for such articles.

The mortgage does not include a charge on the insurance or earnings of the vessel, although it is not unusual for an assignment of the earnings and insurance to be contained in a separate collateral agreement.

The Merchant Shipping Act 1894 prescribes two forms of mortgages: the account current form and principal sum and interest form. The principal sum and interest covers no more than the principal sum and interest concerned; it is not generally favoured. The account current form secures all debts owed by the mortgagor to the mortgagee and enables mortgagees to recover for sums expended for insurance premiums or costs incurred in regaining the ship. It also can be adapted to cover past, present, and future debts or advances not yet made. Generally this is done by specifying in the account current mortgage that it is regulated by separate instruments such as a loan agreement or deed of covenant.

The mortgagee's right to safeguard his security

As previously mentioned, the Ship Mortgage Act is not a comprehensive statute. Its purpose was to enhance the ship mortgage by giving it maritime status and a certain priority among maritime liens. The statute contains the following simple sentence: "Upon the default of any term or condition of the mortgage, such lien may be enforced by the mortgagee by suit *in rem* in admiralty". Other rights which may be available to the mortgage are not referred to but are not precluded. Following the guidance of the act, the usual procedure for enforcement of a preferred ship mortgage is the commencement of a proceeding *in rem* in Admiralty.

Mortgages on U.S. flag vessels invariably include provisions granting the mortgagee authority, in the event of default, to take possession, to operate and charter the vessel and to sell the vessel at private or public sale without court proceedings. All of these are remedies sanctioned under the Uniform Commercial Code as previously discussed. It should be noted, however, that only the forced sale in the admiralty courts extinguishes all maritime liens and claims against the vessel and results in a vessel free and clear.

Under the Ship Mortgage Act, the mortgagee must give actual notice of the Admiralty action *in rem* to the master or caretaker of the vessel, and to any person who has recorded a notice of claim of an undischarged lien upon the vessel. Failure to give notice makes the mortgagee liable to the lien holder for any loss suffered upon the sale of the vessel as a result of the *in rem* action.

In England, the mortgagee has the right to take possession of the ship and to operate it or sell it. This right is generally regulated by the collateral agreements and is a right emanating from the common law rather than by statute.

The mortgagee may proceed in two ways to protect his interest: (1) he may act on his own and take possession of the ship under the rights in the collateral agreement or in the exercise of his rights under the common law, or (2) he may invoke the powers of the Admiralty Court and proceed by an arrest of the ship.

Possession can be actual or constructive. Actual possession is achieved by putting the mortgagee's own representative on board. Constructive possession is done by giving notice to the mortgagor, the charterer, if there is one, and by informing the master and directing him to act in accordance with the mortgagee's instructions. Once in possession he must run the ship as a prudent owner would. He can apply excess freight against the mortgage debt but would be required to account for the balance to the owner or other person who might be entitled thereto, such as a second mortgagee. The mortgagee is bound by contracts entered into by the mortgagor when the mortgagor had control of the ship as long as the mortgagee had notice of such contracts. The mortgagee is not bound by other contracts unless those contracts gave rise to maritime liens. If the mortgagee takes possession by invoking the assistance of the Admiralty Court, his rights and obligations remain the same as if he obtained possession on his own.

The mortgagee has the option of selling the ship after taking possession. This power is given under the Merchant Shipping Act 1894, S.35 which allows the mortgagee to sell by private treaty or public auction. However, since the private sale does not extinguish maritime liens, mortgagees generally prefer arrest and forced sale by the Admiralty court.

Priority of mortgages as between themselves

The traditional rule of thumb governing the priority of maritime liens, "last in time, first in right", is reversed in the case of mortgages.

A question has arisen in regard to mortgages that are renewed or in some manner modified. Where amendments or modifications do not substantially change the nature of the obligations, American courts will leave intact the priority of the mortgage as of the date of initial perfection. *Coastal Dry Dock & Repairs Co. v. S.S. "Beybelle"*, 1975 A.N.C. 1736 (S.D.N.Y. 1975). This rule also applies where the mortgage is assumed by a new party if the assumption does not substantially alter the nature of the obligations. *Barnouw v. S.S. "Ozark"*, 304 F. 2d 717 (5th Cir.), *Cert. denied sub nom.*, *Secony Mobil Oil Co. v. Wall Street Traders Inc.*, 371 U.S. 923 (1962).

In England, when more than one registered mortgage is involved, priority between mortgages is determined according to the date of registration, not the date of the creation of the mortgage. However, if the first mortgage covers future advances, it

will not rank ahead of a second mortgage which is registered prior to any advancements under the first mortgage. Equitable mortgages, including unregistered mortgages, rank behind registered mortgages regardless of whether a subsequent registered mortgagee was aware of the prior equitable mortgage. Equitable mortgages will rank ahead of claims for necessities where the supplier commences the *in rem* action subsequent to the date the mortgage is granted.

III. Arrest of ships in the United States

The United States is not a signatory to any international convention pertaining to the arrest of seagoing vessels, and, accordingly, virtually all law regarding the procedure and substance of ship arrest in the U.S. must be found in the U.S. case law and statutory law alone.

The grounds for, and procedures governing the arrest of vessels in the United States are set out in Supplemental Rules B and C of the Supplemental Rules for Certain Admiralty and Maritime Claims of the Federal Rules of Civil Procedure (hereinafter "Admiralty Rules"). The Federal Rules of Civil Procedure are rules issued by the Supreme Court of the United States pursuant to authority given to it by Congress to promulgate rules governing procedure in all suits of a civil nature, that is cases at law, in equity or in admiralty. The Admiralty Rules supplement the more general Federal Rules of Civil Procedure with procedures applicable to the unique aspects of maritime cases. They specifically permit the seizure of a vessel by two related, but distinct means, the "warrant of arrest" and the "writ of attachment". The warrant of arrest is used where the claim is against the vessel (an *in rem* claim). The writ of attachment is available where the claim is solely *in personam* against the vessel's owner; there the attachment serves the purpose of subjecting an absent owner's assets to the jurisdiction of the court (only up to the value of the attached vessel, of course). This is known as *quasi in rem* jurisdiction. Unlike the case with a strict *in rem* claim, the claim in such a case is made against the vessel not because of its potential liability but because of its owner's potential liability.

Rule C provides that a warrant for the arrest of a vessel may be obtained in connection with either (a) the enforcement of a maritime lien, or (b) an action *in rem* permitted under admiralty common law or any statute of the United States which permits a maritime action *in rem* or a proceeding analogous thereto ⁽⁴⁾. Rule B provides that a writ of attachment, which restrains the departure of a vessel as surely as the arrest of a vessel, may be issued with respect to any admiralty or maritime claim *in personam*, against its owner provided the owner can not be found within the district.

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- (4) 46 U.S.C. § 951, for example, provides the basis for an arrest by the holder of a preferred ship mortgage:

"A preferred mortgage (including foreign ship mortgage) shall constitute a lien upon the mortgaged vessel in the amount of the outstanding mortgage indebtedness secured by such vessel. Upon the default of any term or condition of the mortgage, such lien may be enforced by the mortgagee by suit *in rem* in admiralty."

The general view is that a chartered vessel is not a chattel of the charterer and that neither the vessel nor the charterer's interest therein is subject to attachment in respect of a claim against the charterer.

Furthermore, although there is little authority, most commentators would not permit attachment of a time-chartered vessel with respect to a claim against the owner where it would defeat the charterer's right to possession. This is to be distinguished from a Rule C arrest *in rem* where the claim is against the vessel and thus not affected by any contract between owner and charterer. Admiralty Rule E(8) provides that the owner may make a restricted appearance to defend against either a claim *in rem* (initiated by warrant of arrest) or *quasi in rem* (initiated by a writ of attachment) without subjecting himself to liability beyond the value of the vessel under restraint and without subjecting himself to jurisdiction for the purpose of any other claim as to which process has not been served.

Evidence necessary to obtain an arrest

An arrest may be obtained in the United States upon the simple allegation of any maritime lien or a cause of action under a statute which would permit an arrest *in rem*. No evidentiary hearing is required prior to issuing a warrant of arrest; however, a verified complaint, in effect an affidavit as to the truth of the matters contained therein, is necessary. The verified complaint must allege the existence and nature of the maritime lien or maritime cause of action, must describe with reasonable particularity the property that is the subject of the action, and must state that the *res* is within the district or will be during the pendency of the action. A warrant of arrest obtained pursuant to Rule C need not be issued by a judge and, in fact, is routinely issued by the Clerk of the Court simply upon the filing of the verified complaint and payment of the required fees ⁽⁵⁾.

An attachment of a vessel, which procedurally is tantamount to an arrest, may be obtained pursuant to Rule B(1), which provides that a vessel (or other goods and chattles or credits and effects in the hands of named garnishees) may be attached whenever a maritime cause of action exists against the owner personally, and upon a further averment under oath that the owner-defendant can not be located within the district where process is served despite a diligent search. A Writ of Attachment pursuant to Rule B(1) is obtainable by a procedure very similar to that governing a Rule C arrest and is routinely issued by the Clerk of the Court upon the filing of the necessary verified complaint and affidavit that the defendant can not be found in the district, and upon payment of the required fees. A Rule B attachment may be used as a basis for the quasi *in rem* jurisdiction referred to above and is permissible only where the court does not otherwise have personal jurisdiction over the defendant.

(5) Upon filing of the complaint in required form, "the clerk shall forthwith issue a warrant for the arrest of the vessel or other property that is the subject of the action, and deliver it to the marshal for service". The actual practice is for the clerk to return the warrant to the attorney who then delivers it to the marshal.

Functionally, the Rule C arrest and Rule B attachment differ in that the Rule C arrest is the means by which to execute upon a traditional maritime lien on the vessel or bring a statutorily authorised maritime claim *against a vessel* while the Rule B attachment is a means for a plaintiff to acquire jurisdiction over, and security from, a defendant against whom he has only an *in personam* claim and no *in rem* claim over the particular vessel upon which the writ is served.

Notice requirements before arrest or attachment

U.S. Rules of Practice do not require that any notice be given to any party before the initial attachment or arrest of the vessel, for the obvious reason that the vessel might well escape the jurisdiction were its owner or other interested parties to know in advance of the impending arrest.

The United States rules, however, require notice quite soon after arrest or attachment, and certain statutes under which an arrest or attachment may be obtained have additional notice requirements. Rule C(4), requires that if the property is not released within 10 days after service of the warrant of arrest on the vessel by the Marshal, the plaintiff must cause public notice of the arrest to be given in a newspaper of general circulation in the district. Local rules of practice elaborate this requirement. In New York, for example, the Rules (Local Rule 3(a)) require publication of notice of the arrest in a newspaper of general circulation upon at least one occasion, and require the notice to state that any Claimant must file his claims within ten days after the arrest or within such other time as may be allowed by the Court, otherwise the vessel may be sold to satisfy the demand set forth in the Complaint. Furthermore, Local Rule 3(b) specifies that the case may not be heard and sale may not be ordered until after such publication. Additionally, both the Admiralty rules and local admiralty rules now require immediate notice to the owner of the vessel, provided his identity can be established upon diligent search, immediately upon service of the Warrant of Arrest; this requirement is in addition to the traditional requirement that notice is to be posted upon the vessel in certain conspicuous locations at the time the Marshal serves the Warrant ⁽⁶⁾.

Rule C specifically notes that the Ship Mortgage Act, 46 U.S.C. § 951, contains additional notice requirements with respect to vessel mortgages. That section requires that, in addition to any notice of publication, actual notice of the commencement of the suit shall be given by the libellant (claimant or plaintiff), in

(6) Local Admiralty Rule 10(b) of the Southern District of New York, for example, requires prompt notice of an attachment in writing, by telex, telegram or cable, and further provides that failure to accomplish or to have diligently attempted such notice, shall be deemed evidence of "manifest want of equity" which would permit the Court to dismiss the arrest after an immediate hearing.

such manner as the court shall direct, to (1) the master, other ranking officer, or caretaker of the vessel, and (2) any person who has recorded a notice of claim of an undischarged lien upon the vessel as provided in 46 U.S.C. § 925, “unless after search by the libellant satisfactory to the court, (it appears that) such mortgagor, master, other ranking officer, caretaker, or claimant is not found within the United States”⁽⁷⁾.

Government owned vessels

In the United States, vessels owned, possessed, or operated by the United States government are immune from arrest. Nevertheless, Rule C provides that an action against the United States may otherwise proceed on *in rem* principles. Under the Foreign Sovereign Immunities Act, 28 U.S.C. § 1602 *et seq.*, vessels owned by foreign governments or instrumentalities thereof are also immune from arrest, except in some cases where the arrest is to satisfy a previously obtained judgment. Nevertheless, process in the nature of an *in rem* suit may be served on a vessel against which a claimant asserts a maritime lien based on the commercial activity of the foreign state, and the owner government may thereafter be found liable *in personam* on an amount up to the value of the vessel upon which the maritime lien existed and process was served. Where such a vessel is knowingly arrested by a lienor, the notice shall be deemed void and no suit may thereafter be brought by that lienor against the vessel.

Mechanics of arrest

Since judicial taking and maintaining of physical custody of the property proceeded against is an absolute prerequisite to the continuation of the proceedings to judgment on the merits ⁽⁸⁾, facilitation of execution of the arrest by the United States Marshal is of prime importance. The pragmatic aspects of execution vary considerably from district to district, ranging from the rigidly formal to the possibility of effecting an arrest by telephone.

The mechanism of an arrest in the United States is governed by local practices, variable from district to district within the United States, by statutory requirements governing the duties and discretion of the Marshal, and by the United States Marshal’s Manual, which is the guide published by the United States Department of Justice for use by individual United States Marshals in determining what actions

(7) Failure to give such notice, while not a jurisdictional defect, subjects the libellant to liability to the other claimant in the amount of his interest in the vessel, terminated by the sale of the vessel.

(8) Neither stipulation to *in rem* jurisdiction, nor appearance by the Owner *in personam*, nor initial arrest *in rem* suffices to permit continued jurisdiction over the *res* where actual custody is not maintained.

within their discretion should be taken in the course of an arrest ⁽⁹⁾. In accordance with the philosophy of the Justice Department and 28 U.S.C. § 1921, the Manual instructs United States Marshals to take no action in furtherance of an arrest without being funded for expenses in advance by the plaintiff and/or receiving an indemnification for any losses or damages which might arise out of the actions of the Marshal ⁽¹⁰⁾. This requirement creates a practical difficulty in accomplishing many arrests, as for example those which must take place upon very short notice during the middle of the night, or on weekends. The United States Marshal's office for the District of New York requires payment of \$4,500 in cash or certified check in advance of service of any Warrant of Arrest or Writ of Attachment upon a vessel as a deposit for initial watchmen's fees and insurance costs.

Inasmuch as certified checks in that amount are unobtainable on weekends (even cash will not always be acceptable), it is essential that an arrest is anticipated as far in advance as possible ⁽¹¹⁾.

As noted, the United States Marshal's Manual admonishes marshals and their deputies to undertake little if any action without (1) a direct authorisation from the Court, (2) prior payment and arrangement of expenses by the plaintiff, and (3) adequate indemnification for the difficulty of arranging services for the vessel during the period of arrest, (due in part to the doctrine that when a vessel is in *custodia legis*, no further lien can attach, and payment for services is dependent upon a court order, which is granted "if equity and good conscience" so dictate). For this reason, suppliers of necessities (food, fresh water, diesel fuel, etc.) usually demand payment upfront or a binding guaranty by the plaintiff.

There are many other strict requirements to be complied with.

(9) See 1972 AMC 569.

(10) 28 U.S.C. § 1921 sets fees in connection with vessel arrests and requires the collection of an advance deposit to cover initial expenses. See also 28 U.S.C. §§ 561-7.5 (outlining duties of marshals and 31 U.S.C. § 665 (prohibiting the obligation of government funds to defray costs incurred in seizures on behalf of private litigants).

(11) In extreme circumstances, it is possible to obtain a Writ of Attachment from a judge at his or her home or chambers on a weekend. Even if that is accomplished however, and the requirements of cash or certified check is either dispensed with by Order of the Court or has been obtained in advance, unless a qualified United States Marshal or Deputy United States Marshal can be located, it is still well nigh impossible to arrange service of the warrant. In that event, the best planning in the world will not have sufficed to accomplish the physical service of the warrant, which is an absolute jurisdictional prerequisite to the Court's obtaining any control or right over the vessel.

While the Marshal's Manual advises the marshal to permit the continuation of loading and discharging and other activities which are part of the vessel's routine port operations, in many jurisdictions the marshal requires a court order before permitting any activity whatsoever ⁽¹²⁾. Part of the reason for this requirement is no doubt so that the marshal may obtain the necessary indemnification by the Court or from the parties, and part of it is due to the marshal's understandable reluctance to permit activities to continue if he is not aware of the outcome of the action. It is for this latter reason, no doubt, that many marshals' offices permit routine discharge and loading operations except where the arrest has been arranged at the behest of the mortgagee of the vessel, since in this situation the likelihood of the vessel being released, and continuing its operations is rather low.

As to the timing of the actual arrest, it should be noted that the *in rem* action may be filed but the issue of process held in abeyance until an opportune moment, as, for example, until the location of the vessel is known with precision (Admiralty Rule E(3)(b)). Needless to say, any aid that can be given to the United States Marshal in locating and reaching the vessel expedites the service of process on the vessel.

Execution of the warrant of arrest is effected by the Marshal upon delivery to him of: (1) the warrant issued by the clerk, (2) a certified check for the initial deposit, and (3) a U.S.M. Form 285, properly completed by the plaintiff's attorney ⁽¹³⁾.

No bond is required of the plaintiff before the initial arrest ⁽¹⁴⁾. Process is executed by affixing a copy to the vessel in a conspicuous place and by leaving a copy of the complaint and process with the person having possession, or his agent (Admiralty Rule E(4)(b)).

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- (12) In other districts, however, the marshal's requirements are quite lax and his willingness to accomodate plaintiffs, as well as the regular port routine for the vessel, is considerable.
- (13) USM Form 285 (see 1972 AMC 572) requires names of parties, a reasonably detailed description of the property and its location, and special instructions (such as arrangements made to facilitate service by the marshal).
- (14) Although a plaintiff is not absolutely bound to file a bond as a prerequisite to a Rule C arrest, pursuant to Admiralty Rule E(2)(b), "the court may, on the filing of the complaint or on the appearance of any defendant, claimant or any other party, or at any later time, require the plaintiff (or any other party) to give security in such sum as the court shall direct to pay all costs and expenses that shall be awarded against him". Since the initial Rule C warrant of arrest is issued by the clerk of the court, a cost bond is not routinely required in the Southern District of New York, if at all, until the defendant owner appears in the action.

Once the warrant is served, the ordinary practice is for the ship's owner or representative to post a bond or P & I letter of undertaking. In many instances arrest of the vessel may thus be terminated within hours of the original service of the warrant. Local practice, in fact, may be for the attorney for the potential arresting party to telephone the attorney for the P & I Club which insures the vessel to inquire whether a letter of undertaking would be issued without the necessity of arresting the vessel and causing attendant delay and burden. Needless to say, such an action cannot be undertaken except where the expectation is high that such a letter will be provided and where such a practice is common and accepted both among the attorneys and their clients.

Where a bond is posted pursuant to the Rules of the Court, it is posted under Rule E(5)(a,b), which requires that the amount of the bond, in the form of a Letter of Undertaking by a qualified surety company, shall be no more than double the amount of the claim or the value of the vessel, whichever is less ⁽¹⁵⁾. If there is a dispute as to the value of the vessel, of course, an immediate appraisal may have to be obtained.

The question of whether a vessel arrest, without notice, upon the bare allegations of a verified complaint, conforms with the fundamental requirements of the due process of United States law, has been addressed by several courts in recent years. The general consensus is that despite the lack of requirement of prior notice or that a judge has to make a finding of probable cause, in order to arrest the vessel, Rule C arrests are constitutional, both because of the long history of such admiralty arrests and because local notice and hearing provisions substantially meet any objections. Thus, both the 5th Circuit, in *Merchants Nat'l Bank v. The Dredge General G.L. Gillespie*, 663 F.2d 1338 (5th Cir. 1981), certiorari denied 456 U.S. 966 (1982) and the 4th Circuit in *Amstar Corp. v. s/s Alexandros T.*, 664 F.2d 904 (4th Cir. 1981) have upheld the constitutionality of Rule C arrests.

(15) 28 U.S.C. § 2464, by contrast, requires the bond to be twice the amount of plaintiff's claim, without any court discretion to reduce the amount; Rule E(5) has been followed and 28 U.S.C. § 2464 generally ignored.

IV Judicial sales in the United States

In the United States the judicial sale of a vessel may occur by order of an admiralty court (a) at a public auction conducted by the U.S. Marshal and subsequently ratified by the court or (b) by private sale, at a price at least two-thirds of its appraised value, which is advertised and subsequently ratified by the court provided no bona fide offer at least ten percent higher than the sale price is made. Judicial sale of a vessel may also be by order of a bankruptcy court by auction, negotiated sale or any other sale device calculated to obtain the highest price ⁽¹⁶⁾. Such sales in bankruptcy are usually conducted at the behest of the Trustee or the Debtor-in-possession and not, as in the case of the Admiralty, at the request of an attaching creditor. Foreclosure of private yachts and other non-commercial vessels in the U.S. is often accomplished by the mortgagee's private repossession of the vessel and subsequent private sale.

Grounds for judicial sale

A sale of a vessel under arrest or attachment in admiralty may occur after final judgment or, as is far more common, after a interlocutory order is issued upon the application of any interested party or the marshal, pursuant to Admiralty Rule E(9)(b). Under Rule E(9)(b) an interlocutory order of sale may issue where the vessel is "perishable, or liable to deterioration, decay or injury by being detained in custody pending the action, or if the expense of keeping the property is excessive or disproportionate, or if there is unreasonable delay in securing the release of property" ⁽¹⁷⁾.

(16) In a reorganisation under Chapter 11 of the Bankruptcy Code, negotiated sales are more common. In a liquidation under Chapter 7, auctions are more common. Although the receiver in the latter case certainly attempts to obtain the highest price, he is also concerned about liquidating assets as quickly as possible. One device sometimes used is that the negotiated price becomes the "upset price" or minimum acceptable bid. If no higher bid is received, the auction serves to validate the reasonableness of the negotiated price.

(17) Certain local rules provide, additionally, that no interlocutory sale may be ordered before the sum chargeable therein is fixed by the court, except upon consent or court order, no doubt to insure that the drastic remedy of sale is not used in a situation where the plaintiff's claim is unliquidated (as in a tort action for personal injury) and the extent of damages is conjectural. See Local Rule 3(d) in New York.

While explicit provision for the interlocutory sale of *arrested* vessels has long been a part of the admiralty rules in the United States and the practice itself dates back to the beginnings of the Republic, see e.g., *Stoddard v. Read*, Fed. Cas. No. 13 (Cir.Ct.Pennsylvania 1783) (interlocutory sale of schooner in "perishing condition" ordered for the ultimate use "of those to whom the same shall be finally decreed"), the interlocutory sale of *attached* vessels has only been permitted for the last couple of decades, since the unification of admiralty and other civil rules of practice. The interlocutory sale of vessels under arrest or attachment is strongly favoured in the United States, apparently in recognition that a vessel under restraint is an inherently wasting asset whose continued layup can benefit neither its owner nor the lienors who have arrested her or made claims against her. The rules recognise that the owner has the right to notice and an opportunity to bond the vessel prior to her sale; but if release is not promptly obtained, it is unlikely that the owner has the wherewithal to continue operations in any event. As protection against highly inflated or wholly unsubstantiated claims the owner and claimants are entitled to a hearing as to the amount of security required to release the vessel. The bias toward interlocutory sale in United States admiralty practice contrasts with the practice in most other jurisdictions, where a final judgment is often necessary before sale. This difference in practice is due partly to the length of time necessary to obtain a final judgment in the United States (exceedingly liberal discovery provisions in United States court actions, together with heavy court backlogs, usually make it impossible to obtain judgment for years) and partly to unwillingness in other jurisdictions to exercise such a drastic remedy until the owner has had a full hearing on the merits of the claims. The interlocutory sale procedure, however, makes considerable sense from the viewpoints of both owner and creditor. The owner has an opportunity to release the vessel or to prove that the claim lacks merit. If he is unable to do either, all interests are better off having the proceeds of the sale of the vessel earning money for ultimate disposition by court decree instead of paying the high expenses of maintaining a vessel which continues to deteriorate and depreciate.

Notice requirements for private and auction sales

Most districts have their own rules specifying the extent of notice before a sale. In New York for example, no public sale may be held except after at least six (6) days notice in a newspaper of general circulation in the district (Local Admiralty Rule 3(c)). In other jurisdictions, considerably less notice may be required by the rules. Needless to say full and adequate notice of an impending auction is wise, regardless of local rules, since it enhances the possibility of a sale at or near market rate, renders unlikely the possibility that the auction will be overturned on a claim of inequitable or improper conduct and minimize the likelihood that a court in another part of the world would permit a pre-existing maritime lien to survive against the vessel after sale. The goal should be "notice to the world" ⁽¹⁸⁾. It goes without saying

(18) Such notice should require that all liens must be asserted by a particular date, otherwise a separate notice would have to be published to make it clear.

that an acceptable sale price can be obtained only where the buyer is relatively certain that the vessel is sold "free and clear of all liens". The best means of ensuring that courts in other jurisdictions recognise a judicial sale as an admiralty sale which has "washed" the vessel of all liens, is to demonstrate that best efforts were made to notify all maritime lienors in time to claim against the proceeds of sale.

For this reason, prudence often dictates that the sale should be advertised for longer than the minimum local requirements. While a sale by an admiralty court in the U.S. has traditionally been accepted around the world for this purposes, a sale by a bankruptcy court, as discussed below, is more problematical. If a bankruptcy sale is required, the cautious practitioner must be even more careful to ensure adequate notice to possible lienors world-wide.

Sale in admiralty in the United States may be either by open public auction or by private sale, but there is a strong bias toward sale by public auction: the private sale method is virtually never used in admiralty even though neither the Ship Mortgage Act nor any other maritime statute precludes its use. The United States Marshal's Manual, to which the Marshal turns for guidance on every aspect of the arrest, custody and sale process, does not even suggest the private sale as an available option. The bias is probably due in part to the possibilities of collusion inherent in the private sale method (if fraud is determined, the bill of sale may not effectively transfer the vessel free and clear of all liens) ⁽¹⁹⁾. Additionally, the court may sanction a private sale only if certain rigorous conditions are met. A private sale may be approved pursuant to 28 U.S.C. paras 2001 and 2004 only if no bona fide offer at least ten percent higher is received after publication of the terms of the proposed private sale in a newspaper or newspapers of general circulation at least ten (10) days before confirmation by the Court. 28 U.S.C. para 2001. Needless to say, an intending purchaser might be unwilling to invest much energy toward such an uncertain end.

The preference for public auction in admiralty sales of commercial vessels is to be contrasted with the preference for sale by private treaty (by sealed bid) in such jurisdictions as England and Singapore and the preference for court approved negotiated sales in bankruptcy sales. For reasons which are apparent (confidentiality, opportunity to inspect the vessel fully, opportunity to arrange financing), negotiated sales probably maximize the sale price despite the risk of collusion. Interestingly, mortgagees foreclosing upon private yachts in the United States invariably take

(19) Curiously, the present English and Singapore preference is for sale by private treaty. According to several barristers, this preference arises out of several experiences in which the public auction was collusively manipulated.

possession of the yacht and negotiate a private sale according to the very liberal provisions of the Uniform Commercial Code 9-504, which simply seeks to ensure that the sale is commercially reasonable. In the case of commercial vessels, admiralty process is undoubtedly necessary due to the likely existence of numerous maritime liens which must be expunged upon sale. Maritime liens of suppliers, etc. on private pleasure craft is considerably less likely and the expense of judicial seizure, custody and sale in admiralty no doubt outweighs the benefit of the admiralty court's powers. The bias toward public auction does not appear to benefit either the owner or the lienor in most instances in that it clearly has a chilling effect on the sale price of the vessel. The Marshal supervises the public auctions, however, and obtains a worthwhile commission thereby. Moreover, since the sale is open and public, the Marshal is relatively assured of immunity from claims of wrongdoing.

Appraisal requirements

Before confirming the private sale of an arrested vessel pursuant to 28 U.S.C. 2001, 2004, the court must appoint three disinterested persons to appraise the vessel. No private sale may be confirmed at a price less than two-thirds of the appraisal value.

If the sale is to be by public auction, the court is not required to order an appraisal, although in many local jurisdictions an appraisal must be ordered upon the application of any interested party ⁽²⁰⁾. Often, one or more parties will propose that an "upset price", or minimum bidding level, be set by the Court. The Court will then receive testimony as to valuation and as to the benefits of having an upset price at all. While an upset price assures that the vessel will not be sold at an unconscionably low level, many brokers believe that the upset price simply deters prospective buyers from attending the auction.

Conduct of sales

The U.S. Marshal's Manual outlines the procedure to be followed at an auction. Its emphasis is upon giving all bidders ample opportunity to reflect upon their bid and does not promote the professional auctioneer's more dramatic methods. A deposit of ten percent of the bid in cash or by certified check is required of the successful bidder at the time of the auction. The balance is payable when the sale is confirmed by the Court, when the Marshal's Bill of Sale is received. Following the public auction the court will usually conduct a confirmation hearing; in some jurisdictions (including New York), confirmation is automatic if no one objects to the conduct or results of the auction and if the Order of Sale makes no special requirement of a confirmation

(20) Local Admiralty Rule 11 in New York states that such an order may be entered "as of course, at the instance of any party interested, or upon the consent of the attorneys for the respective parties". The appraiser must give one day's notice of the time and place of the appraisal to the attorneys. The appraisal is to be filed when made.

hearing. Where an auction is attacked, it will ordinarily be vacated only upon a finding that the sale price was grossly inadequate and that another buyer at a considerably higher price is available.

Effect of judicial sales

Sales in admiralty by the United States Marshal are deemed by other jurisdictions to transfer the vessel free and clear of all liens and encumbrances. The effect of a sale by a bankruptcy court in the United States is uncertain and there is controversy about whether bankruptcy courts are constitutionally empowered to exercise admiralty powers and wipe a vessel free of maritime liens. The controversy is likely to be resolved so that United States bankruptcy courts will be entitled to exercise full admiralty powers; this may be accomplished by a proforma approval of the court's action by a United States District Court judge, with clear constitutional authority to exercise admiralty jurisdiction. A sale by a bankruptcy court ought to be recognised as a sale of a vessel free and clear of all liens inasmuch as the procedures which guarantee a valid Marshal's sale in admiralty are intact: the bankruptcy courts require full notice of sale and full notice to lienors, and they adjudicate maritime lien claims on the vessel in the same way as would an admiralty court. In many other jurisdictions in the world, however, bankruptcy or insolvency courts vary considerably in procedure and in their deference to maritime lien concepts. The ultimate test of the ability of a court to sanction a sale free and clear of all liens, should be based on whether that court requires full notice to possible lienors and a fair opportunity to present their claims against the proceeds of sale in accordance with established maritime lien priority concepts. At the moment, however, since there might well be problems with a bankruptcy sale in the United States, there is not much point in undertaking such a sale where an admiralty sale may be arranged.

It is also quite possible to sell a vessel pursuant to a court order from any of the fifty state court systems in the U.S. where the vessel has been attached pursuant to that state's procedures in order to secure an actual or potential judgment. Since no state court may exercise admiralty powers, however, such a sale would not wash the vessel of maritime liens and hence is rarely considered by creditors.

THE PROTECTION OF MORTGAGEE BANKS: THE BANK'S VIEW

Roger Wilman

This paper is concerned with the commercial banker's view of shipping related business. Success in this sector not only requires sound commercial banking and decision taking judgment but also sound expert advice. Even the most careful and successful banks cannot avoid default by a few borrowers and the collapse of some corporate shipowning customers. However, an integral consideration is the maximisation of recoveries, following a default, by the actions and procedures developed by mortgagees in close association of course with the best available legal advice.

This paper sets out the typical considerations a bank may have to take into account in determining the most appropriate course of action to follow if it is to protect its position as mortgagee, after a borrower has defaulted. That is when the lender is most vulnerable to loss. It is important however first to reflect upon the shipping market since the early 1970s since market events and forces have had a significant influence on the policies of lenders involved in shipping.

The First Market Crisis

During the past 15 years, the shipping industry has witnessed and suffered a measure of permanent harm from two succeeding severe market depressions. Lifeboat procedures introduced by financiers and ship operators supported by carefully drafted legal documentation and considerable optimism did much to see the industry through the worst of the crisis in the early 1970s brought about by the rapid and spectacular increases in world oil prices. The well documented difficulties of such household names as Reksten and Burmah Oil Tankers, to name but two much respected shipowners and operators of the time, certainly sent waves of trepidation and anxiety sweeping through the banking, legal and insurance communities.

Banks closely examined their shipping portfolios and their customers' trading performance in the difficult market conditions and reviewed their security. Lender-appointed legal advisers were instructed to review and comment upon the degree of protection afforded by documentation prepared several years earlier.

In many instances, attempts to remedy or improve the position came too late, not only to save the shipowner but also to prevent the collapse of several prestigious banks and finance houses and long-term difficulties for many banks, such as Hambros, to name but one. Very few lending institutions were not affected in some way by the collapse of the shipping market.

The banking community has taken a great deal of the blame for the shipping crisis for making too much money available on very attractive terms supported by generous incentives from the governments of the major shipbuilding nations. The answer to one simple question: "Who takes the decision to sign a contract for a new ship? Is it the financier, the lawyer, the insurer?" refutes that allegation. There are, of course, exceptions and some of these are now in a strong and healthy position and leaders of their industry. P and O and Cunard are two such companies in Great Britain while Sir Y.K. Pao's companies in Hong Kong are another example.

The background to the crisis was the plentiful supply of cheap oil available to satisfy the ever increasing demand from developed and undeveloped countries alike. Supertankers, VLCCs and ULCCs were designed to provide a cost effective means of transporting crude oil as well as refined products. US\$30m contracts were placed with shipyards for DWT 250,000 tankers, contracts which were then re-sold for say US\$70m, with some banks prepared to lend up to 120% of the final purchase price. Many fortunes were made only to be lost in a few years when vessel values plummeted to record low figures. Many mortgagee banks found it necessary to set up specialist departments whose sole directive was to maximise recoveries following a default (or in most instances, minimise loss!) These defaults and disputes provide the ultimate test for the work of the legal profession throughout the world.

It must not be forgotten however that many mortgagee banks, particularly those who steadfastly pursued a "safety first" approach and who were not too heavily influenced by competitive pressures, emerged relatively unscathed from the first crisis (not without a measure of good luck in several instances). Lessons learnt by the conservative banks were similar to those learned by banks with a more entrepreneurial approach to credit assessment and lending controls. New guidelines were introduced in many banks to ensure greater in-depth critical credit assessment of ship-related proposals, increased day-to-day monitoring of their customers' performance, increased market intelligence and continuous review of security of collateral values and loan documentation.

This last item was particularly important, since it drew together the lenders and lawyers in a more regular and continuous dialogue and exchange of views which undoubtedly assisted the lenders faced with difficult commercial decisions when a loan became or threatened to become "non-performing".

The Second Market Crisis

The most severe impact of the first shipping crisis fell principally on the oil sector (tankers and mobile offshore drilling rigs). Many shipowners managed to survive but in a weakened and cash starved condition. Intensive care was the buzz word in many banks' shipping departments when reviewing customers' positions. Nevertheless, optimism returned and in an effort to diversify away from tankers, many owners began ordering dry cargo tonnage in the belief that a world economic upturn was just around the corner with consequential increases in demand for raw materials. What they, and many eminent economic forecasters, failed to appreciate was the

severe effect increased oil prices were to have on developed and undeveloped countries alike. Manufacturing costs increased, hyper-inflation became a 'norm' and many nations' ability to service and settle international obligations was crippled.

The dry cargo market became quickly oversupplied with tonnage (at one point by DWT120m). Panamax sized vessels, under construction at a cost of US\$30m each, were only worth US\$12–15m by the time of delivery.

No banker, lawyer, insurer or shipowner could fail to see the serious effects of the latest slump, not least because many shipowners had barely begun to recover from the previous slump and had minimal liquid resources. Many shipowners quickly became desperate. A number of financed vessels were lost under suspicious circumstances. It is said that one vessel, whose owner had been informed that the bank would have to arrest her, mysteriously caught fire on the due date. Another reported incident concerned a ship running on to the only rock between US and Venezuela and then catching fire in four different places.

One banker described shipping as "a stateless industry, in which owners operate a business that has no cultural laws, every owner by definition living and working in multiple societies and with no cultural minimum standard of behaviour."

Damage Limitation

The task facing lenders and mortgagees in trying to make the best possible recovery or to limit potential losses was daunting. Lessons learned in the previous difficult years were invaluable but the degree of desperation among most shipowners who faced acute financial difficulty led to subconscious, sometimes blatant, unwillingness to cooperate with lenders and mortgagees, who consequently had to develop sharp and effective recovery procedures.

Banks had to act speedily and decisively to keep losses at a minimum. Failure to do so might mean that the bank lost its position as the prime decision-taker in a process which then became more expensive, complicated and difficult if any measure of success for those involved was to be achieved.

It became very important for lenders to ensure that they had a clear idea, at the highest level of their organisation, as to how and when they should arrest or seize the ships of a defaulting borrower and, more important, what they intended to do with the ship after they had arrested it.

Many lenders came to grief because they failed to research the background properly before taking action, homework which cannot be undertaken except by working closely with the legal profession and to a lesser extent the insurance market. Great demands are placed on a lender's legal adviser. His task is especially exacting where the shipowner, the builder and the lender are of different nationalities: a vessel may after all be built in Japan for a Greek owner with a loan from an English bank, and on the basis of a long-term charter party with an American oil concern. Thus action

involving the mortgagees of the ships has numerous international aspects and considerations especially as it often happens that a vessel is arrested and sold in yet another foreign country.

Maritime laws of course vary from country to country so creating uncertainties for maritime creditors, particularly relating to the recognition and enforcement of foreign-created ship mortgages and the relative priorities of ship mortgages to maritime liens. A ship may be arrested at the request of some other creditor, sometimes even an unsecured creditor, in one of the many countries where maritime liens have priority over mortgages. The value of the bank's security would then depend on the law of a jurisdiction which is not of the banker's choosing.

Negotiation

Against this background the mortgagee should carefully determine the commercial options open to him as part of his strategy to reduce the potential losses. He may be able to develop jointly with the shipowner a commercial solution on an amicable and mutually beneficial basis, or the existing loans may be restructured with repayments adjusted and extended to match the vessel's potential trading income. Additional funds may be made available to assist the shipowner during a temporarily difficult trading period, and in a few cases, the lender may assist with an injection of equity funding and seek board representation to enable the company's day-to-day performance to be more closely monitored.

However, if and when it is obvious that this additional help and assistance cannot provide a long-term solution to the shipowner's problems, the mortgagee will declare the default, demand repayment and begin formal recovery procedures.

Taking possession

If the vessel has been operating under a charter, the mortgagee will ensure that there is no risk that the action proposed interferes with the performance of the charter and results in the mortgagee being liable in damages to the charterer.

The mortgagee will then take possession of the vessel, usually appoint new vessel managers and check that the vessel insurance arrangements are satisfactory particularly that there are no premiums or P and I calls due but unpaid. In some cases, the mortgagee has to make his own arrangements with brokers and underwriters to ensure that he remains fully covered.

The major decision the mortgagee must take, without too much delay, is whether to sell the vessel privately or by court sale, and where is the most appropriate place or jurisdiction for the sale to take place.

While working very closely with his appointed legal advisor, the mortgagee also requires assistance from sale and purchase brokers, preferably with international representation.

There are advantages and disadvantages in both private sale and court sale as perceived by a bank, which have to be very carefully considered and thoroughly researched in each case, not least because several of the points under consideration involve predictions of what may happen in the future. Leaving aside the legal aspects, geographical considerations become significant when, for instance, comparing the costs involved in administering the sale. In one case the mortgagee bank finally had to take possession of a vessel in the Philippines. Research revealed that it was going to be less costly to move the vessel from the Philippines the long distance back to the UK and take the appropriate action in UK rather than in Hong Kong or Singapore. One of the many factors considered was for example that mooring charges are very high in Hong Kong. The convenience to a UK bank of disposing of the vessel through the British courts would be a bonus.

Private sale compared with court sale

The advantages of a private sale are that the sale price should be higher than that which can be achieved by court action because there should be a willing buyer and seller; the vessel may continue to trade, generating valuable income to cover operating costs and possibly enhance the total amount recoverable; trading vessels are better sales prospects than ships in the hands of the court because they have been maintained and all machinery and equipment is seen to work; time expense, as compared with a court sale, is reduced; by settling with trade creditors or by the conclusion of the sale before others can issue writs, indemnity risks are reduced.

There are however disadvantages in that the operational cost remains a burden while the vessel continues to operate, since it may not be laid up; there are ongoing risks under the Norwegian Sale Form indemnity with no expiry date; some trade creditors would need to be paid at the expense of the mortgagee to ensure a smooth sale without untimely inconvenience; there is little likelihood, because of sales costs, of any excess income being generated; low-key marketing will not cover the entire market so the sale is likely to be fairly discreet; trade creditors may contest provisions of the Supreme Court Act 1981 in jurisdictions where English law is not recognised.

On the other hand a court sale means that once all claims are assessed by the court to ensure that the first mortgagee's position is unassailable, the threats of trade creditors are nullified; risks arising on the Norwegian Sale Form are reduced; costs and expenses are controlled; the jurisdiction of the sale is chosen by the mortgagee in possession; more money may be raised because of better control over trade creditors.

These advantages are balanced by the potentially lower return from a "forced sale", the lapse of time which may be as much as 8–10 weeks; the loss of earnings in the meantime; court costs; and lay-up costs; the stigma of a court sale; variations in the bidding processes such as sealed bids and comparison with court approved appraisal; the risk of indemnity claims, though reduced; no control of timing of sale.

Conclusion

Many of the points and considerations touched on above are being fully covered in detail in other papers presented at this conference. The main objective of a mortgagee clearly emerges as the maximisation of recoveries and the minimisation of potential losses within appropriate and carefully selected legal procedures. In other words, commercial decisions need to be supported by the best legal advice.

PROTECTION OF LESSORS

Richard B. Barnett

1. Reasons for leasing

Leasing as a means of financing the use of personal property has a long history. Lease financing of ships came into prominence in the United States in the 1970's because of the tax benefits available in such transactions. Several reasons are frequently cited for the use of lease financing today in the United States and in many other countries.

Less costly financing for user of property – tax-oriented leases

Frequently, the owner of property is entitled to special tax benefits connected with the ownership. In the United States the benefits have included an investment tax credit and an accelerated depreciation deduction; other countries have had similar tax benefits. Their purpose is to encourage investment in capital equipment and thus stimulate the country's economy.

Often the shipowner is not in a position to take maximum advantage of these special tax benefits. If the tax benefits can be transferred by transferring ownership to a financial institution which leases or charters the ship to the ship user, the ship user or charterer may be able to finance its use of the ship at less cost than by owning the ship directly and borrowing the money to pay for it.

Off-balance sheet treatment for lease obligations

Corporate management is under constant pressure to make financial reports look attractive to potential investors. The borrowing of money to finance the purchase of capital equipment has obvious effects on the balance sheet. The cost of the property is shown as an asset; the indebtedness undertaken to acquire it appears as a liability. The result may be a high debt/equity ratio. If on the other hand the ship is chartered instead of purchased, the balance sheet effects may not be so adverse. The corporation may not be required to show the ship as an asset or the charter hire obligations (other than the current hire obligation) as a liability on the financial statements.

In the United States these advantages are no longer possible. Leasing is now subject to uniform accounting standards such as Statement of Financial Accounting Standards No. 13 "Accounting for Leases" ("FASB 13"). FASB 13 distinguishes between capital leases and operating leases. A capital lease is one in which:

1. the lessee gets ownership at the end of the lease term, or

2. the lease contains a bargain purchase option, or
3. the lease term is equal to 75% or more of the estimated economic life of the property, or
4. the lessor recovers 95% of the fair value of the property through the present value of minimum lease payments.

Most financing leases would qualify as capital leases; therefore, balance sheet considerations are no longer as significant as they once were in tilting a company towards leasing as a way of obtaining the long-term use of a ship or other significant piece of capital equipment.

Remedies available to a lessor which are not available to a secured lender

For a financial institution the remedies available to an unpaid lessor often appear preferable to those available to an unpaid lender. The traditional remedy available to a mortgagee of a ship, in the event of a default by the shipowner, is enforcement of the mortgage in judicial foreclosure proceedings, which may be expensive and time consuming. The judicial sale of a ship may be delayed for as much as a year, or more in some jurisdictions. Ships are expensive to maintain in lay up. The custodial costs and other administrative expenses of foreclosure proceedings may materially diminish the lender's recovery. On the other hand, under a lease or bareboat charter arrangement, if the charterer fails to pay hire or otherwise defaults in its obligations, the owner is entitled to step in and retake the ship.

This advantage has its limitations. The ability of the owner or lessor to step in and retake the ship without the involvement of the courts may be more apparent than real. The acquiescence of those in possession of the ship is essential. If the lessor succeeds in retaking the ship, the ship is still subject to whatever liens may exist arising out of its operation by the lessee. The secured lender can wipe out many such claims by foreclosing its mortgage, the lessor cannot. In order to prevent arrest by lien-holders, the lessor may have to settle the claims upon which the liens are based. Amounts paid in settlement may exceed the costs a secured lender would incur in enforcing its mortgage.

If the charterer is the subject of bankruptcy proceedings, the ship is treated as the property of the bankrupt estate, and the lessor will be stayed or prevented from taking any action towards repossessing the ship unless the permission of the bankruptcy court is obtained. However, the lessor of property has certain advantages in bankruptcy proceedings over a secured lender. This topic is discussed in section 7.

In the United States under the Uniform Commercial Code (the "UCC") the nominal lessor may be regarded as the holder of a security interest in the ship, if too many of the incidents of ownership are passed to the charterer. The nominal lessor may be

worse off in this case than if it had taken a perfected mortgage on the ship because its security interest fails to meet the statutory requirements for perfection. The problem of distinguishing between true leases and conditional sale agreements or other types of security arrangements, is dealt with in Section 9-102 of the UCC which provides that Article 9 of the UCC governs security interests created by leases intended as security. Section 1-201(37) states:

“whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.”

2. Dual role of lessor

The lessor has legal title to the property and thus for many purposes is regarded as the owner of the property. The owner of property has liabilities and obligations, many imposed by statute and many of which cannot be contracted out of.

The lessor is also the supplier of financing to the property user and attempts to achieve a legal position with respect to the property which is superior to that of the user's other creditors. But the notion that the “owner” of property can have an interest in the property which is superior to that of the user's creditors, many of whom may have liens granted by statute or recognized as part of the general maritime law, is difficult to accept and appears unfair in certain situations.

What are the obligations which the lessor, as property owner, may have? The first set of obligations includes warranty obligations which the supplier of a piece of property owes to the user. Many of these obligations can be eliminated by contract between the supplier and the user. This will be discussed below.

Protection laws impose cleanup obligations on shipowners for pollution caused by the ship for which the shipowner may be liable.

The lessor may also incur direct obligations to the user's creditors if the lessor is deemed to have entered into a joint venture with the user or appointed the user as its agent. Increasingly, commercial lessors structure lease financings so that the return paid to the lessor partly depends upon the financial results of the user's operation. Giving the lessor a share of the lessee's profits as additional compensation raises the risk that the lessor will be held to have engaged in a joint venture with the property user and is, thus, obligated directly to the user's creditors.

If the interest of the lessor in the property is subordinate to the interest of creditors who have liens against the property, the lessor may be said to have incurred a liability. An indemnity from the user provides some protection for the lessor in these areas but such protection is incomplete.

3. Means of protecting the lessor against the obligations of an owner

Denial of warranties

In the United States, article 2 of the UCC entitled "sale" applies generally to "transactions in goods" (UCC section 2-102). An increasing number of cases in recent years have held that leases of personal property may be "transactions in goods" with the meaning of article 2 of the UCC. One such case is *Industrialease Automated & Scientific Equipment Corp. v R.M.E. Enters., Inc.* 58 A.D. 2d 482, 396 N.Y.S. 2d 427 (1977). In that case, a transaction structured as a lease was held to be in reality an instalment sale. This made it easier for the court to conclude that the transaction was subject to the provisions of article 2 of the UCC including the warranty provisions. Similar results have been reached in other cases. While most of these cases have dealt with situations where a transaction structured as a lease was in fact an instalment sale, the trend is clearly towards bringing lease transactions within the orbit of article 2 of the UCC and in some cases dealing with leases the court has assumed they were subject to article 2 without even considering the question.

The significance of this trend lies in the warranty provisions of article 2. Particularly important is section 2-314 pursuant to which a warranty of merchantability is implied in contracts. If such a warranty can be implied in a lease, the lessee may have a defense to a claim for payment of rent or hire if the ship is defective on delivery.

Section 2-316(2) of the UCC provides that the implied warranty of merchantability may be excluded by proper language which is in writing and conspicuous. Therefore, to protect the lessor, a lease should contain a strong disclaimer of warranties which at the very least meets the test in the UCC section 2-316(2). A typical disclaimer of warranty provisions is as follows:

"The owner makes no representation or warranty, express or implied, as to the title, seaworthiness, value, condition, design, merchantability or operation of the vessel or as to the quality of the material, equipment or workmanship in the vessel, or as to the fitness of the vessel for any particular use, or as to the eligibility of the vessel for any particular trade or any other representation or warranty whatsoever, express or implied, with respect to the vessel; and under no circumstances whatsoever shall the owner be liable or responsible to the charterer for any consequential damages. In addition, the acceptance by the charterer of the vessel under this charter shall be conclusive proof, as between the owner and the charterer, that the vessel is seaworthy, is in accordance with the plans and specifications forming a part of the construction contract, is in good working order and repair and without defect or inherent vice in title, condition, design, operation or fitness for use, whether or not discoverable by the charterer as of the date of such acceptance, and is free and clear of all liens, charges and encumbrances other than the rights of the charterer hereunder."

Most charters go on to provide that the disclaimer of warranties is not intended to affect any rights against the builder of the vessel. The lessor assigns to the lessee all rights to enforce any warranties against the builder so long as no event of default has occurred under the charter. It is customary and appropriate, however, for the lessor to warrant to the lessee that the vessel is and will remain free from any liens arising out of any action or inaction by the lessor which is unrelated to the lease transaction. This warranty is intended to protect the lessee against such things as tax liens on the leased property arising out of unrelated tax obligations of the lessor.

Indemnity by the user

If the lessee is credit-worthy, the first line of protection for the lessor against claims arising in connection with the leased property is the indemnity given by the lessee. In the typical lease-financing transaction the lessor-owner supplies the finance for the bareboat charterer or user to acquire property in exchange for rent or hire. The property is returned at the end of the lease period. Until that time, however, the lessor does not have the property in its possession or control. In most cases the lessor is not involved with the construction or purchase of the vessel except to supply funds to pay the builder when the vessel is completed. It is generally accepted that the lessee should assume most of the risks related to the condition and use of the property. Therefore, a typical lease provides a broad form of indemnity by the lessee in favour of the lessor, lenders, trustees and others connected with the financing transaction. The following is typical:

“Whether or not any of the transactions contemplated hereby are consummated, the charterer hereby indemnifies the owner and its successors, assigns, employees, servants and agents against and agrees to protect, save and keep harmless each thereof, from any and all liabilities, obligations, losses, damages (including without limitation obligations based on strict liability and tort), penalties, claims, actions, suits, costs, expenses and disbursements, including legal fees and expenses, of whatsoever kind and nature, imposed on, incurred by, or asserted against the owner or any successors, assigns, employees, servants or agents thereof in any way relating to or arising out of (i) the construction or chartering of the vessel, (ii) the manufacture, purchase, acceptance or rejection of the vessel under the construction contract, (iii) the ownership, delivery, non-delivery, charter, sub-charter, possession, registration, re-registration, use, operation, condition, sale, return or other disposition of the vessel (including, in each case and without limitation latent or other defects whether or not discoverable) and any claim for patent, trademark or copyright infringement, and all liabilities, obligations, losses, damages and claims in any way relating to or arising out of injuries to persons, properties or the environment or strict liability in tort.”

The limited exceptions to this broad indemnity include claims arising out of the lessor's gross negligence or wilful misconduct or claims arising out of transactions entered into by the lessor unrelated to the financing transaction.

Documentation and structuring – joint venture and agency

Occasionally, lessors seek to increase their return by providing for the payment of additional charter hire based on the profits of the charterer. Such an agreement creates the risk that the lessor will be held to be engaged in a joint venture with the lessee and liable, as a result, to third parties for damages arising out of the operation of the vessel. Such provisions should be avoided.

Warranties from seller or manufacturer

In most cases, it is the lessee or bareboat charterer which negotiates the shipbuilding contract with the shipyard. A far-sighted charterer may stipulate that the shipbuilding contract may be assigned to a lessor before delivery of the ship, although this is not always the case. The lessor should negotiate provisions in the assignment which not only protect the lessor from any claims by the manufacturer but also shift responsibility to the manufacturer or shipbuilder for claims by the lessee or third parties resulting from defects in the ship's design or construction.

To protect itself from claims by the shipbuilder, the lessor should require the shipbuilder to look solely to the lessee for any unpaid balance of the purchase price. The shipbuilder should be bound by these provisions through the consent and agreement, which the shipbuilder signs, to the assignment of the construction contract.

Ordinarily, a shipbuilding contract contains warranties by the shipbuilder in favor of the purchaser, including a warranty that the purchaser will receive good title to the ship, that on delivery the ship will be free of liens including liens in favor of subcontractors or other suppliers of materials, and that there will be no defects in material or workmanship. The applicable law may impose other warranties on the shipbuilder such as a warranty of marketability and fitness for a particular purpose unless these warranties are expressly denied.

As part of the protection package against claims by third parties who suffer damages as a result of a defect in the condition of the ship, the lessor should make sure that the manufacturer's warranty protects the lessor as well as the lessee, and it should be clear that the manufacturer will indemnify both the lessor and the lessee against claims by third parties arising out of a breach of any applicable warranties.

Insurance

The insurance section of the lease or bareboat charter is a key section for the lessor protecting as it does the lessor's interest in the property against diminution in value from claims of third parties and protecting the lessor itself against claims by third parties arising out of the use and operation of the ship. The insurance also provides protection to the lessor in the event of physical damage to, or loss of the ship. Although insurance is arranged by the lessee or bareboat charterer, the lessor must be concerned both as to the scope of the coverage and the detailed arrangements for

coverage which are set forth in the insurance provisions.

Third party liability coverage may be placed in the form of liability insurance or entry in a P. & I. Club. In either event the scope of the coverage must be broad enough to include not only the traditional risks of cargo damage and personal injury but pollution liabilities and other liabilities imposed by operation of law. Even though the ship is operated by the charterer, the owner may have liabilities to third parties or to governmental entities in connection with pollution liabilities. The owner must be protected by the insurance as a named assured but if possible without liability for premium.

Customarily both the hull and the P.&I. insurances contain warranties of seaworthiness and other warranties, the breach of which by the bareboat charterer would give the underwriter or club a defense to claims. Under the usual policy terms, the rights of the lessor as owner are no better than those of the bareboat charterer in the event of a breach of warranty. In other words, if the underwriters have a valid defence against a claim under the policy because of a breach of warranty by the bareboat charterer as assured, this defence is also available to the underwriters if the claim is pressed by the shipowner. Therefore, an important element of protection to lessors is insurance which will protect the owner-lessor if there is a breach of warranty by the bareboat charterer. This protection may be in the form of a waiver of these defences by underwriters in the event of a claim by the owner-lessor or a separate owner's equity insurance which protects the lessor to the extent of its interest where there has been a breach of warranty by the bareboat charterer and the regular insurance does not cover. Owner's equity insurance does not protect against the risk of non-payment under the charterer's policy because of bankruptcy of the underwriters or club or if the primary insurance does not cover because of non-payment of premiums by the assured. In order, therefore, for the lessor to protect itself in the event of non-payment of premiums as a result of insolvency by the lessee, the lessor needs notice of non-payment of premiums by the lessee and an opportunity to cure the default by payment of premiums prior to cancellation of the policies by the underwriters. The lessor should also insist upon receiving copies of all of the insurance policies and the right to review them and approve the form in order to make sure that the scope of cover is sufficient and that the deductibles, named assureds and loss payable clauses are all in order. Insurance policies expire and new policies are issued. Frequently, the terms of cover are changed from one policy to the next. A prudent lessor will follow up to see that all renewed policies are carefully reviewed in order to protect itself in the event of insolvency by the lessee.

Additional security

As further protection, particularly where the credit standing of the lessee is less than first rate, the lessor may demand additional security such as a cash collateral account or a letter of credit which can be drawn on if the lessee defaults in any of its obligations including the indemnity obligations.

4. Protection of lessor's interest in the physical condition of the ship

A basic feature of a lease is that the right of the lessee to the possession and use of the ship is for a fixed term. At the end of that term the lessee returns the ship to the lessor. Therefore, the lessor has an interest in seeing that the ship is properly maintained and is in fit condition upon its return.

The lessor will almost always require that the vessel is kept in a condition which qualifies it for the highest classification and rating from a recognized classification society and that the lessee furnishes evidence annually that the classification and rating are being maintained. However, many elements of sound maintenance are outside the classification society's requirements so it is necessary for the lease to have a more general clause for the protection of the lessor, requiring the lessee to maintain the vessel and its equipment in good condition, running order and repair (ordinary wear and tear excepted) in order to keep the vessel in every respect seaworthy and in good operating condition. The country of the vessel's registry or countries to which the vessel trades may also have requirements as to its condition. To protect the lessor, the lessee may be required to comply with all the requirements of governmental authorities which have jurisdiction over the ship.

On redelivery the lessor requires the vessel to be returned with no outstanding classification society requirements and in the condition required by the lease. Often a survey is held to determine the condition of the ship. The special survey position which the ship must be in at the time of redelivery is often a matter of extensive negotiation between the lessor and lessee.

Ship operators in financial difficulties often defer maintenance expenditure, which may lead to serious consequences such as expensive breakdowns which interfere with the employment and operation of the ship and in turn make the operator's financial problems even more serious. It is difficult for the lessor to protect itself against this situation, but the bareboat charter or lease should at least provide for periodic inspections by the lessor and should give the lessor the right to declare the lease in default if the lessee fails to meet the maintenance requirements.

5. Position as supplier of financing

Documentation and structuring of a lease transaction

While the interests of the lessor and the lenders are in most cases the same, on certain issues a divergence of interest occurs.

The first issue is whether the lessor may step in and cure defaults by the lessee in order to prevent the lenders from foreclosing on the property. The first time a payment default occurs, the lenders may decide that their interests are best served by foreclosing on the property and getting out. This is contrary to the interests of the lessors who are concerned about losing valuable tax benefits and having their subordinated position wiped out by a foreclosure proceeding instituted by the

lenders. The lessors, therefore, during the negotiating process usually seek rights to cure. If the lessee is unable to make a payment, the lessor wants the right, but not the obligation, to step in and make a payment on behalf of the lessee.

If the right to cure continues indefinitely, the lender may be seriously prejudiced because of the decline in the value of the collateral and because of the deteriorating position of the lessee. Usually a compromise is struck so that the lessor has limited rights to cure, subject for example to a limit on the aggregate and on the number of times in succession the right can be exercised.

An area which frequently gives rise to a conflict between the lessor and the lenders is the extent to which the indemnity rights of the lessor constitute part of the security package which the lender is given. The lessor has bargained separately for tax indemnity rights as well as general indemnity rights and takes the position these rights should not be part of the security package. Again, a compromise is often reached under which the lenders agree to a carve out of the indemnity rights or part of them.

The issue of which has the right to give consents and waivers under the lease is another issue that must be negotiated between the lessor and the lender. In almost all cases it is exercised only by the lender after an event of default has occurred.

Remedies against the lessee

If the lessee defaults, the basic remedy of the lessor is to retake the property from the lessee subject to any rights which a lender may have in the property. The ship cannot be retaken if there is a risk of a breach of the peace. The lessor may need the assistance of a court order in a possessory action where the property is physically located.

If the market for the vessel has changed since the original transaction was entered into, the lessor may also have a claim for damages against the lessor even though the property has been recovered. The damages clause in the bareboat charter or lease should be carefully drawn to provide several alternative measures of damages; the purpose is to provide a measure of damage that will make the lessor whole but will not risk being held to be a penalty clause.

Examples are:-

- (a) The lessee is required to pay to the lessor an amount equal to that which the lessee would be required to pay to the lessor if the vessel were lost and no insurance proceeds were available. The amount is sufficient to make the lessor whole by returning its investment plus the agreed rate of return. If the vessel is later sold the lessor will pay over to the lessee the net proceeds of the sale.

- (b) Instead of paying the amount set forth in (a) above, the lessee may be required to pay to the lessor the excess of the stipulated loss value of the vessel over the fair market charter value or the fair market sale value of the vessel as of the payment date. The fair market sale value and the fair market charter value of the vessel are deemed to be zero if the lessor is unable to recover possession of the vessel.

Rights to perform lessee's obligations

As part of its cure rights the lessor usually ensures that the bareboat charter or lease expressly recognizes its right to perform the lessee's lease obligations.

6. Problems for the lessor arising out of financial difficulties of user

Liens against property

A lessee facing financial problems often delays payment of trade creditors, who furnish supplies and repairs to the vessel and who have a maritime lien or other right against the ship itself. This right has priority over the interest of the lessor.

The lessor has limited ways of protecting itself against a diminution of its interest in the vessel because of creditors coming ahead of it. One method is to monitor trade debt and promptly to declare the lease in default before the matter becomes critical. This is difficult in practice, however.

Another method followed by many lessors is to create a mortgage on the vessel which constitutes a claim prior to any trade debt. At the inception of the lease the lessor may create a subsidiary company to own the vessel. The parent company then makes a loan to the subsidiary to enable it to acquire the vessel. The loan is repaid out of the rent or charter hire. This practice has been followed for many years, but the arrangement has been thrown into question in the United States by recent cases which have held such mortgages invalid.

The problem is illustrated by the decisions in *Equilease Corp. v m/v Samson*, 568 F. Supp. 1259 (E.D. La. 1983) and related cases, which involved a contest between a marine insurance broker attempting to collect insurance premiums out of the proceeds of sale of certain vessels and Equilease, as holder of first preferred mortgages on the vessels.

For the first time it was held that a claim for unpaid marine insurance premiums is a claim for necessities and carries a maritime lien like other claims for repairs, supplies and necessities furnished in the United States. However, the decision cited turned on the question whether the mortgages on the vessels were first preferred mortgages under the United States Ship Mortgage Act.

In 1974 Equilease arranged to provide interim construction financing for the owner and builder of three tugs. The owner and builder defaulted before the completion of the tugs and Equilease took them over. The tugs were completed in 1978 by another shipyard. As each tug was completed, it was delivered to a Unilease company. Each of the Unilease companies was a subsidiary of Equilease. Each vessel was then mortgaged by the Unilease company to Equilease to secure the amounts advanced by Equilease for the construction and acquisition of the vessel.

At the same time Equilease arranged bareboat charters of the tugs to Solar Fleet Inc., operations of the tugs were unsuccessful and ultimately the vessels were subject to foreclosure proceedings in which there was a contest between the claimant for insurance premiums and Equilease for the proceeds of sale.

After dealing with the question of the lien for the claim for unpaid insurance premiums, the court went on to find that in the particular case, the Unilease corporations were the *alter ego* of Equilease. The court then seized upon the requirement in the United States Ship Mortgage Act that an affidavit be filed stating that the mortgage is made in "good faith and without any design to hinder, delay or defraud any existing or future creditor of the mortgagor or any lienor of the mortgaged vessel" to invalidate the mortgage. The court held that the Affidavit of Good Faith in this case was a sham.

The court said:

"Although the Equilease-Unilease arrangement was not of itself illegal, third parties must be protected from suffering financial loss caused by that arrangement. Had Equilease continued to hold title to the three tug boats, James [the insurance premium claimant] undoubtedly would have had the first lien on all three vessels. Hence, Equilease cannot put itself ahead of other legitimate creditors by transferring the boat to three controlled corporations, and then taking a preferred first mortgage on the vessels, the amount thereof representing capitalization of its investment in those vessels."

There is a strong suggestion by the court in describing the arrangements that the creditors of the vessel were under the impression that Equilease was providing financial backing to the bareboat charterer. Thus, creditors may have been misled into extending credit where they would not otherwise have done so.

At the time the vessels were completed by the shipyard, the Equilease companies were clearly the only "owner" in the picture, which is different from the usual leasing situation. However, this case, and at least one other, question how much protection a lessor can obtain by using this device.

Limitations on remedies after default

In the United States the ability of the lessor to step in and retake the property is subject to two important limitations. One is the obligation imposed by section 1-203 of the UCC on all parties to a contract to act in good faith. The other is that self-

help remedies cannot be exercised if doing so would lead to a breach of peace.

Problems in perfecting security interest

The Ship Mortgage Act, 1920, provides for the recording of bills of sale and mortgages and amendments, assignments and discharges of mortgages but has no provision whatsoever for the recording of bareboat charters or other forms of vessel user agreements (this is not true in the case of aircraft in the United States; under the FAA rules, leases may be recorded).

7. Bankruptcy

Application of bankruptcy law to lease transactions

In the United States as in most other countries a financially troubled shipowner may seek the protection of a court in dealing with its creditors. If the debtor is to be liquidated the proceedings take place pursuant to the provisions of Chapter 7 of the Bankruptcy Code. If the debtor is to be reorganized, the proceedings are governed by Chapter 11 of the Bankruptcy Code.

If the debtor leases or bareboat charters a vessel, the interest which the debtor has in the lease is considered to be a property interest which becomes part of the debtor's bankrupt estate and so may be subject to orders of the bankruptcy court.

If the lease is terminated, before the commencement of the bankruptcy proceedings perhaps as a result of the lessor's concern about the lessee's financial condition, (assuming the provisions of the lease entitle the lessor to terminate) the debtor no longer has an interest in the property and it is not property which is subject to the jurisdiction of the bankruptcy court. The lessor cannot terminate the lease to avoid the jurisdiction of the bankruptcy court. Thus, the lease cannot be terminated upon the commencement of bankruptcy proceedings or the appointment of a trustee (section 365(e)(1)).

Automatic stay

The commencement of bankruptcy proceedings either under Chapter 7 or Chapter 11 of the Bankruptcy Act results in an automatic stay (section 362 of the Bankruptcy Act) which not only prevents secured lenders from commencing proceedings to enforce their rights but prohibits the lessor from taking any steps to reclaim the leased property or from accepting payment of the charter hire or rent provided for in the lease (see section 362(a)). If the lessor is within the jurisdiction of the bankruptcy court, the stay applies not only to action by the lessor within the United States but to actions which the lessor might take to enforce its rights against property outside the United States.

For example, if the debtor who has commenced bankruptcy proceedings in the United States has a ship under bareboat charter physically located in Singapore, the owner or lessor of that ship cannot commence proceedings in Singapore to regain possession of the ship if the lessor has sufficient presence in the United States to give the bankruptcy court jurisdiction over the lessor.

Under certain circumstances the lessor may request the bankruptcy court to lift the stay and permit the lessor to retake the property. Section 362(d) of the Bankruptcy Act sets out two different grounds on which the stay may be lifted. The first is that the bankrupt debtor is unable to provide adequate protection for the lessor's interest in the property (section 362(d)(1)), although recent cases in the United States have not been inclined to grant lessors relief on this basis (see *In re Sweetwater*, 40 B.R. 733 (Bankr. D. Utah 1984)). However, the courts have granted relief where the debtor has failed to provide insurance coverage (*In re Stagedoor, Inc.*, 32 B.R. 13 (Bankr. W.D. Pa. 1983)).

The other basis for relief is that the debtor has no equity in the property and the property is not necessary to an effective reorganization (section 362(d)(2)). In general, however courts are not willing to lift the stay until there has been an opportunity for the trustee to assume or reject the lease, subject to the court's approval, under section 365(a) of the Bankruptcy Act.

Assumption or rejection of an unexpired lease

The most significant provision in the Bankruptcy Act relating to lease transactions is that which permits the trustee either to assume or reject any unexpired lease subject to certain conditions (section 365(a)). This right exists whether or not the proceeding is one for liquidation under Chapter 7 of the Act or one for reorganization under Chapter 11.

In a case under Chapter 7 the trustee must assume the lease within sixty days of the order for relief, unless the court, upon good cause being shown within the sixty-day period grants additional time, or the lease will be deemed rejected (section 365(d)(1), (4)). Under Chapter 11, on the other hand, the trustee may assume or reject the lease at any time before confirmation of the reorganization plan (section 365(d)(2) or as part of the reorganization plan. On the request of any party to the lease, the court may order the trustee to come to a decision within a specified time whether to assume or reject the lease (section 365(d)(2)).

The question of assumption or rejection of the lease may be brought before the bankruptcy court by the lessor or by the trustee for the debtor. The decision to assume or reject will be approved by the court if the decision is within reasonable "business judgment", and the other conditions required by the Bankruptcy Act are met. These conditions (see section 365(b)(1) are as follows) where the trustee has elected to assume:

1. The trustee must cure payment or other defaults or provide adequate assurance that it will promptly cure the defaults.
2. The trustee must compensate the lessor for actual pecuniary loss arising out of the defaults or provide adequate assurance that it will promptly make compensation. Payment of legal fees in connection with the default constitutes part of the pecuniary loss which the trustee must cover. (*In re Foreign Crating Inc.*, 55 B.R. 53 (Bankr. E.D.N.Y. 1985)).
3. The trustee must provide adequate assurance of future performance. Many factors must be taken into account by the bankruptcy court and obviously there is room for considerable disagreement as to whether the trustee's proposal constitutes "adequate assurance".

If the lease is assumed by the trustee with the approval of the court and the lease is subsequently breached, the breach gives rise to an administrative expense claim against the bankrupt estate which would have priority over other general claims. This priority claim, pursuant to section 503(b) covers rents, attorneys' fees and expenses. The claim for the period arising after the breach would be a general claim for damages for breach of contract which would have the same priority as the claims of other general creditors.

During the period after commencement of the bankruptcy proceedings and before assumption of the lease or the lifting of the automatic stay, the debtor is liable for the reasonable rental value of the property as an administrative expense (section 503(b)(1)(A). (see *In re Sweetwater, supra*).

Special provisions relating to aircraft, vessels and rolling stock

Lessors of (a) aircraft equipment, (b) certain vessels and (c) rolling stock equipment are given special protection under the Bankruptcy Act (section 1110). However, these provisions are of limited relevance to the financing of ships because the special vessel provisions apply only to U.S. documented vessels which are leased to a water carrier that holds a Certificate of Public Convenience and Necessity or Permit issued by the I.C.C. As a practical matter the only substantial group of vessels which qualify under these special provisions are barges used in the inland water ways for regulated carriage of goods.

When the provisions do apply, however, they give the lessor the following protection. Instead of having a reasonable period of time in which to decide whether to assume or reject a lease, the debtor must decide within sixty days of filing either to cure all existing defaults or fully perform its other obligations under the lease on a current basis or surrender the leased equipment. These special provisions differ from those relating to assumption of leases in that the debtor must actually cure the existing defaults and not simply give adequate assurance of a future cure.

8. Proposed new article 2A of Uniform Commercial Code leases

A new article 2A dealing with leases has been drafted as a proposed amendment to the UCC. The drafting was done under the auspices of the National Conference of Commissioners on Uniform State Laws. The proposed legislation deals with many of the problems which have been discussed in this paper.

“Lease” is defined as a “a transfer of the right to possession and use of goods for a term in return for consideration”. A sale is excluded from the definition (section 2A-103(j)). A “finance lease” is recognized as a special form of lease in which the lessor does not select, manufacture or supply the goods but acquires the goods or the right to possession and use of the goods in connection with the lease. To qualify as a finance lease, the lessee must either receive a copy of the contract evidencing the lessor’s purchase of the goods on or before signing the lease contract, or the lessee’s approval of the contract evidencing the lessor’s purchase of the goods must be a condition of effectiveness of the lease contract (section 2A-103(g)). Finance leases are given special treatment in article 2A particularly in sections dealing with warranties.

Warranties

The benefit of any warranties, whether expressed or implied, under a supply contract, which would presumably include a shipbuilding contract, extend to the lessee even though the supplier’s or builder’s promises are made to the lessor under the supply contract. The lessee’s rights are also subject to the terms of the supply contract and to all of the supplier’s defences or to claims arising therefrom. The lessee’s rights exist only to the extent of the lessee’s leasehold interest under the finance lease. This provision would not, therefore, apply to a lease which is not a finance lease, and the lessee would have to obtain the agreement of the supplier to the assignment of the rights to the lessee under a lease which is not a finance lease.

Certain of the warranty provisions in the leases article are similar to those in the sales article. In the sales article of the UCC, a warranty of title is implied in the sale agreement. The leasing article provides that a lease contract is deemed to include a warranty that for the lease term no person who holds a claim to, or interest in, the leased property which arose from an act or omission of the lessor, shall be permitted to interfere with the lessee’s enjoyment of its leasehold interest (section 2A-211).

As in the sales articles, the article on leases also states that a warranty of merchantability shall be implied in leases. However, an exception is made for finance leases in which no such warranty is implied (section 2A-212).

The finance lease is also excluded from the provision dealing with an implied warranty of fitness for a particular purpose (section 2A-213). The requirement for exclusion of warranties is similar to that which appears in article 2 – Sales (section 2A-214). The proposed Act has several alternative provisions dealing with the extent to which third parties may benefit from warranties made to, or for, the

benefit of the lessee (section 2A-216).

Liens

The article expressly recognizes the enforceability and the priority over an interest of the lessor or lessee of liens given by statute or rule of law for services or materials furnished with respect to property subject to the lease contract. This presumably would include liens for supplies and repairs to a ship to the extent such liens are recognized by the applicable law (section 2A-306).

Defaults and remedies

The proposed act has extensive provisions dealing with defaults and remedies. The existence of a default is determined by the lease agreement; the rights and remedies of the lessor (or lessee) in the event of a default are governed by the proposed action and as provided in the lease agreement except to the extent that rights and remedies are limited by the statute (section 2A-501).

The statute recognizes the right of the parties to make provisions for liquidated damages in the lease agreement "but only at an amount by a formula that is reasonable in light of the anticipated harm caused by the default or other act or omission" (section 2A-504). The Act has a series of provisions dealing with the lessor's remedies in the event of a default by the lessee. If an event of default occurs the right of the lessor to cancel the lease, retake the goods, dispose of them and recover damages or retain them and recover damages or, in a proper case, recover rent, are recognized (section 2A-523). The retaking may be done without judicial process if it can be done without breach of the peace, or the lessor may proceed by legal action to recover the goods (section 2A-525).

The statute expressly recognizes several alternative remedies for the lessor. The lessor has the option of disposing of the goods provided it is done "in good faith and without unreasonable delay by lease, sale or otherwise" (section 2A-527). If the disposition is by lease and the lease is made "in good faith and in a commercially reasonable manner", the lessor may also recover damages from the lessee including accrued rent unpaid at the date of default and the difference between the rent for the remaining term of the original lease and the total rent for the new lease contract.

If the lessor elects to retain the property or disposes of it by sale rather than lease, the measure of damages is the difference between the rent for the remaining term of the original lease and the market rent at the time and place for tender, computed for the same lease term. The statute also provides guidance on the means by which market rent should be determined (section 2A-507).

The proposed statute does not present any dramatic new legal concepts, but if widely enacted, as it is likely to be among the states in the United States, it should be helpful in eliminating some uncertainties as to what law applies to the leasing of

ships and other property.

9. Conclusion

The *Equilease* case and others like it provide a striking illustration of the problems that can arise because of the ambiguous nature of the lessor's relationship to the vessel. Is the lessor the owner – in which case the claims of creditors dealing with the vessel are likely to be given priority in the event of insolvency by the lessee? Or is the lessor really a secured lender?

In the United States these problems are being confronted not only in the courts but also by the proposed changes in the statutes such as article 2A of the Uniform Commercial Code. The difficulties, however, which arise out of trying to place the lessor in a convenient pigeonhole which does not quite fit, such as "owner" or "secured lender", will likely continue to lead to some unexpected results in bankruptcy proceedings and other legal proceedings to enforce leases in the United States.

SIX LEGAL APPROACHES TO PROTECT THE UNPAID SHIPBUILDER OR REPAIRMAN

Ralf Richter

1. The overall right of retention

It depends on national tradition and national legal systems whether a contractor who manufactures a product from his own or his customer's material or does some work on a chattel, like repairing it, has a general right of retention.

Some civil law systems are very strict on this point. For example, Italian law provides for a right of retention which entitles a ship repairer to refuse to surrender the ship to the liquidator in bankruptcy. The liquidator can obtain possession only by paying the claimant who has exercised the right of retention ¹⁾.

The so called right of retention can be based differently: as, for example, a right to refuse to perform an obligation such as the delivery of merchandise where the contract provides for prepayment or simultaneous payment against delivery. In this case it is not the property of another which is retained.

The laws of some countries, example the DDR, provide that the right of retention accrues even if the customer's obligation to pay has not yet fallen due ²⁾, if the circumstances, particularly the debtor's creditworthiness, have substantially changed. The law of the Federal Republic of Germany defines these circumstances as a declaration of bankruptcy or of the customer's intention to stop payments ³⁾.

Another even more specific instance, where the right is conferred explicitly by operation of law as in FRG and Peru is the right of a contractor, to withhold property belonging to his customer on which work has been done ⁴⁾, despite the general rule, that the physical substance of the improvement becomes the customer's property by permanent attachment.

The effectiveness of the right of retention is as variable as its preconditions. In its weakest form it is an imperfect right. Legislators have assumed that the difference between the cost of the work and the value of the item is so great that the customer would not be prepared to lose its economic use for longer than necessary unless, of course, he is forced to because of insolvency. The right, however imperfect, is strong enough to resist surrender of the property even in the event of seizure, unless payment is made or first ranking in the proceeds of forced sale is guaranteed. In bankruptcy the right of retention would carry a right to sell the item separately, but not, as a rule, and unless otherwise agreed, to have it sold privately.

At its strongest a perfect right of retention is exercised like a possessory lien. After due notice to the debtor the claimant exercises his right by public sale, without the obligation first to obtain an enforceable judgement *in personam* against the debtor.

The shipbuilder's and shiprepairer's right of retention of the vessel deserves particular attention when it comes to the competing rights of the mortgagee, of the holders of maritime liens and of the ordinary creditors. The Dutch Supreme Court has held that a shipyard can exercise its right of retention, arising from the repair of a ship, against a mortgagee whose mortgage was registered before the repair ⁴².

Both the 1926 and the 1967 Conventions on Maritime Liens and Mortgages give the highest priority to maritime liens in the same order as listed; no other right has better priority. Nevertheless some states adhering to the 1926 Convention retained within their national legislation the right of retention as an overall preference, as reported by the Italian ⁴³, Spanish ⁴⁴, and Brazilian ⁴⁵, MLAs ⁴⁶. It is not clear whether that rule applies in cases where vessels flying the flag of non-contracting states are involved, or where claimants are nationals of non-contracting states, both admitted by the 1926 Convention, or whether it would operate in those countries in derogation of the member states' obligations under the Convention.

The overall right of retention seems to operate in Japan, Peru and in the Netherlands. In France the right of retention is not mentioned in Law No. 67-5 of January 3, 1967, but the *privège du conservateur* (art. 2102-3° Code civil) continues to exist as one of the *privèges communs* embodied in art. 33 of the Law 67-5, but ranking after *privèges maritimes* and *hypothèques*, as a *privège de second rang* ⁴⁷. The French MLA, referring to the right of retention which is conferred on an unpaid vendor, explains that in practice it would not be successfully exercised (*"utilement"*), however, in the law of bankruptcy, at the stages of liquidation or judicial administration (*"en règlement judiciaire"*) of the estates the vendor is entitled to retain. Maybe that also affords some protection for the unpaid ship repairer regarding items of equipment which he has renewed. Whether or not he might be considered as a *vendeur* regarding the value added by his repair work to the vessel is difficult to say.

If there is a straightforward seizure and enforced sale of the vessel, the position of the *conservateur* is poor, and far from being an overall right of retention. To some extent the repairman's position is better. Where there is a contract which the master has concluded far from the home port, the shipyard has a maritime lien (see below. "The pattern of the 1926 Convention") ranking before the mortgages, which now extends to the case when the ship's agent (*consignataire*) ordered the repair (Law No. 69-8, of January 3, 1969).

The law of the Federal Republic of Germany besides rights of retention under the Civil and Commercial Codes contains special provisions regarding customer's property which came into the possession of a contractor for work to be done ⁴⁸ giving priority over ordinary claims. No liens without possession are admitted and they depend on continuation of possession. Interestingly enough, with regard to

registered ships or ships under construction the contractor's right is modified. So instead of a possessory lien he is entitled to insist on the shipowner's consenting to the registration of a hypothèque ¹¹⁾, though without priority over hypothèques already registered. Nevertheless, as Abraham has pointed out, that provision cannot operate on a foreign registered vessel ¹²⁾, so that the shipyard is advised to stick to the possessory lien. Such a lien, however, seems not to have first priority since the special provisions of § 761 Commercial Code do not admit of any lien with priority over maritime liens. On the other hand if the shipyard's right is seen rather as a right of retention, the outcome could be doubtful ¹³⁾.

The responses from the Maritime Law Associations of other states subscribing to the 1967 Convention (the Scandinavian states ¹⁴⁾ and those having construed their national legislation according to its pattern like the German Democratic Republic ¹⁵⁾), show that no overall right of retention exists, except that which "ranks" after maritime liens and before mortgages ¹⁶⁾; perhaps it is better to say with the Lisbon Draft of the revised convention, which "may be exercised against" mortgages and hypothèques. The general right of retention would be then regarded as a possessory lien preceding the (non possessory) mortgage (§ 236, 238 GIW). No right of retention at all has been recorded in the CMI materials prepared in Lisbon by the Maritime Law Associations of Bulgaria, Canada, Costa Rica, India, Switzerland, the United States, the USSR and Venezuela.

A common feature of the rights of retention or possessory lien granted to a contractor by non-maritime civil or commercial codes, is uninterrupted possession. It cannot be renewed or survive after possession has been lost unless the property has been transferred into judicial custody (by arrest or for enforcement) by the marshal or the appropriate court officer which implies maintaining its top rank when a lien or mortgage is executed and leads to a forced sale.

The amount secured is only the value of the work done by construction or repair. Damage done to the shipyard or economic loss or claims outstanding from former business may not be exercised in preference to claims secured by maritime liens and mortgages.

As a rule the right of retention prevails, whether the property belongs to the customer of the shipyard or to a third person, provided it has been left with consent, for example based on a charter.

The right of retention is not affected if during possession by the shipyard, ownership passes, mortgages are registered or liens accrue. In the last case, however, wages for the crew and fiscal duties may be considered a special case.

2. The English possessory lien

There is a lot of similarity between the non-maritime law of retention in civil law countries and the English possessory lien for a ship repairer's claim. First there is the common law origin, which means in England non-Admiralty, and in civil law non-

maritime based. The English possessory lien obviously derives from the law of bailment ¹⁷⁾. The *raison d'être* of the right to continue possession until payment is the improvement which has been made to the property of the bailor, not by chance but ordered by him or at least made with his consent, such as reconstruction or repair.

There has to be, as in the right of retention, uninterrupted possession, which, however, according to Palmer, need not be immediate physical possession ¹⁸⁾. The vessel's presence in the shipyard's dry dock is sufficient, perhaps also the vessel's being under the command of the shipyard's master in a wet dock belonging to the shipyard. Possession is doubtful however where the vessel is under the nautical command of the owner's master even though the ship's papers are in the office of the shipyard. Possession no longer exists if only the port authorities' permission to leave the harbour is lacking. In any case the loss of possession cannot be reversed. An arrest by the shipyard by serving a writ *in rem*, cannot be based on former possession ¹⁹⁾ but rests on the statutory right *in rem* ²⁰⁾ under the Supreme Court Act 1981 ²¹⁾. In an action *in rem* by another creditor which has been held admissible – "*The Tergeste*" where priority was obviously undoubted – the court said "the marshal must protect the rights of the possessory lien holder, i.e. the proceeds of sale would be subject to the same rights that the possessory lien holder had over the ship" ²²⁾.

As far as the relationship to other liens and encumbrances of the vessel is concerned, the ranking of the possessory lien seems to be as judgemade as its origin. The British Maritime Law Association answered the C.M.I. Questionnaire of 1982 as to the existence of a right of retention having precedence over maritime liens and mortgages in the affirmative ²³⁾, but some clarification is necessary. Tetley's investigations, so amusing to read, found authorities such as Dr. Lushington J. ranking the possessory lien after salvage and seamen's wages earned up to the time the shipwright took possession ²⁴⁾. Butt J. added the costs of repatriating crew ²⁵⁾. In this century Bateson J. completed the list by giving priority to the costs of seizure and sale of the vessel ²⁶⁾. More important in the same case which was decided in 1925 is the expression that the possessory lien of the ship repairer ranks higher than the mortgage. However, precisely this opinion was rejected in 1932 by Langton J. in "*The Zigurds*" where he held "there was no equitable doctrine to justify giving priority to the repairmen's lien over the mortgage" ²⁷⁾. Not so clear both as to the status of the creditor (shiprepairers or necessariesmen) and the uninterrupted possession of the yard (there had been a towage by a third person) was "*The Pickaninny*". Hewson J. seems to consider that the priority of the possessory lien over a mortgage depends on whether or not the mortgagee had knowledge ²⁸⁾.

The repairman's possessory lien is important not only because it gives him a priority ahead of mortgages but also because he otherwise has no more security than ordinary creditors, not even having an ordinary lien ranking after mortgages, which would at least grant him priority in the proceeds of forced sale. Change of ownership while the ship is in the possession of the yard seems not to affect the possessory right, nor do liens created after the yard has obtained possession.

3. The United States maritime lien of the ship repairer

In the United States a ship repairers' security does not depend on possession. ²⁰⁾ Since the ship repairer is given a true maritime lien ³⁰⁾ he is entitled to an action *in rem* even after losing possession. His claim is not affected by a change in ownership on voluntary sale ³¹⁾.

The shipyard is in a better position than with the common law based non-maritime lien, especially if the person who ordered the service or repair work, is not the owner of the vessel. The managing owner, ship's husband, master or any person entrusted with the management, ³²⁾ are considered competent, as well as the demise or bareboat charterer, or even the time charterer if the work ordered is within the scope of the time charterer's responsibility under the charter. The shipyard is protected unless it knew or should have known that the charterer did not have authority to bind the ship. ³³⁾

More significant for the ship repairer's position is rank. The Federal Maritime Lien Act ranks the ship repairer's lien behind the preferred mortgage which is the most usual long term security if the creditor is a U.S. national.

If it is a foreign vessel, a preferred mortgage includes "any mortgage, hypothecation or similar charge created as security upon any documented foreign vessel duly registered in accordance with such law in a public register" ³⁴⁾ In international repair contracts, to be considered here in first instance, the ship repairer's rank gives him protection just as effective as the protection afforded by the right of retention in other countries: regarding foreign flag vessels the ship repairer's lien ranks ahead of mortgages (Federal Maritime Lien Act [46 U.S.C.A. § 951 (West 1975)]) ³⁵⁾.

4. The pattern of the 1926 Convention on Maritime Liens and Mortgages

Within the framework of this convention there are advantages and disadvantages for the shipyard. The national legislation of many states whether contracting states or not, nevertheless reflects the pattern of the Convention.

At first glance, the ship repairer's services are properly safeguarded. His claim is secured by a maritime lien. In this way he is given priority over other claims by the shipowner's creditors in general, and, particularly, priority over mortgages or hypothèques. However on examination of the legislators' intentions, the father of this idea may be found in the common law lien for master's disbursements, the grandfather possibly in the 1681 *Ordonnance de la marine*: a captain, far from his home port and without communication with the owner should be enabled to continue the voyage by taking a loan on the vessel's account – which would be valid in some jurisdictions even today as bottomry – and to enter on his own account into contracts for supplying and repairing the vessel. The master is central to the borrowing, and he is secured by the lien for disbursements either out of his own pocket or on credit.

Presumably it was the physical presence of the captain rather than the reputation of a distant shipowner which made the ship-supplier more inclined to deliver goods for credit. ³⁶⁾

Originally the maritime lien was to be granted only on condition – as far as supplies and repairs are concerned – that the master himself had assumed personal liability for the debt, not as representative of the owner, that there must have been an urgent need of materials or repairs for the continuation of the voyage and that there was no chance for the master to communicate with the owner. The maritime lien for master's disbursements thus attached only if the credit was taken or supplies were made or repairs were done somewhere other than at the home port. ³⁷⁾

As a result of the deliberations in preparing for the 1926 Convention, the requirement that unpaid bills for supplies, repairs and equipment had to be incurred on the master's personal credit in order to be secured by the lien has been dropped. The requirements that the vessel should not be in the home port, that it was the master who ordered the goods or services, and that they were really necessary for the continuation of the voyage or the preservation of the vessel still hold good. Last but not least, to avoid any circumvention of the rule and possible deterioration of the mortgagee's preferred security in the vessel, the ship repairer's claim is only secured by maritime lien if the contract is within the scope of the master's authority according to law and not granted by a special power of attorney. ³⁸⁾ On the whole the 1926 Convention protects *inter alia* a shipyard unable to check the creditworthiness of a distant shipowner but trusting in the value represented by the vessel, but under restrictions which give the rule only a few practical applications. Tetley, again, has posed the question what repair of any significance would nowadays be ordered by a master rather than by telecommunication between the owner and the shipyard?

The master has legal authority to order only repairs needed for the vessel to reach her home port, which means there is no protection for the shipyard for modernizing and reconstructing the vessel under the fifth maritime lien of art. 2 of the 1926 Convention even if ordered by the master. Take on the other hand, a big vessel heavily damaged which has to be repaired in order to continue the voyage: the captain by ordering millions of dollars worth of work would significantly exceed the scope of his contract of employment, but he would be well within his legal authority, for the work is necessary to continue the voyage. If it is he who gave the order, the shipyard is protected by the maritime lien. That law is a legacy from the time of the windjammers. The distinction looks artificial and unjustifiable nowadays. The 1926 pattern is followed by Italy, Portugal and the majority of the countries in the French and Spanish civil law tradition.

5. The pattern of the 1967 Convention on Maritime Liens and Mortgages

In the early sixties it was felt that the adoption of the 1926 Convention was progressing too slowly. To improve the situation it was thought appropriate to revise the convention mainly to strengthen the position of long term creditors such as mortgagees against secret encumbrances such as liens. As far as shipbuilders' and ship repairers' security was concerned, their claims were completely taken out of the list of maritime liens, so that they should no longer be a hidden encumbrance when a mortgagee foreclosed his mortgage, taking a priority in the distribution of the proceeds of a forced sale. On the other hand it was explicitly left to the discretion of contracting states to confer on the shipbuilder and ship repairer a right of retention or a possessory lien, which might take precedence over the mortgage but be postponed to all the maritime liens set out in art. 4. The effect of this ranking is open to dispute and there are variations in the procedure for exercising the right of retention. For example, should the marshal be bound to recognize the right of retention by refusing to do anything until the mortgagee who applied for seizure satisfies the unpaid shipyard? Or has the shipyard in possession to release the vessel against security by a bank guarantee while waiting for the proceeds of forced sale? Or, the other way round, in order to protect the weaker party, should the shipyard be entitled to have its money and put up security in case the proceeds turn out to be sufficient to satisfy only the maritime lien? Against action *in rem* by the holder of a maritime lien or a subsequent seizure no objection whatsoever would be allowed, provided however the vessel was judicially sold. The court officer has to be careful to preserve the shipyard's claim to be satisfied from the proceeds, if any, before the mortgagee is paid off or, in common law, takes possession of the vessel.

The Maritime Law Associations represented by the C.M.I. confirm the justification of the 1967 compromise solution. ³⁹⁾ In preparing for the 1983 Lisbon Draft Revision the overwhelming majority of Maritime Law Associations voted to retain art. 5 para 2 with slight amendments. Professor Berlingieri, Chairman of the International Subcommittee and President of the C.M.I. and of the Lisbon Conference, expressed it well in the Final Report: ⁴⁰⁾

"The lien of the shipbuilder seems to be of little significance (. . . .). If title in the ship under construction has passed to the customer who then seeks financing on the basis of a security on the ship, it is (. . . .) difficult to conceive that the lender agrees to do this without obtaining the consent of the builder or making sure that the loan is utilized to pay the builder (. . . .)".

Vice versa the right of retention is sufficient for the shipbuilder *vis à vis* maritime liens, which can hardly come into existence before the ship is a ship. And further:

"The lien of the ship repairer requires greater consideration. In fact, normally the value of the vessel is increased by the repairs and therefore when such increase is equal to the costs of repairs the security of the holder of the mortgage or hypothec is not practically affected. On the other hand repairs normally contribute to the safe operation of the ship. There seems therefore to be sufficient reasons to justify the priority of this lien over, or this right of retention against, mortgages or hypothecs."

Furthermore, shipyards when acting as ship repairers have to be aware of the priority of maritime liens. Particularly when repairing ships after collisions or other accidents at sea they should ask for security other than the ship. The ship's limit of liability gives insufficient protection, as it does not take into consideration to what extent the guilty vessel has been damaged herself and so lost value, whether the shipowner had valid insurance cover to prevent the exercise of a maritime lien arising out of a tort claim, and whether there would be a market for a second hand ship if the shipowner turned out to be insolvent. Otherwise the right of retention could turn out to be a dead right.

6. The right to arrest the vessel (*saisie conservatoire*) or the statutory right *in rem*

The debtor's assets are the creditor's security. The danger of the debtor becoming insolvent or going bankrupt makes the creditor look for security before competing creditors can grasp any assets for individual execution, or even worse, before a fraudulent debtor can dissipate his assets or take them outside the jurisdiction. For the creditor who has a claim in tort or contract, the need for security is even more urgent, since the shipowner's assets are floating and often far from the creditor's domicile. In civil law countries, the right to seize an asset to secure the later execution of a future judgment is granted to any creditor and may be exercised against any item of property provided the debtor is suspect or, if he is a foreigner with no other assets in the jurisdiction, he is at least able to remove his property to defeat enforcement. Property subject to a lien or in any other way charged without the possession of the person entitled, such as *nantissement* under the French law, may be seized as soon as the credit secured by the lien is due, which in civil law based countries is only a particular case. The main items which may be charged with a lien without requiring possession by the lienholder, are ships.

A ship or vessel by maritime law tradition is not equivalent to any other asset belonging to a debtor. The old idea of the "common adventure" and the "risk community" of the share holders of the ship, the cargo owner the freighter as well as all other persons interested in the success of the adventure, including the creditors of the owner, had led to the principle that the owner's liability is connected with the fate of the vessel and restricted to the vessel or its value and the unpaid freight.

Though this system in most countries has now been replaced by liability limitation expressed in units of account per ton and all assets of the owner are eligible for enforcement, the idea of the connection between a distinct vessel and the maritime origin of the claim, and the restriction of enforcement to action against that vessel, have survived, not only in the concept of maritime liens but in some cases also in the concept of arrest of vessels.

Thus it is not every claim which may be enforced by arrest, but only those which are to be regarded as maritime claims. Furthermore the vessel, in connection with whose operation the claim has accrued, is eligible not only for claims against the owner, but also against the non-owning operator like a bareboat or demise charterer,

and under certain circumstances other charterers.

This system is reflected in the Arrest Convention 1952, although with an important expansion in the type of property capable of being attached: if the debtor who is personally liable for the maritime claim owns another vessel, the claimant is entitled to arrest her; something he could not otherwise do because the maritime claim did not arise in connection with that ship.

This characteristic of a claim, to be secured through the operation of law by the possibility of arresting a ship (an action from which other claimants are prevented) and to be so secured irrespective of the identity of the personal debtor, may explain to a civil law jurist the attitude of English Law. In English law the right to arrest a ship for those special claims is regarded as a part of a real right, a statutory right *in rem*; the claim is regarded as "against the vessel" ⁴²⁾ and the procedure leading to arrest as the action *in rem* or at least as the first step in this action.

The right to security by arrest being restricted to certain types of claim and on the other hand extended to claims for which the owner is not the personal debtor and to the arrest of a sistership, which otherwise would be safe from arrest, it is of the greatest importance that shipyards' claims are on the list of the maritime claims so privileged, and they are.

The ship repairer's claim like that of the shipbuilder is a maritime one in the sense of the Convention (Art. 1, 1°, lit. 1), entitling the claimant to apply for arrest, thereby giving greater privilege to those creditors than to the non-maritime creditors who are not permitted to arrest in the courts of member states, at least as far as vessels flying the flag of member states are concerned. The right to apply for arrest, or to file an action *in rem*, extends to other vessels belonging to the personal debtor (sisterships).

The second item seems to be even more important: the conventional right to arrest a ship for shipbuilders' and ship repairers' claims exists on the one hand irrespective of ownership, even where the contract for repair has been made with the demise or other charterer ⁴³⁾ provided that, on the other hand, the latter had been authorised to bind the ship. According to art. 9, the Arrest Convention cannot create a right of action not recognised by the law applied by the court where the arrest takes place nor any maritime lien not already existing there or created in the relevant international convention on maritime liens and mortgages. Thus the shipyard's right to arrest a vessel differs from country to country, and depends within a contracting state on whether or not the vessel involved is flying the flag of a contracting state.

In those countries and circumstances where national legislation grants a maritime lien or other lien for the ship repairer's claim, which is an encumbrance to the vessel irrespective of the owner, the claim may be provisionally secured by arrest or action *in rem* for a debt incurred by the charterer. That is the case in the United States (not by virtue of the Arrest Convention, to which they do not subscribe, but by virtue of national legislation). In England the possessory lien also encompasses the repairer's

claim against a demise charterer or time charterer as personal debtor, but once the ship is allowed to leave it loses its force as a lien. Fortunately English law provides a statutory right *in rem* which enables a claimant to bring an action *in rem* against a ship (or its sistership) for repairing or building costs incurred by the beneficial owner or demise charterer ⁴⁴. The restriction is as to time and voyage charterers. To give an example: a time charterer, who is not to be regarded as in possession of the ship, and who by virtue of the time charter party is entitled to erect shifting boards, could order a shipyard to do this work: the shipyard has no right to arrest that vessel, but may arrest a vessel of which the time charterer is the beneficial owner.

If there is a break after exercising a right of retention, the right of arrest will probably only be exercised if the lien granted by national legislation is one of the lowest rank or a special statutory right *in rem*, as in England, which does not protect claims against time charterers as shown.

The Lisbon Draft Revision of the Arrest Convention has stated the restriction more precisely: where the debtor is not the owner or demise charterer of the vessel only a claim listed as secured by a lien is able to confer a right to arrest that vessel. Ship repairers who would like to file an action *in rem* in countries where the national legislation is based strictly on the 1967 Convention could only do so if the personal debtor is simultaneously the shipowner or demise charterer. No lien exists. Firstly the right of retention is not provided for in the Convention, but merely permitted to remain in national legislation, but secondly, it is doubtful how this right can be converted, after possession is lost, into a right of arrest for a claim against a personal debtor for which there would otherwise be no right *in rem*. And finally: a vessel, at one time susceptible to arrest, cannot be attached if the owner has changed, other than where the claim is covered by a maritime lien, which travels with the vessel irrespective of changes of ownership. Under the Arrest Convention the ship repairer would have no chance of arresting the vessel involved after a change of ownership unless there is a lien given under the 1926 Convention, which would be for a claim on a contract made by the ship's captain in the scope of his legal authority to ensure the completion of the voyage.

A final last aspect of arrest, from which ship repairers also derive some benefit, is the effect of arrest in bankruptcy. By international more-or-less uniform rules, all assets fall into the liquidation, unless the property has already changed hands. It is reported from the United States that serving a writ *in rem* will keep the proceedings in Admiralty and consequently, exclude the asset from the mass, although there is no priority giving lien. ⁴⁵.

Conclusions for the future

The shipbuilding industry in many different parts of the world is affected by today's overtonnage and crisis in the shipping industry. It will happen more frequently than ever that a shipyard has to face the insolvency of its customer. Time and space is lacking to discuss all the measures which a prudent shipbuilder could take besides trusting in the security represented by the vessel in his dock. Some of them have

been mentioned earlier.

Contractual stipulations taking the vessel as the most readily accessible security is one alternative but it is difficult to make them effective against third parties who invoke a better secured right.

Creating a lien by contract with the customer without possession offends the principle of publicity of encumbrances; all of them have either to be registered or be obvious for example where the ship is in the possession of the claimant (which is no real encumbrance), the only exception being maritime liens which are valid by operation of law. A further uncertainty in securing shipyards' claims arises out of the different approaches to the shipbuilder's or shiprepairer's lien under the rules of private international law. An analysis of the responses of the Maritime Law Associations to a questionnaire yields the following observations. As to the creation of maritime liens, England and other common law countries such as Australia, New Zealand, but also Bulgaria, France and Sweden, apply the *lex fori*. By contrast, the law of the vessel's flag is applied by Argentina, Denmark, Italy, Peru, Poland, Portugal, Venezuela and Yugoslavia. The German Democratic Republic applies the *lex rei sitae* of the vessel at the time when the claim secured by a maritime lien accrues (save for liens arising on the high seas, where the law of the flag would be applied), while the Federal Republic of Germany follows the *lex causae*. Some courts in the Netherlands have applied the *lex causae*, but others in earlier cases have applied the law of the flag. The courts of the U.S.A. evaluate the points of contact that the event leading to the lien has with potentially relevant laws.

Laws governing the priority of maritime liens *inter se* and with respect to other encumbrances like mortgages or hypothecs, again show considerable diversity. Japanese and Dutch authority is divided, yet on these issues, the GDR, the FRG and the U.S.A. join the common law nations in favouring the *lex fori*.⁴⁶⁾

The work of reconsidering the subject matter by IMO and UNCTAD, now in the Joint Intergovernmental Group of Experts (JIGE), proceeds but slowly. It has been suggested that liens for certain claims should be eligible for registration⁴⁷⁾. Perhaps that could be a way of changing the shipyards' right of retention into a registrable charge without losing its ranking above mortgages and at the same time avoiding the necessity of an immediate forced sale before possession is lost. Sometimes it would be better to allow the shipowner the chance to earn money to pay for the repairs; sometimes a forced sale is not sensible where there is no market for second hand ships. For the time being the idea is making no progress as there are doubts about the expense of maintaining a register, about its reliability, and about protection against abuse, technically as well as by the unchecked reservations of liens.

Footnotes:

- 1) Art. 2756 Civil Code, art. 53 Law on Bankruptcy, as referred to in the Reply of the Italian M.L.A. to the C.M.I. (first) Questionnaire, M.L.M. 1926/1967-4.
- 2) § 230 Gesetz über internationale Wirtschaftsverträge (GIW) (Act on International Commercial Contracts)
- 3) Federal Republic of Germany § 370 Commercial Code; see also Portugal: art. 468 Code de Commerce; France: art. 63 Act of July 13, 1968
- 4) E.g. Federal Republic of Germany: § 647 Civil Code; Peru: art. 1029 Civil Code; obviously Japan: (MLM 1926/1967-24); Portugal: art. 754 Code Civil MLM 1926/1967
- 4a) Hoge Raad, May 1, 1964, Schip en Schade 1966 No. 49 as cited by Maritime Law Review 01-16-08
- 5) Op. cit. Fn 1)
- 6) Spain: MLM 1926/1967-31, (II/7)
- 7) Brasil: MLM 1926/1967-28
- 8) The UNCTAD Report TD/B/C.4/ISL/48, para 91 naming also Argentina, Portugal and France at least as not in conformity with the Replies of the Maritime Law Associations of those countries, as MLM 1926/67-
- 9) Rodière, *Le Navire*, pp. 180 et 182, see also du Pontavice, *Le Statut du Navire*, p.157
- 10) § 647 Civil Code
- 11) § 648 (2) Civil Code
- 12) Schaps-Abraham, *Das deutsche Seerecht*, 3. Auflage (West) Berlin 1959 S. 425 Anm. 128 Ziff. 3 zu § 8 Schiffsrechtgesetz
- 13) Schaps-Abraham, *Das Seerecht in der Bundesrepublik Deutschland*, 4. Aufl. (West) Berlin - New York 1978, S. 1532 (Anm. 31 zu § 760 HGB)
- 14) Comité Maritime International, *Yearbook 1986-1987* p. 130. Besides Denmark, Norway and Sweden, the Syrian Arabic Republic has become a contracting state to the 1967 Convention.
- 15) §§ 120 - 124 Seehandelsschiffahrtsgesetz (SHSG) (Merchant Shipping Act)

- 16) § 119 (3) SHSG, § 16 Schiffsverkehrsverordnungsordnung
- 17) C.f. Tetley, *Maritime Liens and Claims*, London 1985, p. 270. The references below are based on Tetley's book.
- 18) Palmer, *Bailment*, 1979, p.80
- 19) *The "Gaupen"* (1925) 22 L.L.R. 57
- 20) Willmer J. in *The "Ally"* [1952] 2 Lloyd's Rep. 427
- 21) Sect. 21 (3). Hewson J. in *The "St. Merriel"*, [1963] 1 Lloyd's Rep. 63, Tetley, op. cit. p. 271 contrary to p. 269
- 22) [1903] P. 26 Tetley, p.271.
- 23) MLM 1926/1967
- 24) See Tetley p. 278: (1862) Lush. 506; 167 E. R. 230 (*The "Gustaf"*)
- 25) [1883] Q.B. D. 37, *The "Immacolata Concezione"*
- 26) *The "Latalf"*, (1925) 22 L.L.R. R. 251
- 27) *The "Zigurds"*, (1932) 43 Ll. L. R. 387, at p. 389
- 28) [1960] 1 Lloyd's Rep. 533
- 29) Tetley, op. cit. p. 265
- 30) Federal Maritime Lien Act, 46 U. S. Code sect. 971
- 31) U.S. MLA Reply to the CMI Questionnaire, III 9 v, MLM 1926/1967-54
- 32) Federal Maritime Lien Act, 46 U. S. C. A § 972
- 33) Tetley, op. cit., p. 261
- 34) Federal Maritime Lien Act, 46 U. S. C. A § 951
- 35) E. Harper's Reply on behalf of the U.S. MLA to the CMI Questionnaire, III. 4., MLM 1926/1967-54, perhaps disputed
- 36) Tetley, op. cit. p. 179
- 37) For more details see Tetley, op. cit. p. 183

- 38) The last words have been said explicitly in the former version of the German Commercial Code § 754, no. 8 which had been a condition to invoke the limitation of the shipowner's liability which was restricted to ship and freight.
- 39) *Maritime Liens and Mortgages, A Progress Report* by Francesco Berlingieri, CMI News letter September 1983, p. 2 at the bottom right; further *Summary of debates of the Lisbon Conference of the CMI*, CMI 1985 Lisboa II, p. 100
- 40) MLM 1926/1967-66, no. 23 and 24
- 41) For the history see Tetley, pp. 450 et seq.
- 42) Jackson, *Enforcement of Maritime Claims*, London 1985, p. 5
- 43) Art. 3 para 4
- 44) Supreme Court Act 1981 sect. 20 (2) n in connection with sect. 21 (4)
- 45) Tetley, op. cit., p. 489
- 46) Analysis of Responses, Annex no. I to MLM 1926/1967 - 27.IV.83.
- 47) *A new approach to the international régime for maritime securities*
Report by the UNCTAD Secretariat, TD/B/C.4/AC.8/2 = IMO LEG MLM/2/

THE PROTECTION OF SHIPOWNERS

Takeo Kubota

I. Position of shipowners on the bankruptcy of charterers

1. How does it affect an existing charter?

When charterers become insolvent, they may apply for one of the following procedures, which are typically adopted in Japan upon insolvency.

- (1) Bankruptcy proceedings in the court
- (2) Rehabilitation proceedings in the court
- (3) Recomposition proceedings under the supervision of the court

In bankruptcy proceedings the trustees collect all the assets belonging to the bankrupt company and distribute them to all creditors according to the law. On the other hand, in corporate rehabilitation proceedings the trustees reorganize and operate the company under the strict supervision of the court for the purpose of reconstructing the company. In corporate recomposition proceedings debts are rearranged by the voluntary acts of the company and its creditors with the assistance of the trustees and the approval of the court. In this procedure the former management of the company still has full powers to operate the company, whereas in the corporate rehabilitation procedure the former management has no power and the trustees take over.

The legal position of the owners is different in each procedure.

(1) If the charterers are adjudicated bankrupt

(a) Bareboat charter

The charter does not terminate automatically even if the bareboat charterers are adjudicated bankrupt. However, either the owners or the trustees of the bankrupted charterers may terminate the charter at any time by declaration. In this case neither party may claim compensation for damages arising from the termination of the charter. The owners' claim for unpaid hire earned before the adjudication of bankruptcy is treated as a claim in bankruptcy and is recoverable only on a percentage basis. Payment of the hire and other expenses arising after the adjudication and up to the time of redelivery of the vessel to the owners is treated as a superior obligation in the bankruptcy proceedings and is settled apart from the bankruptcy when funds are available.

Note: In a case involving a Japanese time-charter the old supreme court gave a judgment in 1928 to the effect that a time-charter is a contract combining the lease of a vessel and the supply of crew/labour. This principle has been maintained. The theory that a time-charter has the nature of a lease of a vessel and is to be treated the same as a bareboat charter under the law has been criticized in the shipping world as it does not reflect the real situation of a time-charter and deviates from normal shipping practice. No judgment has yet been rendered by the new supreme court on this point, but there is a possibility that it will be overruled.

Protection of the owners

In order to keep the amount of unpaid charter hire to a minimum before the adjudication of bankruptcy it may be useful to shorten the period of charter hire payment to semi-monthly payment. In this way the owners may detect the deteriorating financial position of the charterers and take the necessary action earlier by withdrawing the vessel.

If they have a performance guarantee from the charterers' parent company, a bank or other party the owners can avoid the risk of non-payment of hire and may recover damages according to the provisions of the charter-party.

(b) Time and voyage charter

Here again the charter does not terminate automatically. However, in this case the trustees of the charterers have an option to cancel the charter or to require the owners to perform the charter. If the trustees desire to continue the charter, the trustees have to perform all the charterers' obligations.

The owners may request the trustees to declare their intentions within a reasonable period. If the trustees do not do so the charter will be deemed cancelled. If the trustees choose to continue the charter, they have to obtain the prior approval of the court whereas they may decide to cancel the charter in their own discretion without court approval.

The question which arises is how to determine what is a reasonable period to allow. After adjudication of bankruptcy, the trustees and the court are normally very busy dealing with the many issues. A "reasonable period" is flexible depending on the pressure of work, and the owners are placed in an unstable position during that period.

If the trustees cancel the charter, the owners' claim for the unpaid hire earned prior to the adjudication of bankruptcy and for compensation for damages arising from cancellation of the charter is treated as a claim in bankruptcy and is recoverable only on a percentage basis. The payment of the hire and other expenses arising after the adjudication up to the time of redelivery of the vessel to the owners is treated as a superior obligation in the bankruptcy proceedings and will be settled apart from

the bankruptcy proceedings.

Protection of the owners

In addition to a performance guarantee and a shorter hire payment period it is advisable to insert a clause in the charterparty reserving the owners' rights to cancel the charter and withdraw the vessel if the charterers are adjudicated bankrupt. If there is any default on the payment of hire before the adjudication of bankruptcy, the owners may then cancel the charter and withdraw the vessel from the service according to the provisions of the charterparty.

(2) When rehabilitation procedures are commenced

The legal position of the owners is the same under a bareboat charter, a time charter and a voyage charter.

The trustees have an option to continue the charter or to cancel it. The owners may demand that the trustees declare their intention to continue the charter or not within 30 days. If the trustees fail to reply within 30 days, the charter will be deemed continued. Upon the request of either the trustees or the owners, the court may designate a shorter or longer period than 30 days depending on the situation.

If the trustees choose to continue the charter, they have to perform all the obligations of the charterers under the charter. If the charter is terminated by the trustees, for which the trustees have to obtain prior permission from the court, all hire unpaid up to the commencement of rehabilitation and compensation for damages arising from the termination is treated as a claim in the rehabilitation procedure. Payment will then be made according to the rehabilitation plans agreed by the creditors and approved by the court. Normally, the owners recover only a percentage and only by instalments.

Hire arising after the commencement of rehabilitation and other expenses incurred up to the time of redelivery of the vessel to the owners, is treated as a superior obligation and is settled separately from the rehabilitation plan.

Protection of the owners

As stated above, the Corporate Rehabilitation Law provides an option for the trustees to continue the charter or not. Furthermore, the trustees may extend their period for consideration by obtaining permission from the court, during which period the owners will be placed in an unstable position. The trustees will make sure they retain the profitable charters to help the rehabilitation of the company, cutting out the unprofitable charters.

In order to avoid such a situation a special clause is often inserted in a charterparty to the effect that the charter shall be terminated when rehabilitation procedure are commenced.

Article 4 of the Corporate Rehabilitation Law provides that Japanese rehabilitation procedures have legal effect only on assets located in Japan, while foreign rehabilitation procedures have no legal effect on assets located in Japan (there are similar provisions in the Bankruptcy Law). Charterers' assets abroad may be seized by the creditors, irrespective of the rehabilitation procedure in Japan. A problem arises in the case of a Japanese flag vessel in a foreign port. Is she still deemed an asset belonging to her port of registry in Japan or an asset located abroad? Although there have been many arguments on this issue, the majority opinion is that the "location" provided in the law means where the ship is "physically located" rather than her port of registry. There is thus a great risk that the assets of a company undergoing rehabilitation (including vessels) may be seized abroad.

In order to avoid such a situation it is normal practice for a company about to undergo rehabilitation in Japan to negotiate with its creditors to achieve a settlement to prevent their operations being threatened by creditors arresting their vessels abroad. Reconstruction of the company would be difficult in practice in such circumstances.

In the case of *Sanko Steamship Co., Ltd.* negotiations with domestic and foreign creditors, prior to the commencement of the rehabilitation procedure, resulted in a settlement of the damages arising from the termination of the charter. The settlement was such that Sanko immediately paid 5% of the total hire for the remaining period with a further 5% as claims for common benefit, which would be a preferential payment apart from the rehabilitation plan.

After the settlement had been agreed with most of the creditors, the court approved the rehabilitation for Sanko, a practical solution to avoid the risk of arrest.

A guarantee from a third party of the due performance of the charterers or the undertaking of a third party to take over the charter on the same terms and conditions, if the charterers undergo rehabilitation, is of great benefit to shipowners.

(3) When recomposition procedures are commenced

As stated earlier, under the recomposition procedure the former management still has full powers to operate the company and the recomposition does not affect the existing contract. Therefore, the charter survives on the same terms and conditions, and the owners may not cancel it unless there is a default on the part of the charterers, or the charterers agree to cancel it through negotiation.

The terms of the recomposition plans are negotiated with the creditors and have to be approved by the court. Once they are approved, the creditors are bound by them. Normally, recomposition plans provide only a percentage recovery of the creditors'

claims by instalments with a waiver of remaining claims. This applies to general claims without any security or preferential right arising before the commencement of the recomposition procedure. Therefore, mortgages, maritime liens and other preferential rights may be enforced against the charterers' assets even after the procedure is commenced.

Hire earned afterwards is treated separately and is recoverable outside the procedure.

Protection of the owners

It may be advisable to insert a special clause in a charterparty to the effect that the owners may cancel the charter and withdraw the vessel when the charterers' business is subject to recomposition procedures. In this way the owners have an option to take back the vessel depending on the market then prevailing.

In the same way as for rehabilitation (see above), the legal effect of recomposition is limited to assets located in Japan; any assets of the charterers, vessels or freights, are attachable abroad.

2. The owners' obligation to carry the cargo to its destination

(1) Whether the owners are obliged to carry the cargo to its destination

After the charter is terminated, whether the owners are obliged to carry the cargo to its destination under a bill of lading already issued depends on the type of charter.

(a) Bareboat charter

In the case of a bareboat charter, the charterers employ and supervise the master and crew. The contract for the carriage of the cargo is concluded between the charterers and the cargo interests. A bill of lading is issued by the charterers in their own name. Therefore, the owners are not bound by the bill of lading and they have no obligation to carry the cargo to its destination.

However, the owners are custodians of the cargo on board and are required to act as good custodians. In practice, the owners try to negotiate additional freight or the transshipment of the cargo for account of the cargo interests. If negotiation fails, the owners may discharge the cargo at a convenient place and deliver it to the cargo interests. The owners then have a lien on the cargo for the costs of discharge, and for storage expenses.

(b) Time charter

Where there is a time charter the obligation of the owners to carry the cargo to its destination depends upon whether the owners are bound by the bill of lading issued for that shipment.

In the normal way it is contemplated in a charterparty that the charterers will issue bills of lading while the master of the vessel provides a letter of authorization for the charterers to sign them on his behalf. The owners are bound by the bills of lading, and are obliged to carry the cargo to its destination.

On the other hand, if a bill of lading is issued by the charterers in their own name without any reference to the owners or the master of the vessel, the owners are not bound by it and are not obliged to carry the cargo to its destination. Again, however, the owners have to act as good custodians of the cargo on board as in the case of the bareboat charter.

Protection of the owners

If the time charterers become insolvent, a difficult situation arises because the owners suffer substantial damages from non-payment of hire, failure to supply bunkers, and to pay port disbursements at discharge port, all of which are for the charterers' account. Cargo interests are extremely reluctant to pay additional freight, unless the freight is collectable at a discharging port, since it duplicates the freight payment already made to the charterers.

The practical solution is for the owners to request shippers to share the expenses incurred if the owners complete that voyage.

Theoretically, if the charterers undertake to issue bills of lading without reference to the owners or the master of the vessel and if the form of the bill of lading can be agreed with the charterers, the owners should be able to avoid having to carry cargo to its destination without compensation.

(c) Voyage charter

In the case of a voyage charter bills of lading are normally issued by the owners and the owners are obliged to carry the cargo to its destination.

(2) The owners' liens on the cargo and on subfreight

Under Japanese law a lien arises only by operation of law and it cannot be created by agreement between the parties. Article 753 of the Commercial Code gives the owners a lien on the cargo for the following claims:

Freight (which is to be received by the owners and does not mean sub-freight), demurrage, contributions in General Average, salvage remuneration, incidental expenses incurred during carriage of the cargo and expenses advanced by the owners.

The above liens may be enforced within two weeks even after the cargo has been delivered to the receivers, unless a third party takes possession of the cargo. The owners may apply to the court for the sale of the cargo and the cargo will be sold through a court auction. If the owners fail to enforce the lien, the owners' claims will expire against the charterers and the shippers. However, in such a case the charterers or the shippers have to return to the owners such benefit received by them.

The law does not specially provide for a lien over subfreights; however, subfreight is attachable for the owners' claims under the provisional attachment procedure.

A question arises whether the owners are entitled to a lien on freight-prepaid cargo for hire unpaid by the time charterers. The answer depends on the owners' obligation to carry the cargo to its destination. If the owners are bound by the bill of lading, the owners are obliged to carry the cargo to its destination and deliver it to the holder of a bill of lading, and no lien on cargo arises.

On the other hand, if the owners are not bound by the bill of lading (including the freight prepaid term), there is room for a lien on the cargo for charter hire not paid for that voyage. It is unfair to expect the owners to carry the cargo without any remuneration, so non-payment of hire is deemed the same as non-payment of freight, which gives the owners the right to a lien on the cargo.

3. The owners' right to withdraw the vessel

(1) If the charterers refuse to return the vessel

In the case of a time charter, the owners control the vessel through their master and it can be withdrawn without difficulty.

However in the case of a bareboat charterer, the charterers control the vessel through their master and the owners may not withdraw the vessel without the agreement of the charterers. If the charterers do not agree to return the vessel voluntarily, the owners have to apply for an injunction to arrest the vessel and thereafter have to obtain a judgment to recover possession. The procedure for the injunction requires the owners to put up security: thereafter judgment to take back possession of the vessel has to be obtained through normal litigation. This can be a very heavy burden on the owners.

The protection of the owners

There have been many cases in which the charterers became insolvent and refused to return the vessel to the owners even though the owners decided to withdraw. Often the master and crew have received no wages and there is little hope of receiving any money from the charterers. Negotiations with the master and crew for them to leave the vessel on receiving their unpaid wages and allowances from the owners normally results in smooth and quick redelivery. The costs of repatriation have to be borne by the owners.

(2) How the crew will be treated

This question relates to the previous point. The master and crew are entitled to a maritime lien over the vessel for claims arising from their employment contracts, which covers their wages and various allowances. Bareboat charterers are of course obliged to settle such crew's claims as employer, but if they fail, the crew may recover from the vessel through a court auction. In any event the crew's claims, to which they are entitled under the law, have to be settled if the vessel is withdrawn by the owners.

(3) Maritime liens may be enforced by other parties

During the charter, and even after the withdrawal of the vessel by the owners, there is always a great risk of arrest under a maritime lien by the creditors of the charterers.

Article 842 of Commercial Code allows maritime liens for the following claims:

- (a) Costs of auctioning the vessel and costs of preserving the vessel after the commencement of auction proceedings
- (b) Costs of preserving the vessel and accessories at the last port
- (c) Tonnage dues, etc. charged in relation to her voyage
- (d) Pilotage and towage
- (e) Salvage remuneration and General Average contribution
- (f) Expenses necessary to continue the voyage
- (g) Claims of the master and crew arising from employment contracts
- (h) Where the vessel has not commenced a voyage after a sale or construction, claims for the sale price or the costs of construction including fitting of accessories, costs for fitting accessories, supply of food and bunkers for her

last voyage.

In addition to the above, the Japanese Limitation Act provides for maritime liens for claims for loss of life and personal injury on board ship, damage caused by the vessel to a third party and damages to cargo and passengers' baggage.

The maritime liens extend to the vessel's accessories and to the freight if not yet received (that is only the freight accrued on the voyage in which the maritime lien arises).

The above maritime liens prevail over a mortgage. The priority among the maritime liens is in the order set out from (a) to (h). The maritime liens provided in the Limitation Act follow on. If maritime liens arise in more than two voyages, the lien arising in the later voyage prevails over a lien arising in the earlier voyage. If liens provided in (d) through (f) above arise in the same voyage, a later lien will prevail over earlier lien. The law protects the later liens.

Maritime liens follow the vessel even after the transfer of title to another party. Claimants who are entitled to a maritime lien may arrest the vessel and apply to the court for its auction. They receive their respective dividends according to the priority detailed above.

Once the vessel is sold through a court auction, all the maritime liens and mortgages existing at that time expire and a successful bidder obtains a "clean" vessel.

Protection of the owners

(a) All Japanese maritime liens expire after one year. The maritime liens provided in (h) above expire when the vessel commences her next voyage.

(b) As stated earlier, a maritime lien follows the vessel even after a sale. Buyers may legally protect themselves after registering the vessel, by publishing a notice requesting those creditors of the vessel who are entitled to a maritime lien to submit their claims within a specific period of not less than one month. If the creditors fail to submit their claims within that period, the maritime lien will be deemed expired by law.

(c) If the vessel is arrested under a maritime lien and the court orders an auction the owners may release the vessel by putting up security, cash deposit or a bank guarantee. Thereafter, the merits of the claims and maritime liens will be discussed in formal litigation.

(d) If a vessel is arrested fraudulently or negligently by a claimant which constitutes a tort, the owners are entitled to counter-claim against the wrongful arrester.

(e) The problem of what law governs maritime liens has not been solved by the Japanese courts. In past cases, some courts applied Japanese law (the law of the *forum*) to decide the validity of a maritime lien and priority among the maritime liens. However, other courts applied the law of the vessel's flag. Thus owners may plead that the law of the flag is the proper law to decide the validity of a maritime lien and its priority. This issue may be important, as under Japanese law all maritime liens prevail over mortgages, while in other countries mortgages may be ranked differently.

II. Position of shipowners in the bankruptcy of shipyards

(1) Recording of mortgages on a hull under construction

The Japanese Commercial Code allows an owner to record a mortgage on a hull under construction by the shipyard. However, before recording such a mortgage, it is necessary for the shipyard to register the title of the ownership. The mortgage may cover the hull and its accessories, and have the same legal effect as a mortgage recorded on a ship in operation.

If either bankruptcy or rehabilitation procedures are commenced for the shipyard, the owners (if a mortgage is recorded in the name of the owners) will be treated as creditors with preferential rights and they will have a better recovery than general creditors. Mortgagees may act independently outside the rehabilitation procedure.

(2) Liens may be exercised by sub-contractors

Besides maritime liens, the Civil Code provides a general lien (preferential right over the property) in some cases. When a vessel is being constructed, the shipyard normally uses many sub-contractors and receives supplies of engines, equipment, etc., which will form part of the vessel. The Civil Code protects the right of a seller to collect the sale price from the property sold, if the property still belongs to the debtor.

A difficult question arises in relation to supplies for a hull under construction. For example, engine manufacturers supply engines to a shipyard, which then becomes insolvent; the suppliers are unable to recover the price. The civil law grants a lien over the property for the unpaid price. If the engines have not yet been fixed in the hull they are attachable by the suppliers. However, once the engines are fixed permanently, they become part of the vessel and lose their independent quality.

Generally, a hull under construction is always exposed to the risk of liens which may be enforced by suppliers.

(3) Transfer of title in the hull during construction

In the normal course of shipbuilding, ownership of the vessel is transferred by the shipyard to the owners at the time of delivery. Therefore, the ownership of the hull under construction lies with the shipyard and creditors of the shipyard may seize the hull when the shipyard becomes insolvent.

Protection of the owners

However, a special agreement between the owners and the shipyard to the effect that the ownership of the hull and its accessories always belongs to the buyers (the owners) irrespective of the progress of construction (such an agreement is valid under the law), improves the owners' position substantially.

First of all, once supplies are supplied to the shipyard, they are deemed to have been immediately supplied by the shipyard to the owners, and suppliers may not enforce their liens.

Secondly, the general creditors of the shipyard may not seize the hull since the hull already belongs to a third party (the owners) not to the debtor (the shipyard).

However, sub-contractors, who fitted accessories to the vessel and who are entitled to a maritime lien under Article 842 (h) of the Commercial Code, may enforce a maritime lien on the vessel. (This will be applied when the construction is almost completed). Such a maritime lien is enforceable even if the vessel or hull belongs to a party other than the debtor.

(4) Refundment guarantee by a bank

In order to secure the rights of the owners to recover instalments already paid to the shipyard, it is normal practice to obtain a refund bank guarantee from the shipyard, which will operate on cancellation of a shipbuilding contract. Although the owners may recover what they have paid, they will not be able to insist on delivery of the vessel.

However, when the hull is placed in a court auction by the shipyard's creditors, the former owners may bid for it and obtain the ownership. The price in a court auction is normally lower than the market price.

III. Special proceedings to avoid bankruptcy

1. Application for corporate rehabilitation

In order to avoid bankruptcy and to reconstruct the company, the owners may apply to the court for corporate rehabilitation. Under this procedure the reconstruction of a company proceeds under the strict supervision of the court, but the company is protected by the law during the proceedings.

(1) Preservation of assets

It takes normally 2–3 months after an application for rehabilitation is filed for the court to act on it, and it is essential to freeze the company's assets as they are. For this purpose the court issues an order for the preservation of assets within a few days of the application for rehabilitation being made.

The company is prohibited to transfer, sell, pledge or mortgage the company's assets, to make loans or to pay debts without the approval of the court, except for paying wages and running expenses less than 100,000 Japanese Yen.

(2) Stoppage of other proceedings

In order to ease the rehabilitation of the company, the court may order attachment, arrest and auction procedures to be stopped, including the enforcement of national dues.

(3) Investigation

The court may appoint a committee of investigation to decide whether rehabilitation is appropriate. The committee investigates the cause of the insolvency, the company's assets and debts, prospects for the business and the financial position of the company otherwise, and reports to the court.

(4) Commencement of rehabilitation

If the court considers rehabilitation is appropriate for the company, the court orders its commencement. The court appoints trustees, who will operate the company thereafter. The former management is deprived of power. All pending lawsuits are taken over by the trustees. All payments by the company or to the company are entirely controlled by the trustees.

The company's creditors are forbidden to enforce their claims outside the procedure, to effect attachment, or to arrest or auction the company's assets.

The risk that the company's assets located abroad, including vessels, will be seized or arrested, cannot be avoided.

(5) Rehabilitation plan

The trustees investigate all claims filed by creditors; some are accepted and some are rejected. The trustees then prepare a rehabilitation plan and submit it to the court. The rehabilitation plan is reviewed by the court and discussed at the creditors' meeting. When the plan is agreed by the creditors and approved by the court, the rights of the creditors are amended and reduced according to the rehabilitation plan. The company is then released from the balance of the claims.

(6) Closing the procedure

If it becomes apparent that the rehabilitation arrangement cannot be adhered to, the procedure will be discontinued; if the company is insolvent at that stage, the court adjudicates bankruptcy.

When the rehabilitated company completes payment of the debts according to the plan, the procedure is concluded and the management of the company again operates the company under its own powers.

2. Application for corporate recomposition

The company may apply to the court for recomposition to avoid adjudication in bankruptcy. As stated earlier, in this procedure the management of the company still has full powers to operate the company.

(1) Preservation of assets

Upon application, the court may prohibit the sale, pledge, mortgage or other disposal of the company's assets, and stop payments (except for running expenses of a relatively small amount) and taking loans. In this way the company's assets are preserved until the court decides whether recomposition of that company should be permitted or not.

(2) Appointment of committees

The court will appoint a committee, to investigate the financial condition of the company, its assets, debts, prospects for business, and report them to the court.

(3) Commencement of recomposition

After reviewing the investigation report submitted by the committee, the court may order the commencement of recomposition if there is a good prospect of reconstruction. After the order is made by the court, the creditors cannot attach, arrest or seize the company's assets, or enforce their claims except within the

procedure. All attachments, arrests or seizures or other enforcement of claims already started against the company's assets are stopped. The court appoints trustees who assist the company until a recomposition plan is agreed by the creditors and approved by the court.

(4) Recomposition plan

The creditors file their claims with the company in recomposition, for review by the company and the trustees. The trustees then prepare a recomposition plan and call a creditors' meeting. The plan is discussed at the meeting, and if it is agreed by the creditors, it is submitted to the court for approval. When the plan is approved by the court, the claims of the creditors are amended and reduced according to the plan. However, claims with security or having preferential rights are treated separately and are not bound by the plan. Therefore, claimants with maritime liens or mortgages may enforce their claims separately from the recomposition procedure, and in this respect it will be necessary for the company in recomposition to obtain full cooperation from them.

If the recomposition plan is not approved by the creditors, the court will adjudicate the company bankrupt.

FINANCIAL CRISES IN SHIPPING SINCE 1965

Ole Lund

I. Introduction

Insolvency in Maritime Law: in a nutshell it means lack of money to meet financial obligations. It may hit the balance sheet of a company or it may hit its cash flow. In either case from the strict legal point of view a company should apply for bankruptcy. But in spite of the lack of funds and the fact that there is too little to go round all creditors, recent experience is that business will continue. Creditors find continuation more advantageous than bankruptcy. This paper will describe, perhaps not exhaustively, how this has been achieved over the past twenty years.

When a company faces insolvency, its creditors normally start by advancing their legal rights. However, the reality is quickly recognised: it is no help to anyone to insist upon the fulfilment of a contract, whatever its nature, as long as the debtor has insufficient funds to do it. Consequently the legal niceties are forgotten, and a pragmatic commercial view of the cruel economic facts soon becomes dominant.

This pattern is mainly seen where shipyards and shipowners (owners also as charterers) are in trouble and not when it is a pure chartering company which faces difficulties. The "fly by night" operator normally commands very limited sympathy. When it comes to shipyards and owners in difficulties, creditors may, for several reasons which are examined below, take quite another view.

In the late sixties and first half of the seventies, the typical group suffering insolvency in the shipping community was the shipyards. Yards in several countries ran into great financial difficulties and were unable to fulfil their contractual obligations. The best known cases in this group were Götaverken Shipyard in Gothenburg, Sweden, and several Yugoslavian shipyards. However, the problem arose also in Norway, Denmark, West Germany, the Netherlands, France, Great Britain and Italy. Several yards approached their customers and asked for increases in contract prices, waivers of penalties and extensions of delivery time. Some of the owners approached were faced with a difficult decision. They could run the risk of losing instalments already paid and of failing to meet their own contractual obligations, for example where new buildings had been fixed on a long term charter.

The upsurge in shipowners running into difficulties started around 1975 and has continued up to this day. Lack of long term employment combined with an extremely low market year after year, brought an end to the equity for

several owners, and made it impossible for them to fulfil their obligations to financial creditors and in some cases even to trade creditors.

How should such a situation be handled?

II. The problems of the shipyards

- a) What were the reasons for the shipyard crisis in the late sixties and the beginning of the seventies? The answer to this complex question, varies from yard to yard. Some factors seem to be common to most of the yards involved.

First, the change to building much bigger units created technical problems for the shipyards from 1965 onwards. The shipyards, which were carrying the design risk under most of the shipbuilding contracts, bore huge costs in investigating and rectifying faults in design. They were subject to huge claims from the shipowners, and in several cases a calculated profit on a series of vessels turned into big losses due entirely to expenses like these. The yards faced problems both in the design of the hull and of the large engines.

Secondly, several yards also miscalculated the building time of the new vessels. They had calculated the additional time needed for the steel work *pro rata* to the increase in the steel weight. However, on a VLCC as one example, welding takes place at double the distance above the ground compared to a smaller vessel; consequently the steel work took considerably more time. This hurt the yards in three ways, at least: the work was more expensive, delay in delivery meant tremendous loss of interest to the yard and as the miscalculation could not be considered *force majeure*, the yard had to pay penalties to the owners. As an illustration at Götaverken Shipyard only one month's delay in the building program resulted in interest losses of more than 20 million Swedish Kroner.

Thirdly, the yards were hit by currency fluctuations. Between 1965 and 1970 several of the shipyards had fixed contract prices in pounds sterling and suffered severe losses on the devaluation in 1967. Several then turned to the dollar and were even worse hit by the decline in this currency. The worst example was a European shipyard which in 1966 made all its contracts in pounds sterling and lost money. When they launched a new ambitious building program they changed to dollars. Simultaneously they bought steel from Japan in Japanese yen and most of the equipment from Western Germany in D-mark. The result was a catastrophe.

The conclusion was: less income due to currency fluctuations, huge losses of interest due to late delivery, increased building costs for the same reason, technical problems in the building and on top of all that, compensation for the shipowners because of the delays in delivery also due to the technical

problems.

- b) After having exhausted all their own means and reserves, where should the shipyards turn for assistance as an alternative to bankruptcy?

The shipowners were the first target for the shipyards' approaches and the request to the shipowners normally went along the following lines: the purchasers should accept considerable delay in delivery: would they also agree to waive any claim for compensation for the delay? Would they also accept an increase on the price of the vessel, preferably combined with a change in financing terms changing the contract to a cash contract?

To begin with the owners could not believe what they heard: how could a big and reputable shipyard in a big and reputable shipbuilding country ask for an increase in price? The owners knew that there was no legal justification for an increase. Even large and unexpected currency variations could not support such a claim from a legal point of view. The reaction was surprise, anger and a brisk statement that the representatives of the yard should solve their own problems, hopefully with assistance from the shareholders or the government.

But after this first shock and first reaction, realism started to creep in. One approach was of course to maintain a firm refusal and expect the shareholders or the government to move in to assist the shipyard to protect the employees. That was a gamble, and if it did not work and the bankruptcy materialised what could they do?

Owners had to look at the situation pragmatically, and take the following elements into consideration:-

First, whether the market was good and could carry some increase in the prices and the waiver of penalties. Some vessels might have good fixtures and could still catch the cancelling date.

Secondly, if there were a bankruptcy, what would the consequences be? Some owners would be repaid instalments already paid, with interest, as this was covered by a bank or a government guarantee. They lost only the profit anticipated on the contract. But others had no such guarantee, or perhaps the security they had obtained turned out to be valueless because of legislation in the building country. For example, Norwegian purchasers at Götaverken Shipyard in 1971 were running the risk of losing 796 million Norwegian Kroner in prepaid instalments if the yard went into bankruptcy. Should they then gamble that the government would assist?

Thirdly, several owners intended to use the new buildings to fulfil contracts of affreightment. Rates had been calculated on the basis of the new building prices. If the price increased, the net profit under the freight contracts

would be less, but it was still good business. However, if the owners had to go into the market to find substitute tonnage, they would face a severe loss. The pragmatic and commercial view had to take into consideration the risks. As expressed in one meeting of the purchasers of 36 vessels at Götaverken Shipyard: What kind of premium are the purchasers prepared to pay to the shipyard to insure that it doesn't go into bankruptcy, rather than gambling on government support?

But a positive attitude to the request from the shipyards raised another problem. Would the purchasers' support be enough to carry the shipyard through the critical period and was there any certainty that the vessels would be delivered? Shipowners had no wish to throw good money after bad. How could they be sure that they would not face another request for an increase in prices after 6 months or a year as had happened a few years earlier? Then the assistance given was as little as possible and other burdens added which made it impossible for the yard to carry the projects through. Further difficulties arose soon after the main problem was thought to have been solved.

By the beginning of the seventies the lesson had been learned. Owners, through independent auditors investigated for themselves the financial situation of the yards. The investigation had two goals: to see whether the amount asked for was neither too much, nor too little. Owners had to know the true position to avoid unpleasant surprises in the future, and to make sure that if, contrary to expectations and even after the most thorough investigation, the assistance given should not prove sufficient, others would help to solve the problem.

What surprised shipowners in their discussions with the shipyards was the lack of support from governments. Even though some governments genuinely supported their shipbuilding industry, others showed their co-operation with the shipyards by using legislation to make the position more difficult for owners. The most surprising experience was the complete lack of support from the Yugoslavian government. When negotiations started the owners believed that Yugoslavia was one country where the government would intervene. However, the shipyards were not government owned, but owned by the local enterprise which lacked both the funds and the willingness to take the burden. As a matter of ideological principle it seemed that the government would not interfere. In that country the owners had to carry the shipyards' financial difficulties themselves.

One of the most difficult points to resolve was that no one owner wanted to give support unless everybody joined in. To coordinate the owners' side was consequently a considerable task.

When they were all brought into line, the pragmatic owners went ahead: evaluating the risks, and market potential, they moved in without any legal obligation. Prices were increased, penalties waived, deliveries postponed and even technical assistance was given.

- c) When an agreement had been reached in principle to support a yard, the next problem was how to divide the burden among the owners.

It was easily agreed to leave to the individual owner the decisions about waiver of penalties, postponement of delivery and technical modifications.

The difficult question was to decide how much money each owner should put in. In some cases the total amount of fresh capital the yard needed to fulfil the building program was divided among the owners *pro rata* to the contract price of their vessels. Another system was to calculate how much each owner would lose in a bankruptcy, taking into account what securities had been given and when, but not loss of future profit, then to apportion the funds required for the yards' further operation *pro rata* to each owner's exposure. A third system was to divide the additional amount of finance in proportion to the actual building costs of the vessels.

III. The shipowners' problems

- a) A large number of shipowners faced financial difficulties after 1975. A market with only a few highspots in some trades or only very short term highspots, was hit hard. For long periods only running costs, and sometimes hardly those, were covered by income. Values dropped to an unbelievably low level and owners who previously had been considered as safe as a bank, ran into severe difficulties.

What was the background to this continuing crisis? When the crisis started in 1974/1975, it was blamed on the increase in oil prices, the general depression in the mid-seventies and the oversupply of ships, especially on the tanker side, from the middle of the seventies onward, and on the bulk side from the beginning of the eighties. Inflation in the seventies was a contributing factor.

The oil price increase took effect in at least three ways: it made the depression deeper and probably also prolonged it: it directly affected running costs: it reduced world oil consumption so that the oversupply of tonnage was exposed. The uncertain currency situation also had a great effect. In addition to all these outside factors it must be acknowledged that there was a lack of decision-making procedures in several ship owning companies, combined with irrational management structures.

Besides these general factors, what was so special during the post 1975 period which made the crisis so deep and so serious?

One of the key elements in this connection is the large size of the units which shipowners are operating today. In the first years after the second world war 10.000 dwt. tankers were big vessels. In 1987 they are considered barges, while tanker tonnage is completely dominated by VLCC's and ULCC's. These new units are very expensive so the capital cost is huge. Previously a shipowner with twenty 10.000-tonners could survive mistakes with some of his units without any disastrous effect. Nowadays very few shipowners can afford to make any mistakes at all with even one unit. The financial consequences of a mistake are now so great that the owner has to have a very strong back to carry it.

An example is the Norwegian shipowner, Hilmar Reksten's chartering-in of four VLCC's. The average rate for the four vessels was US\$3 and the average charter period three years. If the charterparty had run its course (all charters were cancelled by Reksten) the vessels would have been laid up, or traded with results worse than lay up. The total tonnage of the four ships was some 920,000 tons d.w. Monthly charterparty hire was US\$2,760,000, which over three years totalled US\$100 million out of pocket payments. It is obvious that very few owners can carry such a burden.

With big units the changes in value are more violent, for example a VLCC which was ordered at a European yard in 1969. The contract price was US\$18 million. Because of financial difficulties at the shipyard the contract price was increased to US\$ 22 million. The building cost turned out to be US\$ 40 million. A sister vessel was ordered in 1970 for US\$ 28 million. In 1973 as part of an agreed package, this contract was cancelled by the owners. In that year, the yard was able to sell the contract to another buyer for US\$ 60 million with delivery in 1976. The new buyer could not take delivery in 1976 and the contract was cancelled. The estimated price for the vessel at that time, (if a buyer could be found), was approximately US\$ 15 million. Later on the vessel was sold for US\$ 6 million and ended its life at a scrap yard in Taiwan in 1985 for US\$ 3 million.

Top price US\$60 million, bottom line US\$ 3 million. The drop in values of the big units also affected the owners financially because of the terms of their loan agreements. Most of them had covenants that if the ship's market value dropped below a certain percentage of the remaining debt, the loan could be terminated or extraordinary repayment could be required or alternatively extraordinary security could be given. This applied even if the borrower was paying interest and instalments in full, and even if his liquidity forecast predicted that he would have no future problems. When a financing institution demands extraordinary repayment, the owner may be financially embarrassed. Suppose the vessel contract price was US\$ 40 million and the outstanding loan is US\$ 30 million. If the loan agreement states that the outstanding debt must never exceed 75% of the vessel's value, a drop in the ship's value to US\$ 15 million means that the debt must

immediately be reduced from US\$ 30 million to US\$ 12 million that is by US\$ 18 million. If the owner does not have the necessary liquidity, the capital cannot be repaid and the lender has the choice between bankruptcy or a moratorium. If the owner has funds, strict adherence to the loan conditions can ruin the company's prospects. Thus the combination of big units with the loan conditions can bring an owner to the brink of bankruptcy much more quickly than normal.

Covenants can also have a domino effect through cross default clauses. If an owner faced with huge claims for down payments which he cannot meet, is forced into default, the cross default clauses threaten other commitments he has. Daughter companies, mother companies and other related companies can be affected. The cross default clauses are very often worded in a way which makes it impossible for the borrower in renegotiating other loan agreements, to avoid the effects of the cross default. The satisfactory renegotiation of one loan agreement can thus result in an unpleasant surprise on another. A bank syndicate some years ago asked for the extraordinary repayment of US\$ 18 million, simply because the charterer's mother company and guarantor had obtained postponement of one instalment in another successful loan renegotiation.

A final element which increases the seriousness of the problem is the wide-spread use of partnership, where the partners are jointly and severally liable. The insolvency of one easily spreads to the others, and due to the cross default clauses will spread even further. This domino effect has been a nightmare both for owners and bankers, and has in fact been one of the main reasons for a lot of the restructuring seen in the business lately.

- b) When a shipowner is considering his financial and economic difficulties, he has to consider the different categories of creditors which are involved. What kind of creditors they are is very important in deciding how to conduct a renegotiation. The different creditors must be treated equally, or a logical reason found for not treating them equally. Sometimes the reasons do not have to be logical!

One way is to separate the creditors into fully secured and wholly unsecured. The fully secured creditors have, from a financial point of view, nothing to lose from a bankruptcy as they are likely to be repaid in full. Their main inducement to accept a moratorium is commercial, based upon a judgment as to whether a moratorium could expose them to worse risk. In a moratorium period such creditors must normally be guaranteed normal repayment of the debt. The wholly unsecured creditors have everything to lose on a bankruptcy, as they are likely to get nothing. Their hope for the future is an improvement in the market and in the debtor's position enabling him to pay them something.

Another possible grouping of creditors is financial creditors on one side and all other creditors on the other. Among financial creditors there are the normal financing institutions, shipyards and also owning companies who are involved in a lease financing of a vessel. These financial creditors are normally treated in the same manner, even though the formal relationship in the lease arrangement is a charterparty between the debtor and the ship owning company. Charterparties of this kind are normally combined with purchase options, and the real owner is the real debtor. Financial creditors normally have a mortgage in the vessel or, where there is a lease, the ownership of a vessel. The creditors with a mortgage in the vessel may be fully secured or undersecured or totally unsecured. The undersecured financial creditor especially is in a difficult situation. If the ship value is dropping, his exposure increases, and that may be a reason for him not to agree to a moratorium. However there is also the chance of the market going up, so reducing his exposure. He is consequently the most sensitive creditor, and is subject to pressure from other creditors, especially totally unsecured creditors, who are likely to get nothing in a bankruptcy and can only hope for the future. On the other hand as they have so little to lose, they may be tempted to pressurise the other creditors, especially the undersecured creditors, into paying them off by making an application for bankruptcy. Several unsecured creditors have succeeded in such a "blackmail" operation.

The non financial creditors consist mainly of two groups: trade creditors and the owners of ordinary chartered tonnage. The trade creditors may be secured or unsecured. Normally they have to be given special treatment to ensure the continued operation of an organisation. The owner of ordinary chartered tonnage is also in a special situation, as he is able to withdraw his vessel and operate it himself with, theoretically, the same income as the charterer can obtain in the market. The shipowner could, however, perceive an advantage in continuing the relationship with the insolvent charterer because he may have better earnings than the market, for example, through effective pool operation.

The creditors' situation varies of course from case to case. For a debtor who wants to renegotiate with his creditors, the most difficult creditor is the one which is fully secured and consequently has nothing to lose. If he accepts a moratorium, he may end up losing in the future, while he loses nothing in a bankruptcy. To convince him may be a difficult task. On the other hand the easiest creditor to handle is the one who is totally unsecured, because he will be satisfied with very little.

- c) There are several reason why creditors prefer a shipowning company not to go bankrupt.

First of all it is very difficult to predict what the effect of a bankruptcy will be. The operation of the individual vessels will certainly be disrupted and probably stopped for a period. Income will stop coming in. Capital in the group cannot be put to use and the creditors in each vessel may have to supply working capital. Existing contracts may be terminated by the other party and ships could be arrested with the resulting obligation to put up security. The creditors may find difficulty in disposing of the ships. If there are several vessels, their value in a future sale may be affected.

A going concern is normally better than a bankruptcy because it gives the creditors more time if they want to wind up their business with the debtor. Income continues as normal. New working capital is not necessary and the creditors have enough time to prepare for a sale. Furthermore the creditors may fear the domino effect of a bankruptcy, which may influence other customers, other companies in the group and other engagements they have.

The creditors also keep in mind whether the debtor is a long standing customer, even if he presently has no other activities with the banks. If he is both a long standing customer and a future customer in other fields or with other companies, this will affect their decision making. Another reason for not going through a bankruptcy is that many creditors may want to spread their loss over a period of years instead of being forced to take it all immediately. There is an advantage in having a three year period in which to write off the unsecured part of the debt.

Finally the efficiency of the operation is important. If the debtor is running the vessels better and with better income than others can, there is no sense in putting the operation into bankruptcy since with another operator it will make less income. There is also expense and trouble involved in simply changing from one operator to another.

- d) When a shipowner has reached an agreement in principle with his creditors for some sort of moratorium and/or restructuring of the debt, the arrangement will often have three phases. The first task is to agree the phases, and the second, very important, is to decide how the available funds should be distributed to the different creditors.

The first phase may be called "*the stabilizing period*". Often owners reach agreement in principle with their creditors only after they have used up all available funds and are in fact working on negative liquidity, i.e. financing themselves by delaying payment of bills. What is needed is to restore the working capital of the company, since working with negative liquidity is unhealthy, illegal and rather expensive. The normal pattern is for the creditors to agree that only trade debt shall be settled for the time being not financial creditors. For this purpose the parties to lease – charter arrangements are considered financial creditors. Ordinary chartered-in vessels are paid what the vessels are earning up to the charter rate.

Sometimes payments to the financial creditors are only partly suspended, so that interest may be paid. If this method is chosen, the period will be longer than if the non payment system had been adopted, since the funds which are available are the same.

The second phase may be called "*the non default period*", and normally lasts between two and three years, depending on the market outlook. The point here is to give the owners a reasonable chance to survive and it is in the creditors' interest that the owners are able to work normally without consulting the creditors every day. It is better for everyone involved for the owner to concentrate on commercial matters. The owner should be reasonably confident that he will not default. To this end, one of two systems is normally applied.

In the first, a payment schedule is fixed, based upon the owner's budget for the period, but with a qualification that a default will occur only if his payments are lower than a certain percentage of the budget, say 80%. If the budget is reasonably realistic, no default should occur. The other system, is to link the payments to the vessels' earning, on a "pay as you earn" basis; by definition there is no danger of default.

The third phase may be identified as "*the repayment period*". This repayment period is normally only decided upon at the end of the second period, "*the non default period*", and will very often be linked to the market conditions at that time to make a realistic repayment schedule. At this stage the shipowner has to get back to normal. If he fails to meet the requirements of the repayment schedule, he will be in default. In fixing the repayment period and the conditions, the feasibility of restructuring the debt will be examined, including whether the creditors are willing to write off any of it. No decision on write off is normally taken in either of the two first periods, as the creditors prefer to take a longer look into the development of the owner's business. A write off is often combined with a request for fresh capital from other sources open to the owner, so that the creditor may be satisfied that his reduced debt will in fact be serviced.

- e) One of the most difficult decisions is how the available funds should be distributed. There are several possible systems or combinations of systems. As a starting point trade creditors have to be paid in full. Without total agreement on this point it would be extremely difficult to operate a shipping company. The distribution of the remaining funds is based upon the premise that the trade debt is fully covered.

One system of distributing surplus cash is to simulate a bankruptcy and see how much each creditor stands to lose. The income is then distributed *pro rata* to each creditor's uncovered debt. This method is very seldom used to dispose of cash from the operation of vessels, but can be used when funds come from the sale of assets.

Another system is to distribute available cash *pro rata* to the gross debt without making any deduction for the securities the different creditors may have. This system has only been used when the figures turn out to be much the same as those calculated using other systems.

The “*pay as you earn system*” is one of the most commonly used. The basis is that the creditor is paid what his unit is earning, the philosophy being that the creditor is entitled to withdraw the ship, and if he withdraws it, others may operate it on the market and he then has access to the total earnings of the vessel. If there are several mortgage holders in one vessel, the “pay as you earn” principle is combined with the “priority principle”.

“*The priority principle*” has several different versions. One version is that all available funds from one vessel are applied first to pay interest on the first priority, then capital instalments on the first priority, thereafter moving to the second priority. This is combined with a “pay as you earn” principle for that unit.

Another version is to fix the market value of the unit and regard the debt to the extent of the market value as senior debt, to be serviced fully, reasoning that the creditor may sell the vessel at its market price and get that much money back: he should not be in a worse position by accepting a restructuring of the owner’s total indebtedness. The debt above the market value is called junior debt and will be serviced only if there are more funds available. Non service of the senior debt, but not of the junior debt, may be defined as a default.

The “priority principle” may be applied unit by unit linked to the individual vessel’s earning. It can also be applied to the whole group by fixing the market value, and consequently the senior debt, on the total fleet; the income of the total fleet is then applied to the senior and junior debt so that good units support those with a lower earning capacity.

In some companies it may be difficult to define exactly what the earnings of one unit are. In the offshore business the value of the software can be considerable, and the unit alone cannot take the premium for the full earning of the vessel. In such cases we can find “*the modified pay as you earn principle*”. The creditor in one vessel is for example receiving 70% of the vessel’s earning, while 30% is allocated to a creditors’ fund for equal distribution. The reasoning behind this is that this 30% more or less should be considered the software value, which belongs to all creditors and which not can be utilized by one creditor withdrawing his vessel.

The parties often agree to make deductions from the vessel’s earnings to be used as an incentive to the management organisation to secure its full support. Experience shows that to repay old debt is not sufficient incentive

for any organisation, which needs something more concrete in hand than working only for the creditors.

Another sum will often be set aside to make some payment to the unsecured creditors who are not trade creditors, such as third priority mortgage holders or financing institutions which have unrecovered debt from a previous sale of a vessel. To encourage such creditors not to put a company into bankruptcy, it is often necessary to let them have a percentage of the earnings of the group to give them something more than the zero result they would obtain in a bankruptcy.

- f) Two points often cause lengthy discussions in negotiations of the kind described above, that is the structure of the owning company and creditors' control during phases one and two and very often also, phase three. Creditors in the first phase of the discussions are inclined to suggest a transfer of ownership to companies nominated by them with board representation or at least a creditor committee with the ability to restrict the operation. This type of suggestion fades during the negotiations as no one creditor is prepared to take on the burden and most creditors are reluctant to take part in active ownership of a company. No major changes will thus be made in ownership structure or operation

IV. **Moratorium – bankruptcy rules**

Creditors' agreements are very complex and relating to the bankruptcy legislation is often difficult. Before seeking agreement with creditors, a debtor, from a strict legal point of view, should have applied for bankruptcy. Normally he continues to operate with the understanding of all the creditors as a bankruptcy would jeopardise everything for them. As the creditors' agreements never, or at least very seldom, fully conform to bankruptcy principles, it is essential to secure the agreement of all creditors to a restructuring.

V. **Summary**

Experience since 1975 has shown that when faced with insolvency in the shipbuilding industry or in shipowning, creditors take a pragmatic view. There are exceptions, and creditors in some countries may be less helpful than in others. But the ruling guideline is a commercial and economic one, combined with practical shipping. The target is always the same: what arrangement can give the creditor most of his money back? Open mindedness, imagination and dynamism are needed in judging how best to re-organise a company to fulfil the creditors' understandable objective.

PROTECTION OF LIABILITY INSURERS AGAINST SHIPOWNERS' INSOLVENCY IN MARITIME LAW

John Honour

Approximately 90% of world shipping is entered for third party liability insurance with the Protection & Indemnity clubs which belong to the International Group of P. and I. clubs. Accordingly this paper will concentrate on dealing with the position in those clubs.

The International Group of Clubs comprises some 17 clubs in England, Bermuda, Japan, Luxembourg, Sweden and Norway. The clubs are mutual associations: the members bear each others' liabilities and are non-profit-making. Members contribute, in respect of each policy year, their part of the total amount required to meet claims and the cost of administration and no more. There is no element of profit and no limit of liability except when specially arranged and for oil pollution claims. The clubs are controlled by the shipowner members themselves through a board of directors whom they appoint. The nationality of the directors broadly reflects the various flags flown by the ships entered in the clubs. There are no shareholders in the clubs and therefore no-one to whom a dividend has to be paid.

Although the clubs are located in various countries, most of them have rules which are governed by English law. This paper therefore will consider the position under English law in two main parts, namely:-

1. rights of the P. & I. club against a member in the event of that member's insolvency

and
2. the effect on third parties of a P. & I. club member's insolvency.

These two headings overlap, in the sense that the rights of a P. & I. club against an insolvent member affect the position of third parties, but in order to evaluate the effect on third parties, it is helpful first to understand what rights a P. & I. club has as against an insolvent member.

1. Rights of the P. and I. club

The relevant rules of the West of England Club form the basis of this examination, since although the rules of the clubs in the International Group are not identical, most are similar in effect. Indeed, it is only because of their similarity that nearly all the clubs have been able to enter into a pooling agreement, which has existed for many years, under which claims above a certain figure and up to a certain limit are pooled among the clubs which are parties to that agreement.

The contract of insurance between a club and its members is based on the club's rules and it is to these rules that the parties must refer in order to ascertain the rights of a club when a member becomes insolvent. Under the West of England rules and the rules of most clubs in the International Group, if the member is an individual and a receiving order is made against him or he becomes bankrupt or makes any composition or arrangement with his creditors, he ceases to be insured for all vessels entered by him. Similarly, if the member is a corporation it too ceases to be insured upon either the passing of a resolution for voluntary winding-up, or upon an order being made for compulsory winding-up, or upon dissolution, or upon a receiver being appointed.

The West of England club rules provide that cover is likewise terminated if an event having a similar effect under another system of law occurs. Furthermore, the membership ceases immediately upon the happening of any of these events even though the normal period of insurance is from 20th February of one year to 20th February of the next year.

Thus the first and most important effect of his insolvency on a P. & I. club member is that he ceases to be insured, ceases to be a member and is not covered for any risks arising thereafter.

There is at least one club which further provides for cesser of insurance "upon its (i.e. the shipowning company) commencing proceedings under any bankruptcy or insolvency laws to seek protection from its creditors or to reorganise its affairs." This provision would have the effect of terminating the insurance even though the member were allowed to continue operating under the supervision of the Court, for example under certain provisions of Chapter 11 of the U.S. Bankruptcy Code, without an actual liquidation taking place. In the case of P. & I. rules similar to the West of England's, cover would not cease in such circumstances.

Under another rule, when a member ceases to be insured, the club managers can assess the estimated liability of the member for further calls (i.e. additional or overspill calls). These assessments are commonly called releases because upon paying the amount assessed the member is released from further calls. The release, of course, is payable in addition to other calls which may be owed by the member. Accordingly, the practice is for the managers to calculate a release and send out a demand for payment.

Another rule deals with failure to pay calls. The insolvent member may already owe advance calls and he will certainly be unable to pay the release call. So at that stage the member will probably be served with a notice requiring him to pay outstanding calls and releases before a certain date. If he fails to pay, not only does the member cease to be insured, but in addition the club ceases to be liable to pay any claims for which he would otherwise be covered (whether the events giving rise to the claims or liabilities occurred before or after the cessation of insurance). This is commonly known as retroactive cancellation of cover, and the rule applies whether the cessation of insurance took place as a result of non-payment of calls, or, earlier for

another reason such as liquidation.

At the same time there is a rule (commonly known as the "payment first" rule) under which it is a condition of reimbursement by the club that the member shall first discharge the liability incurred towards the third party, or pay the cost or expense which he is seeking to recover from the club. If a member is insolvent, he is unlikely to be able to comply with this rule.

Yet another rule makes it a condition precedent of a member's right to recover from the club that all calls (including releases) have been paid in full by the member. The directors of the club may waive this particular condition, but if they do, the club is entitled to set-off any amount owed by the member against any amount due to him from the club.

The overall effect is that the member cannot make any claim against the club if he has failed to pay calls or releases, whether the claim arose before or after his insurance ceased (whether as a result of insolvency and/or failure to pay calls or releases). Thus, any claims which he has already paid but which the club has not reimbursed, such as repatriation of seamen and crew sickness claims, will not be paid by the club and, in addition, he is not protected against any claims for liabilities already incurred which may be made against him.

Mortgagees are generally not members of a club even though under the mortgage arrangements there may be an assignment of P. & I. insurance to the mortgagees. The policy of the clubs is to issue a letter of undertaking under which the assignment is noted. The club furthermore assents to what is known as a "loss payable clause" under which the club undertakes to pay claims direct to the mortgagees if the mortgagees notify the club that a member has defaulted on the mortgage. The club managers also undertake to give notice to the mortgagees of intention to cancel its member's cover for non-payment of calls.

Mortgagee banks are not entirely happy with this policy. For their part the clubs will not agree to an assignment of cover in favour of the mortgagees or to having the mortgagees entered as co-assured, because the mortgagees will not generally accept responsibility for the payment of calls or releases. On the one hand the mortgagee may take action against the member and his vessels if the member defaults on the mortgage. Indeed when mortgagees arrest vessels for debts owed under the mortgage they have a prior claim against the vessel and rank in front of ordinary creditors, including clubs who are owed calls or releases. This puts the clubs in an unfavourable position compared with the mortgagees. On the other hand, the clubs already make a concession to mortgagees by agreeing to dispense with guarantees from the mortgagee for the payment of calls and releases, notwithstanding the rule under which cover ceases when the vessel is mortgaged unless such a guarantee is provided.

The club is further protected by two rules, one which deals with the employment of lawyers and others such as surveyors, and the other which sets out the powers of the managers relating to the handling and settlement of claims. The managers may

discontinue the employment of lawyers at any time and normally do so where there is a conflict of interest between the member and the club or where cover has been cancelled. The managers also have the right to control the conduct of any claim or legal proceedings in which the club may be involved. A member's cover is prejudiced if he does not follow the managers' recommendations as to settlement of a claim. Furthermore, where the club has provided bail or other security to release a vessel from arrest, the club after due notice is entitled (in the name of the member) to defend, settle or otherwise deal with the claim if the member fails to comply with the managers' recommendations. Thus, where insolvency leads to retroactive cancellation of cover, the club's managers normally instruct lawyers and others to withdraw from the case. If, however, the club has given bail, it remains concerned and will instruct the lawyers to settle the case or if there are merits, to defend the case in the name of the member. Of course, the managers have to consider very carefully whether to instruct a lawyer to withdraw because of the dangers of a default judgement being given against the member when, had it been defended, the case might have been won. If a default judgement were obtained against the member, a third party might try to proceed direct against the club.

A case in point arose in the U.S.A. The member appeared to be insolvent though not actually wound up. There had been an earlier conflict of interest between the member and the club (the club alleging that the member had been in breach of the rules), so the member was being separately represented in defending the claim against him. The stage was reached when the member was unable to pay the costs of continuing separate representation. The lawyers said that unless the club agreed to pay their costs they could no longer act and it was likely that a default judgement would be entered with consequent risk to the club. The club's managers believed that there were defences open to the club under the insurance contract with the member which had nothing to do with insolvency and wished to maintain them. It proved impossible to obtain the services of lawyers to defend the case on the member's behalf without prejudice to the club's alleged defences and a default judgement was accordingly entered against the member. The claimants then stated their intention of pursuing the club under the Third Parties (Rights Against Insurers) Act of 1930. In the event the case was settled before proceedings were commenced.

The club rules contain a London Arbitration Clause under which disputes between members and the club are to be referred to arbitration in London. However, if there are outstanding calls or releases, the club generally tries to obtain security by arresting a member's vessel or other assets. Unfortunately, there are not many countries in the world where vessels can be arrested for outstanding premiums. This is because they are not secured by maritime lien and are not in a class of claims for which arrest is allowed under the 1952 Arrest Convention. However, in England there is another way of seizing a member's assets; that is by means of what is known as a *Mareva* injunction which has a similar effect to an arrest. In the U.S.A. also there is a procedure whereby a vessel can be seized for outstanding insurance premiums although, again, it does not constitute an arrest. Furthermore any Greek flag vessel may be subject to a conservatory arrest in Greece even if it is not in Greece at the time so that the vessel cannot be sold or disposed of while the debt is outstanding.

Of course, the mere fact that assets are seized and security provided does not mean that the club will be paid the outstanding call or release, since the member can insist on arbitration under the club rules and challenge the club's right to claim. However a number of successes have been recorded.

Unfortunately, where a member is insolvent, it is unlikely that security can be obtained for the debt. The club's only remedy is to claim in the liquidation or claim against the proceeds of sale of the vessel. Since there is generally no maritime lien for the debt, the club has no priority against certain other claimants such as mortgagees. The proceeds of sale of the vessel and/or assets are frequently insufficient for the club to recover the debt owed by the former member.

2. The effect on third parties

The English Statute upon which claimants rely is the Third Parties (Rights Against Insurers) Act, 1930, the relevant provisions of which are as follows:-

"1. (1) Where under any contract of insurance a person (hereinafter referred to as the insured) is insured against liabilities to third parties which he may incur, then -

- (a) in the event of the insured becoming bankrupt or making a composition or arrangement with his creditors; or
- (b) in the case of the insured being a company, in the event of a winding-up order being passed, with respect to the company, or of a receiver or manager of the company's business or undertaking being duly appointed, or of possession being taken, by or on behalf of the holders of any debentures secured by a floating charge, of any property comprised in or subject to the charge;

if, either before or after that event, any such liability as aforesaid is incurred by the insured, his rights against the insurer under the contract in respect of the liability shall, notwithstanding anything in any Act or rule of law to the contrary, be transferred to and vest in the third party to whom the liability was so incurred.

.....

1. (3) In so far as any contract of insurance made after the commencement of this Act in respect of any liability of the insured to third parties purports, whether directly or indirectly, to avoid the contract or to alter the rights of the parties thereunder upon the happening to the insured of any of the events specified in paragraph (a) or paragraph (b) of subsection (1) of this section or upon the making of an order under section one hundred and thirty of the Bankruptcy Act, 1914, in respect of his estate, the contract shall be of no effect.

1. (4) Upon a transfer under subsection (1) or subsection (2) of this section, the insurer shall, subject to the provisions of section three of this Act, be under the same liability to the third party as he would have been under to the insured, but:-

- (a) if the liability of the insurer to the insured exceeds the liability of the insured to the third party, nothing in this Act shall affect the rights of the insured against the insurer in respect of the excess; and

- (b) if the liability of the insurer to the insured is less than the liability of the insured to the third party, nothing in this Act shall affect the rights of the third party against the insured in respect of the balance.”

Before the passing of this Act, (i.e. at common law) a third party creditor had no direct right of action against an insurer in respect of any third party insurance effected by an assured who subsequently became insolvent, when the insurance monies became payable to meet the assured's claim (see Halsbury's Statutes of England, 4th Edition, Volume 4, at page 639)

The passing of the Act may have been the result of remarks made by Lord Justice Atkin in *Re Harrington Motor Company Ltd. Ex Parte Chaplin* [1928] Ch. 105 at pages 116 and 117:

“In this case I am of the opinion that the applicant has a real grievance, and if it were possible to decide for him I should very willingly do so. But it appears to me that the general rules of law which govern cases of insurance and indemnity have been laid down in such terms that it is impossible to make an exception in the particular class of cases of which this forms one, and I am bound to say that I myself should be well satisfied if, by the decision of a higher tribunal or by legislation, the general rule of law were altered so as to cover this particular case.”

The case concerned a personal injury sustained in a motor car accident. The decision was followed in *Hood's Trustees v Southern Union General Insurance Co., of Australasia Ltd.* [1928] Ch. 793, which was also a motor accident case.

Thus one purpose of the Act when it was passed was to deal with personal injuries suffered in motor vehicle accidents. But there is little doubt, (and this has been confirmed by more than one English case though it has not been necessary to decide the point) that the Act applies to marine insurance including contracts between P. & I. clubs and their members and that such contracts come within the definition of “contract of insurance” in Section 1(1) of the Act. It has also been decided in at least one case that the English courts will exercise jurisdiction to wind up a foreign company for the purposes of the Act (see *Re Allobrogia Steamship Corporation* [1979] 1 Lloyd's Rep. 190). In the *Allobrogia* case the shipowning company was dissolved under Liberian law. Cargo claimants, who had obtained judgement against the shipowning company, petitioned the English court for the winding up of the shipowning company on the basis of the unsatisfied judgement debt. The court found in favour of the petitioners. In passing, Slade J. considered one of the arguments put forward in the case by the P. & I. club, which had resisted the petition, that any claim against the club was conditional upon the “payment first” provisions in the club rules. Slade J. dealt with this point at page 198 of the Law Report where, in referring to Section 1 (3) of the 1930 Act and the relevant club rule (Rule 28) he said:—

“The effect of Section 1(3) thus, according to its express terms, is to invalidate any provision which is contained in a relevant contract of insurance and purports, directly or indirectly, to avoid such contract or or to alter the rights of the parties thereto upon the

happening to the insured of any of the events specified in Section 1(1), which gives rise to the statutory transfer to the third party of the rights against the insurer under the contract. The manifest purpose of Section 1(3) is to make certain that, in any of the events specified in Section 1(1), the third party shall be able to take the full benefit of the rights against the insurer, unaltered and undiminished by any provision in the contract which is designed directly or indirectly to cancel, prejudice or reduce such rights in the event of one or more such events taking place. The use of the phrase "directly or indirectly" in Section 1(3) shows that a provision in a relevant contract can fall foul of Section 1(3), even though it does not expressly and in terms purport to avoid the contract or alter the rights of the parties upon the happening to the insured of any of the relevant events. The effect of the inclusion of the word "indirectly" is in my judgement that any provision in such a contract which has the substantial effect of avoiding a contract or altering the rights of the parties upon the happening to the insured of any such events is invalidated, even though the contract does not in terms so provide.

Accordingly in my judgement the test to be applied in the present case would be this. Does the proviso to r.28 have the substantial effect of avoiding the contract between the company and the association or of altering the rights of the parties upon the happening to the company of any of the events mentioned in Section 1(1) of the 1930 Act? Clearly the proviso does not have this effect, if the insolvency of a company insured with the association does not ex hypothesi render impossible strict compliance with the condition precedent set out in r.28. Let it be assumed, however, that the insolvency of a company does ex hypothesi have this effect. On this footing it seems to me that the association would find itself on difficult and uncertain grounds in attempting to defend the validity of the proviso, despite what is submitted to the contrary by the learned editors of MacGillivray and Parkington's Insurance Law (6th ed.) at para. 2249. A company which was fully solvent would ordinarily have no difficulty in raising the necessary money to discharge the relevant liability, so as to satisfy the condition precedent to recovery under r.28. Normally only a company in financial trouble would find difficulty in this respect; the nearer its approach to insolvency the greater would be the difficulty, until on the assumption stated, actual insolvency would render satisfaction of the condition precedent impossible. The proviso to r.28 thus would have the substantial effect of avoiding the contract or of altering the rights of the parties upon the insolvency of the company. But, it could be said, the insolvency of the company is not one of the particular events specified in Section 1(1) of the 1930 Act. This is so. Nevertheless, the inability of a company to pay its debts is one of the specific grounds upon which the Court is given jurisdiction by Section 222 of the Companies Act 1948 to wind up a Company and on which winding-up orders are most frequently made in practice. Accordingly, while arguments to the contrary would be available, it might seem but a small step forward to say that the proviso to r.28 would, on the assumption stated, have the substantial indirect effect of avoiding the contract or altering the rights of the parties upon a winding-up order being made on the grounds of insolvency, and that it would, at very least, offend against the spirit of Section 1 of the 1930 Act."

Thus, Slade J. was of the opinion that the proviso to rule 28 of the club rules offended "against the spirit of Section 1 of the 1930 Act" and therefore presumably was of no effect. On the same point, however, Slade J. also indicated that it might have been possible with the co-operation of the petitioners and the liquidator of the company to devise a scheme whereby the liquidator would discharge the shipowning company's debt to the petitioners out of borrowed money which, in due course, would be repaid out of the proceeds of the claims against the club and that such a device would comply with rule 28.

In an American case, *Liman v American Steamship Mutual P & I Association*. [1969] AMC 1669, a shipowner's trustee in bankruptcy was held entitled to recover from the defendant P. & I. club personal injury claims which had been covered by the insurance policy, provided that he first settled the claims and that the applicable deductible in the insurance policy was paid by each claimant to the estate of the bankrupt shipowner. The deductible in each case was \$1,000. Payment by Liman fulfilled the condition of the policy under which the shipowner was indemnified for losses which he became "liable to pay and shall pay". Payment of the deductibles by the claimants ensured they received no undue priority.

Slade's opinion was not necessary for his decision and, therefore, does not constitute judicial authority for the proposition that the "payment first" rule offends the 1930 Act. Indeed, Slade J. went out of his way to say that it was neither necessary nor appropriate for him to reach a final decision adverse to the club on this point, although it appeared to him that there were substantial grounds for arguing that the "payment first" provision did not render the rights against the club valueless in the events that had occurred.

On the other hand there are strong reasons for rejecting these views. The "payment first" provision makes payment by the member a condition precedent to the member's right to claim from the club. There can be no doubt as to the validity of such a provision when a member is solvent. None of the rules, including the proviso referred to above, purports to alter the position upon a member becoming insolvent; thus both the contract and the rights of the parties remain unaltered. If it can be shown that the payment first rule is designed solely to relieve the club of liability when a member becomes insolvent it might then be arguable that the provision is one which "directly or indirectly" purports to alter the rights of the parties upon insolvency and is thus invalidated by Section 1(3) of the 1930 Act. Furthermore, as the learned editors of Arnould on Marine Insurance (16th Edition) at page 1135 state:-

"It is hard to see on a strict interpretation of the Act (i.e. the 1930 Act) how the subsection (i.e. section 1(3)) can apply, since it invalidates only those policies which discharge the Underwriter from liability 'upon the happening' of the insolvency. The Clause in question does not fall into this category since, although the insolvency may make it impossible for the assured to pay the claim, the happening of the insolvency does not of itself bring the Clause into play."

The learned editors go on to state on the same page however, that

"perhaps the Court would feel able to impose a wider interpretation in order to avoid a result which appears inconsistent with the purpose of the Act".

Another important case under the 1930 Act involving a P. & I. club was *The Vainqueur Jose* [1979] 1 Lloyd's Rep. 557. The plaintiff cargo interests, having obtained a default judgement in the U.S.A. and an arbitration award against the shipowners, petitioned the English Companies Court for a winding-up order against the shipowners to enable them to claim under the 1930 Act directly against the P. & I. club in which the shipowners were entered. A winding-up order was duly made

and much later the plaintiffs brought an action against the defendant P. & I. club. The claims made against the club included forwarding expenses which were excluded under the club rules unless the club's board otherwise determined (rule 7(h)). The club, in defending the action, relied on a number of other rules, including rule 8(k) under which the club's board of directors could make a deduction from a claim by the member if the member had not protected his interests as he should have done, and rule 13 under which the club's board of directors had the power to reject the claim if proper notice of it had not been given to the managers.

An action was brought against the P. & I. club, by the cargo interests, standing in the shoes of the shipowner under the 1930 Act. The club's directors met on several occasions to discuss the case and in the exercise of their discretion they decided to reject under rule 13 and make a 100% deduction under rule 8(k) from the claim. The court decided that the club's board of directors was given complete discretion to reject the claim under rule 13 or make a 100% deduction under rule 8(k) provided they complied with general principles applicable to the exercise of discretion. Forwarding expenses were completely excluded under rule 7 and therefore the shipowners were not insured at all for them. The court also came to the conclusion that there was no valid ground for criticising the decision of the club's board not to exercise its discretion in favour of the member or the plaintiffs standing in his shoes, and that there was no improper or unjustified or misguided refusal to exercise the discretion under rule 7(h).

This case highlighted the fact that a third party has no greater rights against an insurer of P. & I. risks than the rights which the member himself has under the contract of insurance.

Another more recent case involving the 1930 Act is *The "Padre Island"* [1984] 2 Lloyd's Rep. 408. This was a case brought against the West of England P. & I. club by cargo owners who had suffered damage to their cargo in 1965. The action was brought against the club under the 1930 Act in the English Commercial Court, the shipowning company having first been wound up in the Chancery Division of the High Court.

The club based its defence on the arbitration clause in the club's rules at the material time, often known as a *Scott v Avery* provision, the effect of which was that no action could be brought in the High Court until there had first been a reference to the committee (i.e. the board of directors of the club) and thereafter to arbitration if the shipowner did not accept the decision of the committee.

The court held that it was not the claim but the contractual rights of the insured which were transferred to the plaintiffs by the 1930 Act and those rights were subject to the arbitration clause including the *Scott v Avery* provision. Accordingly the arbitration clause in the club rules had to be read as though references to the member were replaced by references to the plaintiffs. Although that clause contemplated a dispute with a member, once the claim had arisen it was vested in the plaintiffs following the winding-up of the member. The club was, therefore,

entitled to invoke the *Scott v Avery* provision in defence to the action brought against it.

Some argue that it is inequitable for the clubs to escape liability to direct action under the Third Parties Act, since the Act was specifically designed to prevent insurers from avoiding liability when their assured became insolvent. The clubs' answer would be that the Act was never designed to place the third party in a better position than the assured had he not become insolvent. Furthermore, where calls have not been paid by the member, it is inequitable to require the club to pay a third party without being able to offset the outstanding calls. In the West of England rules, a specific rule makes it a condition precedent to a member's right to recover from the funds of the association, that all calls and other debts have been paid in full. A proviso to this rule enables the board of directors, to waive this condition and to set-off any amount due from the member against any amount due to him from the club.

However, without such a rule, there is little doubt that a set-off would not be allowed. It was decided in *Murray v Legal & General Assurance Society Ltd.* [1970] 2 QB 495, that in an action by a third party against insurers under the 1930 Act following the bankruptcy of the assured, the insurers were not entitled to set-off unpaid premiums owed by the assured. The court's view was that only rights under the contract of insurance in respect of the particular liability incurred by the assured to the third party were transferred under the 1930 Act. The Act did not expressly transfer liabilities of the assured to the insurer. Mr. Justice Cumming-Bruce, at page 503 of the report, concludes that

"The right of recovery of premiums in this case was not a term of the policy which arose in respect of the liability of the assured to the third party. The defendants are in my view left in regard thereto with the same rights as the general body of creditors, namely to prove in the bankruptcy."

It is for the courts to decide whether or not the two rules, the "payment first" rule and the retroactive cancellation of cover for non-payment of calls rule, are valid to protect the P. & I. club from its member's insolvency and the inability of a member to pay first and to pay calls and releases. Although there are clearly arguments on both sides, bearing in mind that the majority of third party claims (other than personal injury claims) are made by subrogated underwriters who have already received a premium for covering their assured's loss, it is difficult to accept that they have any better arguments based on equity than do the clubs. Furthermore, if third parties are really concerned over the possible insolvency of a P. & I. club member they can (and often do in any event, irrespective of the reputation of the shipowner) arrest a vessel to secure their claim, the vessel being released only on adequate security being provided by the club member or his club.

Since the "*Padre Island*" decision, there have been two arbitrations in London involving the interpretation of the 1930 Act and club rules. In one arbitration the effect both of the "payment first" rule and the rule which provides for retroactive cancellation of cover for non-payment of calls were examined and the arbitrator

decided in favour of the club. He came to the conclusion that both rules were valid to defeat a claim by a third party. In the other arbitration only the "payment first" rule was examined but here also the arbitrator decided in favour of the club. The arbitration awards in both these cases were appealed to the High Court.

In *Firma C-Trade S.A. v Newcastle P&I Association (the "Fanti")* [1987], the claim was made direct against the club under the Third Parties (Rights Against Insurers) Act of 1930 by cargo owners who had suffered loss following a casualty involving the "Fanti". The main point to be decided was whether the claimants could recover direct from the club in respect of their loss, despite the fact that the club rules required a claim to be paid by the member before the member had any remedy against the club.

The relevant rule of the club read as follows:-

"4. Subject to the provisions of these Rules, the Member shall be protected and indemnified against all or any of the following claims and expenses which he shall become liable to pay and shall in fact have paid in respect of a ship entered in this class of the Association."

The material provisions of the Third Parties Act are already set out on pages 131-132.

The claimants argued that:

- (1) once there had been a transfer under Section 1(1) of the Third Parties Act, the requirement under rule 4 that the members shall have paid before they can recover from the club ceased to have effect, quite apart from Section 1(3).
- (2) the relevant words in rule 4 purport directly to alter the rights of the parties on a winding up and so have no effect by Section 1(3) of the Act.
- (3) alternatively the same result as in (2) above follows by virtue of the word "indirectly" in Section 1(3).

The learned Judge (Mr. Justice Staughton) decided in the claimant's favour on all three points.

As to (1) the learned Judge concluded that,

"upon the winding-up of the members in this case there were transferred to the claimants all the contractual rights of the members, so far as they concerned this claim, even though the members as yet had no cause of action. Amongst those rights was the term that the members must have paid the claim before they had a remedy against the Association. After the transfer, that became a term that the claimants must have paid themselves. Such a term makes no sense. I do not consider that, in the ordinary or legal meaning of payment, a person can pay himself. At any rate it would be a futile exercise to do so."

and later on in his judgement he said,

“In my judgement once the winding-up order had been made there ceased to be any requirement that the claim should be paid, before the Association could be liable. The rights of the members had been transferred to the claimants, and it would have been impossible or at least futile for the claimants to pay themselves.”

As to (2) the Judge held that,

“the Rules purport directly to alter the rights of the parties in the event of a winding-up: the combined effect of the Act and the Rules is that the third party must pay himself before he can claim against the Association, and that is something which, in my view, he cannot do. So I would hold that the claimants are entitled to succeed on this ground also, albeit with considerable hesitation in view of the novelty of this argument.”

As to (3) the learned Judge decided that,

“a term which indirectly alters the rights of the parties on insolvency is, in my judgement, one that is avoided by section 1(3) of the Act. And the term in this case that a member must have discharged his liability before he can claim against the Association has that effect.”

The case is being further appealed.

Socony Mobil Oil Co. Inc., Mobil Oil Co. Ltd. and Mobil Oil A.G. v West of England Shipowners Mutual Insurance Association (London) Ltd. (The “Padre Island”) (1987) was the other appeal (in addition to *The “Fanti”* reported above). It was taken to the English High Court from an arbitration award where the umpire had found in favour of the P. & I. Association (in this case the West of England). He rejected the cargo owners’ claims under the Third Parties (Rights Against Insurers) Act 1930 for cargo losses on the voyages of the “Padre Island” in the latter part of 1965. The plaintiff cargo owners obtained judgement against the shipowners in the U.S.A. but the judgement was never honoured. The ship owners were in due course ordered to be wound up by the court in England and the plaintiffs started proceedings against the P. and I. club. As a result of the decision of the High Court, referred to on page 9 above, the plaintiffs were obliged to arbitrate.

As in *The “Fanti”* case the main point was whether the claimants could recover direct from the association, despite the fact that the association rules required the claim to be paid by the member before the member had any recourse against it. However, unlike *The “Fanti”* there were other issues (including the effectiveness of the association’s retrospective cancellation of cover clause on the which the umpire also decided in favour of the club) to be determined if the appeal on the main issue were decided against the club.

The material parts of the 1930 Act are already set out at pages 131–132.

In the relevant club rule (rule 2) the club undertook to:–

“Protect and Indemnify Members in respect of losses or claims which they as Owners of the entered vessel shall have become liable to pay and shall have in fact paid as follows
.....”

There then followed a lettered list of risks covered which at letter “J” includes:-

“Loss or damage to or responsibility for cargo”

in the circumstances there set out.

The plaintiffs’ first argument was that section (1) of the 1930 Act transferred to them both the rights under the club cover and the conditions which attached to those rights, and that upon a transfer under the Act the condition that the claim must be paid by the member meant that the third party transferees must pay themselves; such a condition was impossible of performance and therefore should be ignored. This reasoning had the support of Staughton J. in *The “Fanti”* case.

The learned Judge (Mr. Justice Saville) concluded that

“at no time have the Owners themselves had an existing right to be indemnified by the Club in respect of the Plaintiffs’ claim, for such a right only arises under the Club Rules when the Owners have discharged their liability for those claims, which has not happened. In those circumstances I find it impossible to see how it can be said that any present right to an indemnity of any kind has been transferred under Section 1(1) of the 1930 Act to the Plaintiffs – under that Act the Plaintiffs only obtain a transfer of the Owner’s rights; if the Owners have no existing right to an indemnity then no such rights can be transferred to or vest in the Plaintiffs. Section 1(1) of the 1930 Act does not purport to give the third party a right to an indemnity where the insured has no such right – the third party only gets the insured’s rights.”

In the learned Judge’s view the above analysis is supported by the Court of Appeal judgement in *Post Office v Norwich Union* [1967] 2 QB 363, where the Master of the Rolls says (*inter alia*):-

“under that section (i.e. Section 1(1) of the 1930 Act) the injured person steps into the shoes of the wrongdoer. There are transferred to him the wrongdoer’s rights against the insurers under the contract..... Under the section it is clear to me that the injured person cannot sue the insurance company except in such circumstances as the insured himself could have sued the insurance company.....”

Later in his judgement Saville J. says that to adopt the plaintiffs’ argument would be to read

“..... Section 1(1) as having the effect, not of transferring and vesting in the third party ‘the insured’s rights against the insurer under the contract in respect of the liability’, but of creating in the third party a right to an indemnity which the insured never possessed and which accordingly never could be transferred and vested in the third party.....”

In the circumstances the Judge decided on this point that the owners had no right to an indemnity from the club in respect of their liability to the plaintiffs and accordingly no such right could have been transferred to and vested in the plaintiffs under section 1(1) of the 1930 Act.

The plaintiffs' second argument was based on the proposition that section 1(3) of the 1930 Act rendered of no effect the words "and shall have in fact paid" in rule 2, so that the fact that the owners had not paid the plaintiffs' claim was irrelevant. Saville J. dealt with this point as follows:-

"It is common ground that the Owners had no right to be indemnified by the Club until they had discharged their liability to the Plaintiffs. Put the other way round the Owners had at best (subject to the other and for present purposes irrelevant terms of the cover) a contingent right to an indemnity which would arise upon discharging that liability - in short, a contingent right to be reimbursed upon payment. To my mind that right was totally unaffected by the winding-up order: in the words of Section 1(3) nothing in the contract, directly or indirectly, purported to alter (i.e. had the effect of altering) that right - for it remained exactly as it had been throughout. After the winding-up order, as before, the Owners had the same contractual right as they always had, namely that which I have stated."

Later on in dealing with what he refers to as flaws in the plaintiffs' argument he says (*inter alia*):-

"Similarly, if I contract for the right to go on another's land on condition that I only do so on foot, it seems to offend common sense to suggest that when I am unable to exercise my right because I have broken my leg, the condition in the contract has somehow had the effect of altering my contractual rights upon the happening of that event. In both cases the right afforded by the contract remains precisely the same, as in my view is the case with the contingent right of reimbursement in the contract under discussion.

.....

In the second place, the argument treats as one and the same thing the inability of the Owners to pay the Plaintiffs and the winding-up order. These two things are, however, quite different and distinct - indeed the inability to pay (which is the real reason why the problem has arisen at all) necessarily precedes and is the cause of the winding-up order, not its effect."

The learned Judge's decision against the plaintiffs on this main issue was sufficient to dispose of the appeal but as other points in the case were fully argued he proceeded to consider and express his views upon them.

The club had submitted that whatever the effect of the 1930 Act might be, the plaintiffs could not recover against them, since the cover afforded to the owners had been cancelled long before the conclusion of the U.S. proceedings or the winding-up order.

The relevant club rules at the time (i.e. 1965/66) read as follows:-

"21. A Member shall cease to be protected and indemnified by this Association in respect of an entered vessel -

(a) if the Ownership of the vessel is legally transferred; or

- (b) if the entire control and possession is transferred whether by demise charter or otherwise or if the vessel becomes a total loss or is accepted by Hull Underwriters as being a constructive or compromised total loss; or
- (c) if the vessel or the Member's share therein be mortgaged or otherwise hypothecated unless an undertaking or guarantee approved by the Management be given to pay all contributions due or to become due upon the contributing tonnage of the entered vessel, but the Management may, in any case in which it is deemed expedient so to do, waive this provision.

A Member shall cease to be protected and indemnified by this Association in respect of any and all ships entered by him or of his share therein –

- (d) if he fails to pay when due and demanded by the Management any amount due by him to the Association; no forbearance by the Association in demanding or continuing to demand prompt payments of such amount shall prevent the Member from ceasing to be protected and indemnified as provided in this sub-paragraph; or
- (e) if, being an individual, he dies or becomes bankrupt or makes any arrangements or composition with his creditors generally, or if, being a body corporate, it be wound up; unless, in either event, an undertaking or guarantee approved by the Management has been given to pay all contributions due or to become due by the Member (or unless otherwise determined by the Committee); or

.....

Upon a Member ceasing to be protected and indemnified in respect of all vessels entered by him or on his behalf by reason of the happening of any of the events enumerated in sub-paragraphs (c), (d), and (e) of this Rule, there shall be no liability upon the Association for any claims in respect of any such vessels whether already accrued or arising thereafter, but the Association shall nevertheless remain liable to pay claims arising during Policy Years which have been closed prior to the Member having ceased to be protected and indemnified as aforesaid.

.....

- 22. If a vessel is withdrawn from the Association or if for any other reason whatsoever the Protection and Indemnity of a Member ceases in respect of an entered vessel the Association may (a) assess, as at the date of such withdrawal and/or cessation, the liability of the Member for further contribution to Calls in respect of such vessel and the amount of such assessment shall be payable by the Member on demand, (b) release the Member from liability for further contribution to Calls in respect of such vessel upon such terms as the Management may determine to be expedient."

The learned Judge dealt with the club's argument as follows:–

"It was submitted on behalf of the Club that since Owners had failed to pay the release call due under Rule 22, the quoted provisions of Rule 21 retrospectively cancelled any cover the Owners previously had, save in relation to Policy Years closed before the Owners ceased to be protected and indemnified. That exception was not applicable to the present circumstances.

On this aspect of the case I differ from the Arbitrator. The relevant retrospective cesser of cover is expressed to occur "Upon a Member ceasing to be protected and indemnified in respect of all vessels entered by him or on his behalf by reason of any of the events enumerated in sub-paragraphs (c), (d) and (e) of this Rule". On the facts found by the Arbitrator, the Owners ceased to be protected and indemnified either when the vessel was sold, or when the notice given by the Club expired on 20th February 1967. Neither of those events is included in the events enumerated in sub-paragraphs (c), (d) or (e) of Rule 21. Thus in my view it cannot be said that the Owners ceased to be protected and indemnified by reason of any event falling within those sub-paragraphs: because before they could operate the Member had already for other reasons ceased to be protected and indemnified. It follows to my mind that the stipulated circumstances triggering the retrospective cesser of cover never occurred, so that this provision of the Club Rules never came into effect."

Saville J. also dealt with the plaintiffs' argument that Rule 21 was a penalty clause. On this aspect the Judge's view was in favour of the club's submission that Rule 21 could not be considered to be a penalty clause since it did not require the contract breaker to pay money in the event of breach.

Two other points were argued, one dealing with the club's submission that the plaintiffs' claim was time-barred and the other dealing with the club's contention that statutory interest could not be claimed because of a club rule which provides that in no case shall a member be allowed interest on his claim against the association. On both these points the learned Judge's views went against the club.

The case is also being appealed to a higher court.

The decision of Mr. Justice Saville on the main issue in favour of the club contrasts with the decision of Mr. Justice Staughton in *The "Fanti"* case (referred to on page 137). As regards the other issues on which the Judge gave his views in *The "Padre Island"*, it should be mentioned that the retrospective cancellation of cover provisions which existed in the club's 1965/66 rules and which the Judge said were of no effect have since been substantially amended as also have the rules of many other clubs. Accordingly it is submitted that the Judge's reasoning in *The "Padre Island"* would not affect the validity of present club rules on this subject.

It will be of great interest to see what conclusion is reached by the Court of Appeal.

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PART II
REPORT

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Mr. Richmond M. Eustis	– New Orleans	Mr. Guy Fages	– Paris
Mr. Geoffrey J. Fletcher	– Antwerp	Mr. Emmanuel Fontaine	– Paris
Mr. G.J. Fowler, III	– New Orleans	Mr. G. A. Frilot, III	– New Orleans
Mr. Gerard T. Gelpi	– New Orleans	Mr. J. Y. Gilmore, Jr.	– New Orleans
Mr. Paul Goemans	– Antwerp	Mr. Lars Gorton	– Stockholm
Mr. Luc Grellet	– Paris	Mr. P.J.S. Griggs	– London
Professor R.P. Grime	– Southampton	Mr. Raymond P. Hayden	– New York
Mr. Reginald M. Hayden	– Miami	Mr. George J. Healy	– New Orleans
Mr. N.J. Healy, III	– New York	Mrs. M.–J. Heitzler-Illig	– Paris
Professor Rolf Herber	– Hamburg	Mr. Finn Hjalsted	– Copenhagen
Mr. Neal D. Hobson	– New Orleans	Mr. Thomas R.H. Howarth	– New York
Prof. M.A. Huybrechts	– Antwerp	Mrs. Laetitia Janbon	– Montpellier
Mr. R.E. Japikse	– Rotterdam	Mr. James B. Kemp, Jr.	– New Orleans
Mr. C.B. Kende	– New York	Mr. Donald J. Kennedy	– New York
Mr. T.H. Kingsmill, III	– New Orleans	Mr. Herman Lange	– Antwerp
Mr. Jacques-Max Lassez	– Paris	Mr. Pierre Latron	– Paris
Mr. J.D. LeBlanc, Jr.	– New Orleans	Mr. T.A. LeGros	– Seattle
Mr. Bjorn Leste	– Stockholm	Mr. Raymond T. LeTulle	– Philadelphia
Mr. D.A. Lindquist	– New Orleans	Mr. Herbert M. Lord	– New York
Mr. Charles E. Lugenbuhl	– New Orleans	Mr. David W. Martowski	– New York
Mr. H.M. McCormack	– New York	Mr. Corrado Medina	– Genova
Ms. F.M. Mendieta	– Bogota	Mr. John C. Moore	– Riverside
Mr. James F. Moseley	– Jacksonville	Mr. Francis J. O'Brien	– New York
Miss Geraldine Pageard	– Paris	Mr. Richard W. Palmer	– Philadelphia
Mr. Gordon W. Paulsen	– New York	Mr. Gordon L. Poole	– San Francisco

Mr. William W. Pugh	- New Orleans	Professor Jan Ramberg	- Taby
Mr. Kenneth E. Roberts	- Portland	Mr. Jean S. Rohart	- Paris
Mr. Jan M. Sandstrom	- Gothenburg	Professor David J. Sharpe	- Washington
Mr. Richard A.A. Shaw	- London	Mr. Francesco Siccardi	- Genoa
Prof. W. Tetley, Q.C.	- Canada	Mr. Sergio Turci	- Genoa
Mr. G.J. Van Der Ziel	- Rotterdam	Mr. Hendrick Vanhoutte	- Kalken
Mr. Ajay Verma	- New Orleans	Mr. E.D. Vickery	- Houston
Mr. D.R. Villareal, Jr.	- Tampa	Mr. Enrico Vincenzini	- Livorno
Mr. Henry Voet, Jr.	- Belgium	Mr. Kenneth H. Volk	- New York
Professor Enzo Volli	- Trieste	Mr. Jean Warot	- Paris
Mr. Robert P. Whelan	- New York	Dr. FL. Wiswall	- Reston
Mr. Peter S. Wiswell	- New Orleans	Mr. Luc R. Wyffels	- Antwerp
Mr. Benjamin W. Yancey	- New Orleans		

REPORT OF THE COLLOQUIUM AT TULANE

The Colloquium took place at Tulane between November 9th and 12th 1987 and was attended by 113 participants, listed at page 151 and 152. The Chairman was Professor Francesco Berlingieri, President of the CMI, while Professor J.C. Schultz who had convened the Colloquium and prepared its papers, was the General Rapporteur, taking the place of Judge Haight who was unable to be present because of his judicial commitments.

The first part of the first day was devoted to speeches. Professor Eamon Kelly, President of Tulane University, and Professor Robert Force, Director of the Maritime Law Center of the Tulane Law School, joint host with the Maritime Law Association of the United States, warmly welcomed the Colloquium to the University, and to the city of New Orleans.

The President's opening address was given by Professor Berlingieri.

He spoke of the CMI tradition of alternating Conferences with Colloquiums. He remarked that although the immediate purpose of the present meeting was not to achieve unification but rather to study the legal problems involved in the subject matter, the results could well form a basis for future unification or, at least, harmonisation. The method of work would differ from a Conference in that the participants attended as individuals rather than as delegates of national MLAs, and would contribute their own knowledge and experience.

Professor Berlingieri believed that the importance of the subject would emerge from Professor Schultz's Keynote Speech and from the presentation of each (preliminary) paper (reprinted as Part I of this volume) which would follow.

He suggested four aims for the Colloquium:

To collect information as to the law and practice of as many countries as possible about as many of the topics discussed in the preliminary papers as possible;

To consider and compare the effectiveness of the existing means of protection against insolvency;

To consider additional means of protection;

To consider the possibility of harmonising the existing means of protection.

The preliminary papers were intended, he said, to crystalise some ideas about the type of issues which might come under consideration in relation to each group of interests which needed protection and to serve as a foundation for the study to be done during the Colloquium.

Professor Berlingieri then outlined the division of the subjects among four working groups in the following way:-

1. Protection of lenders including banks with mortgages and/or hypothèques:
Chairman: Jean Warot
Rapporteurs: Graeme Bowtle
Emery Harper
Jeremy Baer
2. Protection of lessors:
Chairman: Nicholas J. Healy
Rapporteur: Richard Barnett
3. Protection of shipbuilders and shiprepairers:
Protection of liability insurers:
Chairman: Jan Ramberg
Rapporteurs: Ralf Richter
John Honour
4. Protection of shipowners:
Protection of shippers and charterers:
Chairman: William Birch Reynardson
Rapporteurs: Takeo Kubota
Ole Lund

The four groups would meet for seven sessions. On the morning of the last day of the Colloquium, the chairmen would report to a full session of the Colloquium on the deliberations of their groups whereupon Professor Schultz would sum up.

Professor Berlingieri stressed the importance of active participation from everyone under the guidance of the Chairmen and with the assistance of the Rapporteurs, and he invited the participants to choose which group to attend after hearing the introductions by the authors of the preliminary papers.

After Professor Schultz's keynote speech, reproduced in full below at pages 156 to 161, the authors presented the preliminary papers they had written and circulated before the Colloquium. The participants then chose which of the four working groups to join. The procedure suggested by Professor Berlingieri was followed so that after the chairman of each Group had presented his Report to the full Colloquium at the final session, Professor Schultz summed up the proceedings (again, his speech is reproduced below at pages 218 to 219). Professor Berlingieri brought the Colloquium to an end, stressing the importance of the work which had been done covering so much ground. He expressed the hope that as much detail as possible would be preserved to form the foundation for further study to be undertaken on these topics after proper consideration by the CMI.

As always, the social aspects of the Colloquium were both valuable and enjoyable. All participants were bidden to two evening receptions, one hosted by the CMI at the Plimsoll Club, high in the Trade Center with a spectacular view of New Orleans scintillating by night and an orgy of oysters, and the other, hosted by the United States MLA, in the privileged surroundings of the Historic New Orleans Collection, one of the oldest houses in the French Quarter, lovingly restored and maintained. Most participants were able to see some of this lovely city during their all too short free time. Their spouses were able to explore further afield; some intrepid spirits braved the Bayou in a small boat!

Professor Berlingieri expressed the gratitude of the Colloquium to the Local Arrangements Committee for their hard work ensuring the smooth and efficient running of the event.

KEYNOTE SPEECH

Professor J. C. Schultz

When reading the preliminary papers different, and sometimes contradictory, reactions crossed my mind. Before indicating the nature and colour of those threads, may I first say that we might have had no preliminary papers, at least not of the same high linguistic quality and not so perfectly presented, without the enormous amount of work put into the book by a person who is not even mentioned in it but to whom all of us are greatly indebted: I am surely speaking on behalf of all authors if I express our gratitude to Glenys Travis who did a perfect editing job, saw to it that the book was correctly presented, and prepared the index. And, on behalf of Mrs. Travis and myself, may I also thank the authors for their great willingness to listen to and accept the suggestions which were made from our side, whether linguistic or relating to the contents of the papers.

* * * * *

For several years now conditions in the shipping market have been so bad as to justify the qualification "depression" or even "crisis".

Large shipowning or chartering names have hit problems and received much publicity, and we will hear more about them in the coming days. They are, however, outweighed in aggregate terms by small-to-medium-sized owners if judged by the number of forced sales of ships, mostly after foreclosure of mortgages. In many countries shipyards have been, or still are, in difficulty even if they did not actually go bankrupt.

No wonder, therefore that a colloquium on Protection against Insolvency in Maritime Law should be thought opportune.

Now, protection against insolvency has a practical, economic side which is outside our province. If arrest and foreclosure are rendered necessary because the borrower in reality never had a comfortable working capital base, the lender might have protected himself by not lending. But this is not a legal consideration, and we are not immediately concerned with it.

A slight touch of the law is felt where a shipper under a bill of lading has a choice between a "freight prepaid" and a "freight payable at destination" bill of lading. His choice may be influenced by the risk of the carrying ship being arrested and sold during the voyage. Perhaps he should never have picked this carrier anyway. Again, under a time charter, it will be better to insist on a bill of lading signed on behalf of the master so that the owners are under a duty to carry the cargo to its destination if the voyage should be interrupted because of the bankruptcy of the charterers.

But one wonders how often these and similar considerations in day-to-day practice have any impact on what people actually do.

Protection against insolvency may be hidden in rules which form part of the general law, particularly the law of contracts. A statutory right to cancel a contract may liberate an owner of containers from a contract of hire entered into with a party which becomes insolvent. Or the apparent loss of reliability on the part of the other party may constitute a breach of a fundamental term.

I said that these rules "form part of the general law". This is correct but we should be careful. "The general law" may be understood as "the law other than maritime law" or as "the law other than insolvency law". We are, indeed, dealing with a three faced diamond. Hopefully it will come out of our discussions slightly less rough than before.

"General law" as well as "maritime law" may create entitlements or rights which give protection both in situations which I would call "normal", that is where there is no insolvency, and where there is insolvency.

Liens and "privileges" come to mind. Their creation is "automatic": the lien arises automatically upon the occurrence of an event.

It would be impossible not to stop here for a moment and to air our hesitation when, as non-United States lawyers, we are faced with United States' law on maritime liens.

Why, if creation is automatic, do United States lawyers talk about "putting a lien on the ship" in a case of ship repairs, and why are there time charter party clauses providing for a lien on sub-freights? Let us look here at the index of our book of preliminary papers so meticulously prepared by Glenys Travis, and in particular the entry "contractual liens". "In Japan, not recognized – page 106." But at page 106 Mr. Kubota says no more than that under Japanese law a lien arises only by operation of law and that it cannot be created by agreement. It does not follow necessarily that a lien under a ship repair contract made in the United States of America and/or governed by United States law could not arise or could not be recognized somewhere else.

* * * * *

Mr. Chairman, so far I have been discussing situations where, in actual fact, none of the parties consciously considered the possible ways of protecting itself against the insolvency of the other. Before entering this field I would invite you to focus your mental eye on a higher, somewhat more abstract level.

Maritime law is a special branch of the law. This is true for countries which have no such institutions as admiralty courts, and the more so for countries which do have them, even if there is not always logic in the distribution of jurisdiction among the various courts in such countries.

Even so, the prevailing impression one has after having read the complete book is perhaps this: there are basic notions and ideas which recur in all our legal systems. It is around such basic notions that we may try to fit the kaleidoscopic information set out in the papers.

I take as my starting point *privity of contract*: a contract has effect only between those who are parties thereto. This is certainly well established everywhere.

In many situations, however, the effect of a contract is not really restricted to the parties. Take a contract of sale. One of the main purposes thereof is the transfer of property in the goods from the seller to the buyer. This immediately affects the rights of third parties inasmuch as creditors of the sellers can no longer seize or attach the goods. Obligations of the owner as such pass from the seller to the buyer.

All this may happen independently of what the parties consciously contemplated. They probably did not give one minute's thought to such seemingly abstract matters.

However, for our purpose the matter becomes more interesting as soon as the parties, or at least one of them, starts actively and consciously considering its own position within a context encompassing other creditors of the debtor, of whatever nature such creditors may be. Now, of course, it may be possible to kick the ball into another debtor's court, for example by insisting on a third party guarantee or a letter of credit or a cross liability clause. But if that is impossible, the question arises: what can be done to obtain a privileged position, that is, a position which is better than, privileged with respect to, that of other creditors?

It is this "jockeying" for a priority position which induces the parties consciously to move the chessboard pieces formed by the so-called "real rights", the rights which are effective *erga omnes*.

Here we meet old friends such as mortgages and hypothèques. The shares in a one-ship company may be pledged, as Mr. Bowtle mentions on the first page of his paper. However, a mortgage may not always be available or it may be unsuitable. It is at this juncture that we come across a phenomenon that is well-known in general law: the use of the right of property to obtain a legal position which has priority over that of other creditors. And we should not be surprised that, just as in general law, there are difficulties in accommodating this use of the right of property within the framework of the law.

Mr. Barnett discusses the leasing of ships and then states (at page 72):

The lessor has legal title to the property and thus for many purposes is regarded as the owner of the property. The owner of property has liabilities and obligations, many imposed by statute and many of which cannot be contracted out of.

The lessor is also the supplier of financing to the property user and attempts to achieve a legal position with respect to the property which is superior to that of the user's other creditors. But the notion that the "owner" of property can have an interest in the property which is superior to that of the user's creditors, many of whom have liens granted by statute or recognized as part of the general maritime law, is difficult to accept and appears unfair in certain situations.

No wonder that courts repeatedly had to take decisions in this grey borderline area and that courts or legislators tend to intervene by distinguishing between true leases on the one hand and conditional sale agreements or other types of security arrangements. And where conditional sales are mentioned, we cannot fail to meet reservations of property, again an example of a typical use of the right of property giving rise to the application by legislators of what Professor Richter calls the "principle of publicity of encumbrances".

Now, the tragic fact is that all these efforts to obtain the best possible position may still leave the participants empty-handed. In shipping there is a much greater vulnerability for secured creditors because of the possible concentration of the debtor's fortune in one asset, the ship. The possessory lien of a ship repairer may ruin the mortgagee's tranquillity. An arrest or attachment by a simple unsecured trade creditor may create a situation where the secured creditor cannot enforce his right to the fullest, theoretical extent. And the value of the ship or ships may be insufficient to cover the claim.

Mr. Ole Lund's paper on "Financial crises in shipping since 1965" in reality is the maritime illustration of a development which has been taking place in general non-maritime law. It is the saga of dissatisfaction with traditional bankruptcy law and its automatic cutting off of the debtor's trading personality followed by liquidation of the debtor's assets, a dissatisfaction also with moratorium proceedings where official trustees step in at least to join in the management of the debtor's company.

An interesting article by members of four firms of solicitors in the International Financial Law Review of January 1987, informs us about the collapse of Wah Kwong, Hong Kong's third largest shipping company in January 1986, with debts of \$855m after the collapse of their charterers KKL (Sydney) and Irish Lines. Restructuring the company's debt was the watchword. Unless every creditor agreed, they tell us, it could not work. There were two IPP's (Interim Payment Plans) and a permanent DRA (Debt Restructuring Agreement). Could a dissident creditor have obtained the Court's sympathy?

Creditors find continuation more advantageous than bankruptcy (says Mr. Lund)... the legal niceties are forgotten, and a pragmatic commercial view of the cruel economic facts soon becomes dominant.

And Mr. Lund then states the reasons why creditors prefer to avoid a shipowning company's bankruptcy and he shows us how the arrangement between creditors is commonly structured or better perhaps, how the restructuring is taking place. As I said, in general non-maritime law, the same tendency exists to move from bankruptcy and moratorium to composition proceedings and from there even to restructuring without court intervention. Mr. Kubota's paper shows how one particular legislator distinguished between bankruptcy, rehabilitation and composition proceedings.

On the international level, legal niceties there are, indeed, and even in composition proceedings, at least if not all creditors agree. In traditional bankruptcy law, Mr. Bowtle tells us,

The English Courts do not give effect to the provisions of foreign insolvency proceedings. If such proceedings are pending against the owner (e.g. Chapter 11 of the U.S. Federal Bankruptcy Code) then the Court is not prevented from exercising its jurisdiction as if no such order had been made.

However, at the same time United States courts vacated attachments on United States bank accounts owned by the bankrupt Swedish Salen Company, stressing the bankruptcy objective of assembling all the debtor's assets in a single proceeding so that all creditors would be bound by the one disposition.

Now, if this is the situation with respect to classic bankruptcy proceedings, how much more difficult to grasp will it be with regard to composition proceedings which are not even known to all legislations.

But it cannot be our objective to discuss general composition law or the general principles of conflicts of law.

* * * * *

At the beginning of my address, I stated that there are basic notions and ideas which recur in all our legal systems. I developed a sort of Chinese fan of which the central staff was privity of contract which was then unfolded to become an arch of "real rights" enforceable *erga omnes*.

However, we have more illustrations, of a different nature, of this principle. In general law, the insolvency of a broker may induce us to try to create a direct relationship between the broker's clients and a third party. Where a forwarding agent is adjudicated bankrupt, what happens to the claim for cargo damage which, for all purposes other than that the forwarding agent contracted in its own name, belongs to its client, the cargo owner? And where an insured person or company which is liable in tort is adjudicated bankrupt before the actual payment to the victim has taken place, how can we make sure that the latter benefits in full from the liability cover previously taken out by the tortfeasor? Mr. Honour's paper puts us in the middle of disputes current in the English courts with respect to the rights of the injured third party in the case of the insolvency of a P. & I. club member.

Here we are dealing with somebody (I refer of course to the injured third party) who cannot protect his own interests. It is the legislator who has to consider whether statutory rules are necessary.

Mr. Chairman, too many mental gymnastics may become dangerous. Why, I wondered one moment during the preparation of this speech, did nobody mention insolvency of insurance companies or P. & I. clubs? But look at page 76 where it is said in connection with breach of warranty by the lessee – bareboat charterer that

Owner's equity insurance does not protect against the risk of non-payment under the charterer's policy because of bankruptcy of the underwriters or club or if the primary insurance does not cover because of non-payment of premiums by the assured.

For more information see Murray, in *Tulane Law Review* 1985, and from the United States point of view, Montgomery "Marine Insurer Insolvencies – Who pays the claims?", in the *Journal of Maritime Law and Commerce* 1987, page 395 and following.

* * * * *

A few days ago one of the New Orleans newspapers carried a story under the caption "Dead Man Returns Wants Land". It told us of a man who had disappeared 15 years ago, was declared legally dead and now filed suit seeking title to land his wife sold while he was missing. The wife's lawyer said he believed the man had disappeared to escape debts. He noted that the man had been gone long enough to escape most debts.

Now this may not be maritime law; it certainly is protection against insolvency. I would suggest that we range this man in the same category as the disappearing charterer and restrict our discussion to, at least *prima facie, bona fide* debtors.

WORKING GROUP I
PROTECTION OF LENDERS INCLUDING BANKS WITH MORTGAGES
AND/OR HYPOTHEQUES

Chairman: Jean Warot
Rapporteurs: Graeme Bowtle
Emery Harper
Jeremy Baer
Members: Enzo Volli
M.J. Heitzler-Illig
Jose M. Alcantara
James B. Kemp, Jr.
Leopold Aisenstein
Luis Cova-Arria
Thomas H. Kingsmill
Howard M. McCormack
Neal D. Hobson
Gerard M.C.C. Bruyninckx
H. Lange
Capt. Fredk. F. Burgess, Jr.
Frank L. Wiswall
William Pugh
Dewey R. Villareal Jr.
Pierre Emo
Mrs. L. Janbon
Emmanuel Fontaine
Claes Fontaine
Francis O'Brien
Bjorn Leste
P. Goemans
Kenneth E. Roberts
Corrado Medina
Pierre Latron

The first three papers formed the basis of discussion for Group I.

In introducing the first paper, Graeme Bowtle reminded the audience that the acquisition of ships depends upon banks and that the protection of the banks in the event of a ship purchaser's insolvency is critical to their preparedness to lend, a sentiment echoed by the other two authors. Another concern common to all three was voiced by Jeremy Baer, who presented Roger Wilman's paper:

".....banks, as key parties to the initiation of the transaction, cannot understand how other creditors whose rights arose later, can erode their position."

Emery Harper singled out foreclosure for consideration, mentioning as problem areas the recovery of cash on falling values, the detrimental effect of arrest of ships, the effacing of some but not all liens through the *in rem* process, the difficulty of co-ordinating a group sale worldwide, the transference of rights to the proceeds of sale, interlocutory sale of a wasting asset, and the finality of foreclosure by mortgagees.

Banks believe their task has become more complicated. They are subject to increasing pressure to show a good profit for their shareholders as well as safe investments for their depositors, in the face of growing international competition to lend money. They are also faced with uncertainty as to the value of the property on which the loan is secured, after several trade depressions. There is also a growing feeling that an enterprise must be kept alive if at all possible, to preserve its value for all the creditors, should foreclosure become inevitable. Re-organisation, however, never provides water-tight alternative security for the original lender. Borrowers are increasingly internationally based so that enforcement proceedings may have to be brought in unforeseen parts of the world. It is more imperative than ever to make sure that collateral security in addition to the ship itself, such as insurances, are documented as certainly as possible.

* * * * *

The Group composed a series of questions, the answers to which were collated and formed a comprehensive base for the discussion. They have been incorporated, with the papers on bankruptcy produced by Group IV, into a Summary which is to be found at page 193.

* * * * *

Report

The report on the Group's work was delivered by Graeme Bowtle:-

A. Documentation

1. Mortgages

The position was considered under the laws of the United States of America, Liberia, the United Kingdom, France, Belgium, Netherlands, Italy, Sweden, Spain and Venezuela.

Although in these countries there are different methods of creating a mortgage or hypothec on a ship, the primary objective is to create an enforceable charge which is registered with the appropriate government agency and therefore there is a degree of conformity between the different forms of mortgage and hypothec.

We set out in the Schedule a comparison of the different requirements for a mortgage or hypothèque and it will be seen that there are differences both as to form and procedure. The standard form of hypothèque in civil law countries is a relatively short document – in certain cases a printed form – whereas the standard form of USA or Liberian preferred ship mortgage or a British deed of covenant is generally a more complex document which sets out in detail duties and liabilities of the mortgagee.

However, because of the requirement of ship financing banks to include in hypothèques the “standard form” clauses that are generally found in preferred ship mortgages (USA) or deeds of covenants (UK) there is a trend to conform mortgage documentation. In particular detailed clauses relating to insurances, maintenance and operation of the ship, events of default and the mortgagees’ powers of enforcement (even where these are specified by the proper law) are often now included in a hypothèque making it a more detailed document and comparable with the preferred ship mortgage or the deed of covenants.

Certain of these clauses could perhaps be standardised for inclusion in both mortgages and hypothèques

It was also noted that there was a tendency in certain countries to limit by legislation the effect of standard clauses in contracts which were not consumer contracts and it was agreed that in the area of ship financing this was a tendency that should be deprecated.

2. Collateral documents

Mortgagee banks often require security in addition to the mortgage or hypothèque on the ship and such security includes a specific assignment of the earnings and the insurances (to the extent that these are not included in the mortgage or hypothèque) a specific assignment of a time or demise charter, personal and corporate guarantees, charges on cash deposits, collateral charges (i.e. charges on other property of the owners) and stock pledge agreements.

We discussed additional or alternative ways in which mortgagees could secure their position and in particular we considered the following.

First: the ship could be purchased and registered in the name of a trustee but operated by the “owner” under an operating agreement. This may limit the effect of certain insolvency laws by preventing the ship being part of the estate of the “owner” if the “owner” became insolvent. However the extent to which such a structure would be effective was questioned since if the trustee was merely the nominee of the “owner” the property may well be deemed to be that of the owner and if the trustee was merely the nominee of the mortgagee then it would in effect be a leasing transaction.

Second: the owner could be required to provide a bond issued by an insurance company to cover a possible financial default by the owner. Apparently this had been done in the United States although in certain countries it was considered that the provision of such a bond would be extremely expensive.

Third: in the present market conditions where shipbuilders were often (directly or indirectly) subsidised by their governments they may agree to give a guarantee to the mortgagee of the resale price of the ship. The effect would be that if the mortgage were enforced by a sale of the ship then the shipbuilder would either agree to "re-purchase" the ship at a specified price or alternatively would agree to pay the difference between the actual sale price of the ship and a guaranteed resale price.

3. Ships under construction

It was noted that hypothèques could be registered on ships under construction in Belgium, Italy and France.

It is not possible to register a mortgage on a ship under construction in the United States or Liberia (because until the ship is completed and registered there is no ship against which to register the mortgage), nor is it possible to register a mortgage on a ship under construction in the United Kingdom under the Merchant Shipping Act, 1894, although it is possible to grant an equitable mortgage. However it was noted that under Section 4 of the Canada Shipping Act, 1952 it is possible to grant a mortgage on a ship under construction in Canada.

B. Enforcement

1. Attachment or arrest proceedings

In all countries the validity of the mortgage or hypothèque is a question of the *lex situs*, the law of the state of registry, except in the Netherlands where it is the *lex loci contractus*.

The methods of enforcement in different countries were considered in detail since each country has a procedure for the attachment of a ship in order to enforce a mortgage. In civil law countries if the mortgagee has an enforceable title, e.g. a notarial deed in which the owner has acknowledged the debt, then the ship can be attached and sold by the court without formal court proceedings. If the mortgagee has no enforceable title then the procedure is for the ship to be attached in *saisie conservatoire* proceedings pending court judgment being obtained. In certain cases this will result in the ship remaining under the attachment for several months until the mortgagee obtains judgment and the ship is sold in auction.

In the United Kingdom the procedure is that the mortgagee issues a writ *in rem* against the ship and the ship is then arrested by the Admiralty Marshal. The mortgagee may then apply to the court for the ship for a sale *pendente lite* on the basis that the cost of maintaining the ship under arrest until all the disputes have been determined is uneconomic. A sale *pendente lite* generally takes between sixty and ninety days. After the ship has been sold the funds are paid into court and once the mortgagee has obtained judgment he can apply to the court for the determination of priorities, if there are competing maritime lien holders, and the payment over of the proceeds.

In the United States and Liberia the procedure is similar.

In most countries the ship is sold by auction, but in the United Kingdom the ship is sold by tender.

In the United States, Liberia, France, Italy, the Netherlands and Venezuela the mortgagee may bid for the ship and in Italy, Liberia and the United States he may set off the mortgage debt against the purchase price although in Italy may have to provide a guarantee equal to the amount of the preferred creditors' claims.

2. Possession and power of sale

In most civil law countries a mortgagee does not have a right to take possession of the ship although such a right may be specifically included in the hypothèque in the Netherlands, Sweden and Venezuela.

Under English law a mortgagee has a right to take possession of the ship and such a right may be provided specifically in the mortgage in the United States and Liberia.

In English law a mortgagee has a statutory power of sale (Section 35 of the Merchant Shipping Act, 1894) and in the United States and Liberia a power of sale can be included in the mortgage. Also in certain civil law countries a mortgagee may have a power of sale where this is specifically included in the hypothèque.

3. Exchange control and Taxes

On the sale of the ship there are no restrictions on the remittance of the proceeds of sale to the mortgagee (assuming that the court directs payment to the mortgagee) except in France, Italy, Spain and Sweden where the necessary exchange control approval must be obtained.

There are no taxes on the proceeds of sale in most countries except Italy and Spain.

4. General

Although, again, there were different procedures in the various countries since the object of the procedure was the attachment and sale of the ship, there was in very general terms a limited degree of conformity between the various countries.

C. Effects of Insolvency

The most important differences between the various countries were in the area of insolvency law and the extent to which the insolvency laws can prevent a mortgagee enforcing its rights under a mortgage or hypothèque.

There has been a tendency for countries to revise their insolvency laws so as to alter the emphasis from the protection of the secured creditor to the protection of the debtor and/or the unsecured creditor. In the United States, Chapter 11 provisions relating to re-organisation have been in force for many years and it is only relatively recently that similar provisions have been enacted in other countries. In France the new bankruptcy law introduced in 1985 severely limited the right of a mortgagee to enforce its security where the owner was bankrupt and in the United Kingdom the Insolvency Act, 1986 introduced restrictions on the right of a mortgagee to enforce its security against an insolvent owner.

There is a draft EEC bankruptcy law but although it has been discussed it has not been adopted by the EEC countries for several reasons. Apparently the main reason is that the taxation authorities in each country will not agree to waive the priority accorded to them in national law.

Conclusion

The conclusion of the discussion was that it may well be possible to harmonise hypothèque and mortgage documentation. This tendency will be encouraged by ship financing banks instructing the lawyers to conform their documentation. There may even be a limited degree of harmonisation by the courts of each country recognising the decisions and the procedures of other courts in other countries. It would appear however, that there is little prospect of harmonising insolvency laws themselves, and indeed the tendency is for countries to adopt widely different insolvency laws which give a widely varying degree of protection to mortgagees.

Jean Warot – Chairman)
Jeremy Baer)
Graeme Bowtle)
Emery Harper)

WORKING GROUP II

PROTECTION OF LESSORS AND BAREBOAT CHARTERERS

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In introducing this subject, Richard Barnett directed the Colloquium's attention to the *Equilease* case and described another which re-inforced the *Equilease* conclusion. That was *Customs Fuel Services v. Lombas Industries*. The First Mississippi National Bank loaned money to a company to finance the purchase of a vessel and secured the loan by a preferred ship mortgage. When the shipowner defaulted the bank foreclosed on its mortgage and purchased the vessel at the Marshal's sale. The bank tried to find a purchaser for the vessel but was unsuccessful.

The former shipowner found employment for the vessel and approached the bank with an offer to charter. To effect the charter arrangements, the bank first sold the ship to a subsidiary on credit. They gave back a demand note and a preferred ship mortgage in return. The subsidiary then leased the vessel under a bareboat charter to a company controlled by the former shipowner. All of the earnings from the vessel were assigned to the Bank. The subsidiary played no active role in the supervision of the operation of the vessel or the financing arrangements. The operation of the vessel was unsuccessful and Customs Fuel Services brought an action *in rem* against the vessel and *in personam* against the bareboat charterer and the subsidiary for the value of the fuel supplied to the vessel. The bank intervened to enforce its preferred ship mortgage on the vessel. If the bank held a valid mortgage under U.S. law, its claim would have priority and the trade debt claimants would take nothing.

The Court decided that the bank had engaged in inequitable conduct in that the subsidiary company was but an instrument of the bank, to the detriment of the plaintiff supplier, since it had attempted to do indirectly what it could not do directly. The doctrine of "equitable subordination" meant that a shipowner who had the benefit of mortgage financing must subordinate his proprietary interest to the liens of the vessel's creditors: "Admiralty does not allow vessel owners to thwart the claims of legitimate lienholders by using a ship mortgage for a purpose it was not meant to serve".

Mr. Barnett suggested that it would be interesting to discuss to what extent these decisions lessened the attractiveness of lease financing where a lessor supplies all the financing.

Report

The Group discussed lease finance under six main headings:-

- I Reasons for leasing;
- II The lessor's status;
- III Protection of the lessor against tort claims in case of the lessee's insolvency;
- IV Protection of the lessor against contract claims arising out of the operation of the vessel in case of the lessee's insolvency;
- V Protection of the lessor against the lessee's inability to pay hire and other sums due to the lessor;
- VI Effect of bankruptcy or reorganisation proceedings on the lessor's rights.

I Reasons for leasing

It was the consensus that the principal reasons for leasing were:-

- less costly financing;
- more desirable accounting treatment afforded to lease transactions;
- the right of the lessor to take possession of the vessel if the lessee defaults;
- eligibility to engage in coastwise and other restricted trades;
- and in some countries, eligibility for government subsidies.

II The lessor's status

There was unanimous agreement that under typical forms of lease the status of a lessor is that of a true owner of the vessel, with the rights and obligations incident to ownership, as contrasted with the status of a mortgagee, who has only a security interest in the vessel.

III Protection of the lessor against tort claims in case of the lessee's insolvency

Under this head the Group considered the types of liabilities to which the lessor might be exposed, and methods of protection against each type of liability.

It was the consensus that insurance was the principal method of protection against claims in tort, and the availability of insurance coverage to protect the lessor against each type of tort liability was examined.

As to some types, no particular problems were foreseen, provided the lessor made certain:-

1. that the lease required the lessee to take out and pay for insurance, in proper form and amount, with approved insurers, protecting the lessor as well as the lessee as assureds, and
2. that such insurance was in fact obtained and kept in force.

P & I insurance would protect against the lessor's liability for:-

1. wreck removal costs;
2. water pollution, including clean-up costs;
3. personal injury or wrongful death for which the lessor might be liable, for example by reason of a defect in the vessel at the time of delivery to the lessee. P & I insurance would also cover any claim which carried a maritime lien against the vessel including, for example, personal injury or wrongful death arising under United States law, or the law of Liberia, whose "general maritime law" is that of the United States;
4. damage to piers, wharves, bridges and other fixed objects for which a maritime lien would arise in United States law, the law of Liberia, and possibly the laws of some other countries;
5. one fourth of the liability to another vessel in a collision case, for which a lien might arise, when three-fourths of the liability was insured with hull underwriters and the remaining fourth with P & I insurers;
6. the full liability to another vessel in a collision case, for which a lien might arise, when all of the liability is insured with P & I;
7. damage caused by explosion and fires, which might give rise to maritime liens under United States and Liberian law, and possibly under the laws of some other countries;
8. claims for cargo damage which might give rise to maritime liens;

9. fines and penalties imposed on the vessel for water pollution or for other illegal activities such as drug smuggling.

With respect to this last category, it was the consensus that P & I insurers would cover the lessor's liability for water pollution under the 1969 Convention on Civil Liability for Oil Pollution Damage or the U.S. Federal Water Pollution Control Act. They would also cover its liability for fines and penalties imposed on the vessel or the lessee for smuggling by the master or a crew member. There was some concern about the lessor's right to recover in the event of confiscation of the vessel by governmental authorities for violation of anti-smuggling laws, or for other illegal activities of the lessee itself, without the lessor's privity. But it was felt that it should be possible for the lessor to obtain coverage, perhaps from its owner's equity or breach of warranty underwriters, against such a loss.

Loss of, or damage to the vessel by an insured peril would be covered by the marine risk hull and machinery policy, or by the war risk hull and machinery policy, depending upon the cause of the loss, unless, in the case of a marine peril, such as fire, it was found that the lessee's misconduct, such as arson, brought about the loss. In the latter case, an innocent lessor would be protected by owners' equity or breach of warranty insurance.

The hull policies would also cover claims against the lessor and the vessel for salvage services, general average contributions, and the vessel's liability for collision damage to other vessels, to the extent it was not covered by P. & I.

Other means of protection were discussed, including the creation of a separate corporate entity to own the ship. Such an entity would be a subsidiary of the financing institution, however, and recent decisions in the United States suggest that Courts may tend to pierce the corporate veil in a major disaster and disregard the separate corporate identity of the registered owner where the registered owner is the mere *alter ego* of its parent. A separate corporate entity was thought nonetheless to be of use in protecting the owner in some situations and may have other advantages, such as facilitating the transferability of the financing.

The possibility of using a trust arrangement to protect the financing institution against third party tort claims was also discussed.

In the United States a lease financing transaction frequently involves an owner trust, whereby legal title to the property is held by an owner trustee – a bank or trust company – for the benefit of the beneficial owner of the property. The beneficial owner is known as the owner participant. The owner participant is the financing institution which puts up the money to invest in the ship. Since, under United States law, the owner trust is regarded as a separate legal entity from the owner trustee or the owner participant, the owner trust arrangement provides some additional protection against liabilities arising out of the operation of the ship. In general the view in the United States is that the trust arrangement could not be

relied upon to protect the financing institution in the event of a major casualty where third party claims were not covered by insurance.

The trust arrangement may be useful for administrative or other reasons, however, it cannot be used in European or in other civil law jurisdictions whose jurisprudence does not recognise the legal concept of the trust.

Limitation of liability under the 1957 Convention, the 1976 Convention and the United States Limitation of Liability Act was discussed in some depth. The consensus was that the lessor was a shipowner and therefore entitled to limit its liability under all three regimes, even under circumstances where the lessee would be denied limitation because of "actual fault or privity" if the 1957 Convention applied, wilfulness or recklessness if the 1976 Convention was applicable, or "privity or knowledge" if the United States Limitation of Liability Act governed. It was therefore agreed that limitation presented no real problem for the lessor.

IV Protection of the lessor against contract claims arising out of the operation of the vessel in case of the lessee's insolvency

The Group discussed the potential liabilities of the lessor for ordinary contract claims connected with the operation of the vessel in the event the lessee fails or is unable to pay such claims, as he is required to do under the lease or bareboat charter. Such claims could include wage claims and claims for repairs, supplies and stevedoring. It was the consensus that the lessor would have no direct liability to third parties *in personam*, but would be exposed through the potential priority of such claims over the lessor's interest in the vessel. The laws of various countries were discussed regarding priorities of contract claims in mortgage situations. It was the conclusion of the Group that contract claims brought *in rem* constituted a genuine threat to the lessor's security and that various protective measures should be considered.

Among the measures discussed, three devices were given particular consideration:

- (a) creation of a mortgage;
- (b) registration of the bareboat charter;
- (c) actual notice to creditors of a prohibition against lien provisions in the charter.

In the United States as a result of recent decisions, considerable doubt exists as to whether a leasing company can create a valid preferred mortgage lien in favour of its parent.

Many countries now permit registration of a bareboat charter. The United States does not. However, even in those countries permitting registration, registration is of limited legal benefit to the lessor.

Although the bareboat charter can provide that the charterer may not incur liabilities or grant liens which have priority over the lease payments, such a provision would be without effect as to third parties who were not on actual notice of the charter. Various means of notice were discussed, such as stamping of invoices that supplies are for the account of the charterer and not the owner, or the posting of signs to that effect on the vessels.

Under United States law a preferred ship mortgage normally has priority over third party liens for necessities arising against the vessel subsequent to the creation of the mortgage. In a lease situation, since the lessor does not have security interest in the vessel but is the owner, such third party liens could be held to defeat the lessor's rights. It was the view of the Group that the most protection that can be provided to the lessor would be to ensure that notice of a prohibition against liens clause is given whenever possible. Merely specifying that charterer's failure to notify is a default under the lease would not be of help as against third parties.

V Protection of the lessor against the lessee's inability to pay hire and other sums due to the lessor

If the lessee becomes insolvent the most obvious risk to the lessor is that the lessee will cease paying hire and the lessor will lose the benefit of its bargain. The lessor also faces the risk that the ship itself may be lost because of legal proceedings commenced against the ship by the mortgage, holders of maritime liens or others holding rights against the ship. If the lessor loses the ship to those with prior rights, the lessor may also lose tax benefits which are unvested at the time of the termination of the lessor's ownership. The prior position of the lessor with respect to the ship is obviously quite inferior to that of a mortgagee.

The principal remedy available to the lessor in the event of a default is the retaking of the ship. This remedy appears to be available in most countries whose practice was considered. If the lessor succeeds in retaking the ship the lessor may sell the ship or operate it or charter it out to recover its loss. The lessor in most countries has an obligation to mitigate damages.

The remedy of retaking the ship is simpler and less costly than legal proceedings to enforce a mortgage. This appears to give the lessor an advantage over the mortgagee.

However, in practice the remedy of retaking is subject to serious limitations. If the ship is subject to a mortgage or other liens or rights, the lessor may have to pay or settle such claims in order to obtain possession and use of the ship.

Furthermore, in the United States, at least, the lessor cannot forceably retake the vessel if the lessee is unwilling to hand over possession voluntarily. The lessor may then find it necessary to commence a possessory action in admiralty to obtain a court order directing the lessee to hand over possession. Such a proceedings may be

shorter than a foreclosure proceedings, but in some circumstances the lessee can raise defences which will delay the lessor.

VI Effect of bankruptcy or reorganisation proceedings on the lessor's rights

The Group considered the extent to which a lease financing transaction will be affected by a bankruptcy or reorganization proceedings involving the bareboat charterer.

In the United States, if the bareboat charter has not been terminated in accordance with its terms prior to the commencement of the proceedings, the interest which the debtor has in the lease is considered to be a property interest which becomes part of the bankrupt estate. This appeared to be true in most other countries as well.

In many countries legal recognition will be given to a contractual provision to the effect that a charter will terminate on commencement of bankruptcy proceedings. This is not true in the United States. Under United States bankruptcy law a lease cannot be terminated because of the commencement of proceedings or the appointment of a trustee, even if the bareboat charter so provides.

In most countries, after the commencement of bankruptcy proceedings the lessor cannot take steps to re-take the ship unless certain conditions have been met. The position is similar to that of the mortgagee who cannot arrest the ship after commencement of bankruptcy proceedings unless, in the United States, for example, the automatic stay is lifted.

A considerable variation exists among countries as to the extent to which the orders of a bankruptcy court may attempt to affect actions taken with respect to property such as ships physically located outside the country in which the bankruptcy court sits. Many courts, as a result of the doctrine of comity or express statutory provisions, will give recognition to orders of a bankruptcy court affecting property such as a ship located in the court's jurisdiction.

Many countries recognize the right of a trustee in bankruptcy or a receiver to continue a bareboat charter party to which the debtor is party as bareboat charterer. However, the conditions under which the trustee may do this vary considerably from country to country. The laws and practices of many countries require the trustee to act promptly to fulfil strictly the terms of the charter party if the trustee wishes to preserve its benefit for the bankruptcy estate. In the United States the decision of the trustee to assume or reject the charter may be effectively delayed for a substantial period of time, during which the lessor may receive a rental or hire which is substantially less than the contract rate. This is not true in other countries. Of course, the entire problem of assumption or rejection of the agreement is one which the mortgagee does not have to face.

In the United States, in order to regain possession of the ship after bankruptcy on a negotiated basis, the lessor may be required to agree to a substantial reduction in its claim for damages arising out of the breach of the lease.

Conclusion

It is obvious that absolute certainty in the protection of lessors against insolvency is an impossibility. Nevertheless, if careful attention is given to the preparation of the financing documents, to the maintenance of proper insurance, and to minimising the risk of the creation of liens and other preferred charges against the vessel, a lease arrangement can be made a relatively safe method of providing the financing necessary for the construction or purchase of a vessel, despite the fact that the lessor, as an owner, assumes the legal consequences of ownership, which are not encountered in the traditional mortgage arrangement.

Christopher B. Kende, Secretary

Richard B. Barnett, Rapporteur

Nicholas J. Healy, Chairman

WORKING GROUP III

PROTECTION OF SHIPBUILDERS AND REPAIRERS PROTECTION OF LIABILITY INSURERS

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Finn Hjalsted

Group III considered two entirely separate sets of interest – shiprepairers and liability insurers.

Ralf Richter, introducing the first subject, rationalised the six types of legal protection afforded to shipyards and repairers into two categories, the rights of retention derived from the Civil Codes and the rights of lien which had grown up in Common Law countries. Four questions ought to be considered in connection with each type: whether a right of retention or possessory lien holds good against a ship's owner who is not the debtor; secondly whether that right could defeat the claim of a mortgagee on foreclosure or arrest, and where the right of retention should rank relative not only to mortgages, but also to salvage claims, property damage claims

and maritime liens; whether protection by right of retention ought to be independent of continuing possession by creating a new kind of registrable charge; and whether, where a debt is not incurred by the shipowner himself, should his other ships, as well as any ships belonging to the debtor charterer, be liable to seizure.

Report

Discussions in Group III demonstrated a great variety of approaches as to the protection of a shipyard, but concentrated on its position as a repairer.

The laws of some countries grant a right of retention, rooted in non-maritime law such as civil codes or the law of bailment, which is fundamentally a right to retain a vessel or to refuse delivery. That is also true of the possessory lien in the United Kingdom. Both types of security are subject to the continuation of possession. Loss of possession by release clearly terminates the right to retain. Arrest on the application of the creditor shipyard, because it changes the special character of the possession, also destroys the right of retention.

While most countries recognise the right of retention in some form, unification seems impossible.

Some Civil Law countries additionally grant a maritime lien for the cost of work done on the master's orders to permit the voyage to continue (Art. 2.5 of the 1926 Convention). This maritime lien is of no practical importance given present day telecommunications.

On the other hand, a right of retention is more acceptable to long-term financing institutions than a maritime lien which would add one more hidden encumbrance to those already existing. It is not desirable to have an extended list of maritime liens in the Convention nor to include a lien for repair work among them.

It is desirable, however, that the right of retention should not depend upon whether the owner or the bare-boat charterer placed the repair order.

This conclusion may be justified in different ways, but at the very least, the value added to the ship by the shipyard should give the shipyard the right to defend its right of retention against a shipowner's suit for release.

Some legal systems put forward the theory of the implied authorisation of the bare-boat charterer, and even of the time-charterer, to bind the ship. Shipowners should be aware that ships might be exposed to a right of retention unless the charterer had no authority to bind the ship and the shipyard knew it.

Competition between the claims of the ship's repairer and its mortgagee can arise only if the ship is without interruption in the shipyard's possession when the action to enforce a mortgage or a maritime lien is started, with the arrest of the ship by someone other than the ship repairer.

Generally speaking, priority would be given to a ship repairer's claim on the distribution of the proceeds of a forced sale. There is some variation among the different national legislations, for example, the law of the United States favours a mortgagee who is an United States national.

The holders of maritime liens are in a different position. Apart from the law of the Netherlands, which places the ship repairer's claim above all others, the laws of most countries give the ship repairer's claim priority above the mortgagee's but not above all other maritime liens. It must be said that these latter are normally satisfied by hull and liability insurers before it comes to a competition.

The value added by the ship repairer is not only retained by the vessel but also inures to the benefit of privileged claimants. Since it is impossible to mark the borderline between those claims which deserve protection ahead of a shipyard's claim and those which are not affected by the ship repairer's work, the right of retention should rank ahead of mortgages and hypothèques but behind those maritime liens listed in the 1967 Convention, in the distribution of the proceeds of a forced sale following arrest or bankruptcy. The ship repairer should be aware that his right of retention could not give him full protection if the vessel is burdened with unsettled claims for wages, salvage, property claims, claims for personal injury and death, and oil pollution, etc.

The Arrest Convention 1952 allows a creditor with a maritime claim as defined in the Convention, which includes ship repairs, to arrest a ship which belongs to the personal debtor, and in addition, the sister ships belonging to the personal debtor whether the latter is the owner or the bareboat charterer. The Convention permits the arrest of a repaired ship when the work was done at the behest of the bareboat charterer only to the extent that national law gives a right *in rem* and it is doubtful that another ship bareboat chartered by the bareboat charterer of the repaired ship can ever be subject to arrest.

For the second part of the workshop's sessions, the Group was invited to consider the ethics of shipowners' liability underwriters' position under their rules. P & I Clubs, as mutual insurance associations, believe they ought not to be bound to pay claims directly to third parties, and safeguard themselves through the "payment first" rule. John Honour referred to the reluctance of both claimants and insurers to test that position in the courts, and to the surprising coincidence of two such test cases appearing in the High Court in England at the same time. The two cases were heard by different Judges who, less surprisingly, came to different conclusions, ensuring hearings in the Court of Appeal and, probably, in the House of Lords.

Report

The first question to be considered was:

should third parties have a right of direct action against an insurer of a shipowner's third party liabilities when the shipowner goes bankrupt? Are there laws in other countries similar to the 1930 Third Party (Rights Against Insurers) Act?

During the discussion, it became clear that only in some states in the United States and in some Scandinavian countries, is there a right of direct action against an insurer irrespective of whether the shipowner is bankrupt. In some other countries, such as Belgium and Italy, although there is no right of direct action, there is a procedure whereby a third party can indirectly claim against the insurer. These rights seem to be the result not of considerations of public policy, but rather of a general development of the law.

The consensus of opinion was that unless there are strong reasons of public policy, as in the case of oil pollution and motor insurance, there is no need either for compulsory liability insurance or for a right of direct action against the insurers.

In the case of cargo claims, there are no such considerations especially as cargo interests usually insure themselves.

It is not desirable to proliferate the circumstances in which compulsory insurance is made mandatory by governments, adding unnecessarily to the administrative work involved in carrying out a contract.

The second question to be addressed was whether liability insurers ought to be able to avoid third party action when the assured shipowners go bankrupt, through having a "payment first" rule. The group concluded that there was no reason not to uphold the rule as between the assured and his insurer, but that public policy might influence the attitude of legislatures and courts when third parties were involved. The insurer might benefit unfairly if he had received the premium for the insurance yet was able to avoid paying a proper claim, but equally, he ought to be able to set off any premium owed against that claim.

The Group thought it would be unwise to extend the list of maritime liens to cover unpaid premiums, and to allow a right of arrest as a maritime claim under the proposed revised Arrest Convention would be more satisfactory.

The Group did not reach any conclusion about the desirability of permitting the retroactive cancellation of cover on non-payment of calls, but thought that the same considerations of public policy would apply both to the position as between insurer and assured and between insurer and third party as were noted in the discussion about the "payment first" rule.

WORKING GROUP IV
PROTECTION OF SHIPOWNERS
PROTECTION OF SHIPPERS AND CHARTERERS

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Lars Gorton

Patrick Griggs

Introducing his paper on the Protection of Shipowners, Takeo Kubota emphasised how important it is for people involved in this sphere to know the limitations of the laws of bankruptcy worldwide. His observations were based on the Japanese law of bankruptcy, which, for example, applies only to property in Japan. Thus, once a ship is outside the jurisdiction, it may be arrested even by Japanese creditors. Inevitably, since the same rule applies to rehabilitation and recomposition procedures, a shipowner wishing to make use of such procedures must negotiate with his creditors to prevent them disrupting his arrangements.

Conversely, Japanese law does not admit the validity of similar procedures in other countries so that a ship may be arrested in Japan despite Chapter 9 or Chapter 11 proceedings in the United States.

Takeo Kubota's aspiration is rather for reciprocal and international recognition for bankruptcy procedures preferably through a Convention. Then cargoes could be carried to destination, a ship could return to her home port and continue to trade, while all claimants would apply to and be dealt with by one jurisdiction.

Ole Lund's speech complemented and expanded his preliminary paper by concentrating on the problems confronting shippers and charterers upon the insolvency of a shipowner.

The cargo owner's problems, are usually immediate. Must he as a matter of law accept a lien on the cargo? If he has accepted a bill of lading incorporating the terms of a charterparty, what is the charterer's responsibility for amounts due under the charterparty?

These problems mirror the rights which the ship owner has over the cargo, as described by Takeo Kubota. They are usually solved fairly easily when it is the ship owner who is insolvent. On the other hand, creditors rarely make any strenuous endeavour to support a defaulting charterer, especially if the charterer has misused his rights in issuing bills of lading. Legal questions of fraud and misuse often dominate the discussions.

Trade creditors are in a special position in that they will be paid off first. The other creditors such as mortgagees, permit the necessary funds to be used to secure the continued running of the shipping company.

The charterer's position is more complicated. As Ole Lund sees it, the short term problems are: how to fulfil the next voyage commitment and what should be done regarding the nomination of vessels if he has a freight contract? There are other questions. Is he entitled to cancel? Can he secure his prepaid freight? Can he make a set-off? Has he a claim for compensation and what is that worth? For the future, he must again consider his pool obligations and his freight contract obligations, among others, in deciding how he can protect himself the next time he makes a chartering commitment. But the most important aspect for a charterer is how to keep a ship in service.

Report

The task facing Group IV was threefold: first, to review the various types of action, under statute law, contract and self help, available to shipowners, charterers and shippers to avoid or reduce loss from insolvency; second, to consider the effectiveness of such types of action: third, to discuss possible improvements to existing law and practice and whether harmonisation is practical.

The Group first considered what action shipowners, charterers or cargo owners could take to protect themselves in respect of the insolvency of trading partners as set out below.

A. Protecting shipowners from the insolvency of:-

(i) Ship builders and repairers

The following types of action are open to a shipowner to protect himself from the possibility of insolvency:-

- (a) provide in the contract with the shipbuilder that the latter should waive any lien or right of retention on the vessel;
- (b) provide in the contract with the shipbuilder that title to the vessel should pass progressively to shipowner;
- (c) obtain a bank guarantee with interest in respect of instalments paid;
- (d) make payments direct to the shipbuilder's subcontractors thereby obtaining title to the various components of the vessel; it was also suggested that where there was a building programme involving more than one vessel, the shipowner could obtain security in the promissory notes issued by the shipowner for the first vessel until other vessels were delivered.

As regards possible action on the *actual* insolvency of the shipbuilder/repairer, two main types of action are available to the shipowner:-

- (a) obtain repayment of the instalments already made;
- (b) negotiate with the liquidator for delivery of the vessel at a fixed price.

The Group discussed the possibility of "co-ordinated" action by all owners where a bankruptcy involves a number of vessels ordered by various shipowners. The bankruptcy of shipyards in Sweden and Yugoslavia and the co-ordinated actions taken were specifically mentioned. In both cases the results of co-ordinated action were satisfactory for the shipowners. Although they had to pay the increased costs, additional funds were also made available from public sources.

(ii) Charterers

The Group recognised that a distinction must be drawn between bareboat charters, on the one hand, and time charters on the other. Some of the points made below are more relevant to bareboat charters than to time and voyage charters. The following preventative measures, were considered appropriate:-

- (a) check the charterer's financial standing;
- (b) provide in the charter party that liens of all types are prohibited;
- (c) safeguard financial security by obtaining
 - (1) a performance guarantee from the bank(s) and/or the "mother" company
 - (2) an advance payment covering two or more monthly hire payments;
- (d) make sure that the charterer has time charterer's P & I insurance and a time charterer's liability insurance;
- (e) give notice to known or likely suppliers of the vessel that the owner will not be liable for necessities supplied to the vessel;
- (f) avoid giving rights to the charterer to sign bills of lading;
- (g) ensure that the charterparty contains provision for a lien on subfreights which should also be recorded in the bill of lading;
- (h) include in the charterparty a specific provision enabling the shipowner to cancel the contract and withdraw the vessel in the event of non-payment of freight or hire.

Upon the occurrence of an insolvency, a shipowner can then:-

- (a) withdraw the vessel from hire;
- (b) exercise a lien on the cargo;
- (c) exercise a lien on subfreights;
- (d) have the option to commence bankruptcy proceedings;
- (e) renegotiate with subcharterers;
- (f) attach other assets of the charterer;
- (g) involve cargo underwriters.

(iii) Ship agents

To protect himself from the threat of insolvency a shipowner should:-

- (a) avoid advance payments, and, if this is not possible, furnish the agent with only limited funds in advance;
- (b) require that all money related to the vessel should be paid into a separate account or into a joint account and that all freight is paid directly to him;
- (c) demand that the agent presents a fidelity bond and joins a liability club;
- (d) obtain a waiver of all of the ship-agent's rights of lien in the agency agreement;
- (e) demand that shares in the agency company are pledged as security;

whereas, upon an actual insolvency, a shipowner should:-

- (a) isolate his own funds;
- (b) attach property belonging to the agent;
- (c) co-ordinate action with the Trustee in Bankruptcy;
- (d) stop all further payments;
- (e) negotiate for the assignment of payments.

It was observed that some of these measures might conflict with national bankruptcy laws.

(iv) Banks

The Group considered that protecting a shipowner from the insolvency of a bank presented severe difficulties in practice. However, shipbuilding contracts should provide that the owner should not be liable to the ship builder if the bank which has undertaken to advance funds during the course of building, fails to do so.

(v) Cargo interests

The shipowner should:-

- (a) insist on "freight earned, freight prepaid" bills of lading or at least that freight should be paid before breaking bulk;
- (b) refuse to accept cesser clauses, and insist on a lien on cargo clause;
- (c) avoid freight prepaid bills of lading; (It was observed that in English and Canadian law "prepaid" means "prepayable");
- (d) make sure that the forwarding agent is the agent of the shipper;
- (e) make sure that there is an effective lien; the lien clause should be broad and clear.

(vi) Insurance companies

The best a shipowner can do is to:-

- (a) ascertain what coinsurance and reinsurance arrangements have been concluded by the hull insurer;
- (b) consider the list of members of a P & I Club;
- (c) consider the quality of management of a P & I Club.

Above all, the shipowner should be satisfied that his insurance broker should not only be competent but should also be financially sound.

B. Protecting charterers from the insolvency of:–

(i) Shipowners

To reduce the risk of being involved in an insolvency, a charterer should be advised to:–

- (a) check the financial standing of the owner;
- (b) obtain a performance guarantee from a bank or from a “mother” company;
- (c) introduce a clause giving the charterer an option to buy the vessel on the owner’s insolvency;
- (d) provide for the charterer’s right to take over management of the vessel on owner’s insolvency;
- (e) provide for an appropriate termination clause in case of the owner’s insolvency;
- (f) make sure that owners do not have the right to apply any liens against the charterer;
- (g) make sure that the vessel is in good order and condition;
- (h) check that insurances are appropriate;
- (i) make sure that only charterers may sign bills of lading and that only charterers’ bill of lading forms may be used;
- (j) avoid prepayment or at least accept only short advance payment periods;
- (k) demand a second mortgage as security for owner’s performance;
- (l) prohibit the owner from assigning charter hire.

Members of the Group then discussed the various measures which could be taken before and after bankruptcy and again stressed the lack of uniformity of the bankruptcy laws and protective measures in various countries. It was agreed that a Sub-Group should prepare a general memorandum on this subject (incorporated in the Summary at page 193). The following measures were mentioned in particular:–

- (a) seizure of the vessel;
- (b) piercing the corporate veil.

(ii) Other charterers

It was agreed that the charterers concerned are either head charterers or subcharterers. A very important basic principle is that the “in between charterer” should always make his charter on a “back to back” basis as far as possible, including jurisdiction and choice of law clauses. A particular measure was suggested, namely that the charterer should always demand freight before breaking bulk.

(iii) Cargo interests

Charterers may take the following precautions:-

- (a) ensure that voyage charterparties and bills of lading do not contain clauses relieving the shipper from liability to pay freight, demurrage etc. (cesser clause);
- (b) check type and quality of cargo; consider possibility of dangerous cargo;
- (c) ensure that cargo is properly insured for general average purposes.

C. Protecting cargo interests from the insolvency of:-

(i) Carriers, both ship owners and charterers.

Cargo interests may encounter more difficulty than others in protecting themselves against the insolvency of others. Steps they may take include:-

- (a) checking on the carrier's financial standing;
- (b) ascertaining where the vessel's P & I cover is placed;
- (c) checking seaworthiness and class maintenance and hull insurance;
- (d) arranging for freight to be payable at destination and avoiding "freight earned upon loading" clauses;
- (e) avoiding clauses referring to the charterparty and making clear who signs bill of lading;
- (f) checking coverage of cargo insurance.

Upon the occurrence of an actual insolvency however, they may:-

- (a) discharge the cargo and containers from the ship unless agreement is reached about the onward carriage of the cargo;
- (b) initiate discussions with other interests involved, such as mortgagees, suppliers and trustees in bankruptcy;
- (c) ascertain the obligations of the owner in relation to a bankrupt charterer.

(ii) Forwarding agents

The members of the Group agreed that the term "freight forwarders" should not be used and, instead, the term "forwarding agent" should be adopted. A forwarding agent assembles cargo for the account of and on behalf either of a shipper or of a carrier and accepts no liability for the carrier.

Cargo interests must therefore:-

- (a) make sure in whose name the forwarding agent is acting;
- (b) make sure payment is made direct to carrier.

(iii) Insurance companies

It is essential for cargo interests to be able to rely upon the primary insurance cover, so they should:-

- (a) ascertain the financial position of their cargo underwriter;
- (b) satisfy themselves that the carrier is entered with a P & I Club of repute;
- (c) be satisfied that their broker is competent and financially sound.

Comparative effectiveness of the protection given by the measures listed

While the Group made no novel recommendations regarding the measures open to the parties under consideration, the discussion of the effectiveness of the measures was wide ranging and thought provoking.

The Group accepted that the protective measures stem from three sources: statute law or codes; contract; and self help.

The discussion of statute law centred on the right of some parties to secure their claim by way of maritime liens as provided by national law, sometimes reflecting the provisions of the Mortgages and Liens Convention; the right to arrest or attach, again sometimes reflecting the Arrest Convention; and the right to commence bankruptcy proceedings.

Under the heading of "contract", the Group recalled the numerous references which had been made to contractual terms inserted in charterparties, contracts of carriage and building agreements by all the parties seeking to protect themselves.

Members of the Group also discussed in the context of self help, the ways in which prudence should be exercised in entering into contractual arrangements and the need to act with alacrity and firmness in an actual insolvency.

Inevitably the serious difficulties arising from lack of uniformity in the area of maritime liens, arrest and bankruptcy was an important part of the discussion. Memoranda supplementing the discussion of bankruptcy law are included in the Summary at page 193.

C. Possible improvements to existing law and practice:—

Seven specific proposals to improve existing protective measures were debated:—

1. an international convention, or at least, common rules, on bankruptcy;
2. further steps towards uniformity on rules of arrest and maritime liens;
3. research into methods of achieving common rules on conflicts of law in these fields;
4. research into methods of achieving internationally accepted definitions of legal terms and concepts in the field of maritime operations;
5. the establishment of a central registry at which all creditors could register the credit and obtain information about the debtor;
6. the establishment of a CMI board of arbitration;
7. the drafting and subsequent acceptance of model clauses covering the main maritime concepts such as freight and liens.

Some of these ideas could be put into practice without difficulty or delay, preferably in consultation and conjunction with other pertinent organisations.

SUMMARY OF THE RULES RELATING TO MORTGAGES, HYPOTHEQUES AND PROCEDURES ON INSOLVENCY

1. Belgium

1. Formation and content.

A hypothèque is formed by contract. No notarial deed is necessary. It is governed, as between the parties, by the general rules of contract. It is valid against third parties only through registration in the Ships' Hypothèque Register.

There are no restrictions as to the nationality of the holder of the hypothèque, although the general currency exchange regulations apply depending upon residence, so that exchange control consent is required for external borrowing.

A hypothèque may cover the ship and its appurtenances, but not earnings or insurances. A ship under construction may also be the subject of a hypothèque.

2. Registration.

The Registrar of Ships' Hypothèques registers a hypothèque upon receiving a certified copy of the hypothèque agreement. No notation is made on the ship's papers. The registration is valid for 15 years whereupon the hypothèque must be re-registered; there is no other applicable time limit.

3. Discharge.

A hypothèque may be discharged by:—

- (a) unilateral declaration by the holder of the hypothèque;
- (b) a Court order in favour of the debtor after payment;
- (c) automatically by public sale in the course of seizure proceedings;
- (d) other sales, provided the rules for publicity have been observed; interested parties have two months from the date of the public announcement in which to object;

4. Validity and priority.

Its priority among other hypothèques is established by the date of registration.

5. Judicial enforcement.

6. Extra-judicial enforcement.

7. Restrictions on disposal of proceeds.

8. Insolvency and bankruptcy procedures.

There is no jurisdiction to wind up foreign companies.

A foreign liquidator will be recognised in Belgium, without application to the Belgian court.

2. Canada

1. Formation and content.

A mortgage is created by agreement and contained in one of two forms specified in the Merchant Shipping Act 1894 – account current form or principal and interest form. The first can secure all amounts due from time to time without stating a fixed sum. The details of the shipowner's undertakings to the mortgagee are contained in the accompanying Deed of Covenants.

The statutory form and the Deed of Covenants are both executed by the mortgagor, usually alone, but there is nothing to prevent the mortgagee signing as well.

There are no restrictions on the nationality of the mortgagee.

The statutory mortgage relates solely to the ship; however the Deed of Covenants may include an assignment of insurances and earnings. By virtue of s.4 Canada Shipping Act (1952) a ship under construction may be the subject of a mortgage.

2. Registration.

A statutory mortgage must be registered with the registrar of ships at the port of registry. Both the statutory mortgage and the deed of covenants must be registered with the Registrar of Companies if the mortgagor is a limited company incorporated under the Companies Act or has an established place of business in Canada.

No re-registration is required.

3. Discharge.

The mortgage is discharged when the mortgagee executes the memorandum of discharge on the reverse of the statutory mortgage document and registers it with the registrar of ships.

4. Validity and priority

Mortgages rank in the order of their registration.

3. F.R.G.

1. Formation and content.

A hypothèque is created between the ship-owner and the lender by the owner granting a hypothèque in writing, the signature being witnessed by a notary, and its registration in the Ship's Register at the local court, Amtsgericht, nearest the ship's port of registry.

The documents must name the holder of the hypothèque and the amount secured by it. The total sum is often composed not only of the principal sum but also interest payable on the loan and administrative expenses.

The subject matter of the hypothèque is solely the ship. The holder of the hypothèque is able to claim against the ship's underwriters for the costs of repairing the ship and also to require the proceeds of a total loss to be paid to him up to the value of his hypothèque. Underwriters' defences based on breach of warranty by the ship-owners are restricted by statute and, usually, by the terms of the contract.

A ship under construction may be hypothecated.

2. Registration.

A hypothèque is registered upon application by the ship-owner; and the entry refers to the document executed by the ship-owner. It is not necessary to endorse the ship's papers. No re-registration is required and no special time limits apply.

3. Discharge.

A hypothèque is discharged upon the application of the ship-owner assented to by the hypothèque holder before a notary, and presented to the Court of registration. It is also discharged upon public auction.

4. Validity and priority.

The priority of the hypothèque is determined by the date and time of its first registration.

With regard to foreign mortgages, German precedent is not consistent but the following propositions are thought to represent the better view.

Before a German Court can enforce a foreign mortgage or hypothèque, it must be shown to be valid according to the law under which it was created. If it is found to be valid, the German Court next considers whether the creation procedure is similar to the procedure under German law in order to determine the ranking of the hypothèque or mortgage. It is thought that a German Court will not acknowledge, for example, an unregistered equitable mortgage created upon a foreign vessel in accordance with English law.

5. Judicial enforcement.

A vessel may be arrested and sold by the Court. The holder of the hypothèque has to make an application to the Court showing that he is entitled to have the ship sold. The proof may be either a valid judgement from a German Court or a special document executed before a notary granting the holder of the hypothèque the right to have the ship forced sold if the shipowner fails in his obligation to pay the loan and interest.

How much time the process takes depends upon the complexity of the circumstances and the ease of obtaining a reasonable price. At the auction, the shipowner may intervene to prevent the ship being sold at too low a price, if the bidding has failed to reach a certain percentage of the ship's value. The Court must fix a second date for the auction, but the shipowner cannot intervene again.

The mortgagee may buy the ship at auction. His obligation is to pay the full purchase price; normally however, he only pays sufficient to cover the Court fees and the ship's maintenance till the sale is complete, and to satisfy the claims of those with higher ranking security than his.

6. Extra-judicial enforcement.

No provision exists in German law for the holder of a hypothèque to take possession of a ship even if such a right has been granted by the contract of hypothecation. To enforce his security he must follow the procedure for judicial sale.

7. Restrictions on disposal of proceeds.

No foreign exchange regulations affect the proceeds of sale and there are no taxes payable in Germany.

8. Insolvency and bankruptcy procedures.

Until 1983 the prevailing opinion was that bankruptcy proceedings in another country could not affect Germany and that the effects of German proceedings were restricted to Germany itself, based on the concept of territorial restriction of public acts.

Since then opinion has changed. The Federal Supreme Court decided that bankruptcy proceedings in Germany took effect on assets in another country with the consequence that a creditor who succeeded in executing upon those assets was obliged to reconstitute the amount to the administrator. From this decision may be drawn the conclusion that in future, bankruptcy proceedings in other countries (at least in situations of reciprocity) have to be acknowledged in Germany. This means that the consequences of the foreign procedure – such as in particular the introduction of individual execution – are to be observed in Germany. This opinion, however, is still debated.

Altogether the question of the territorial effects of the procedure is – in Germany as in other countries – still unsolved in its details. The work undertaken in the framework of the EEC on an International Convention is, at the moment, far from being finished.

As regards practicalities, a receiver or trustee of an insolvent mortgagor must pay the same regard to the mortgagee's rights in the distribution of the proceeds of sale of the ship as are paid upon the forced sale of the ship.

4. France

1. Formation and content.

A hypothèque can be formed only by contract. The agreement must be in writing either in the form of a notarial deed or contained in a document attested by a notary public.

No special form of document is required by law but a minimum of information such as the identity of the ship and owner and of the creditor, the amount secured, the rate of interest and the date of expiry is usually included. There is usually a clause providing that the holder's consent must be obtained before a subsequent hypothèque is granted; that consent is not required by law. In practice, the clause is relied upon only when the shipowner defaults.

There are no restrictions as to the nationality of either party.

The hypothèque may secure an existing or conditional debt but not a future debt and the amount must be expressed in French Francs.

The subject matter of the security, besides the ship herself, extends to the insurance indemnity payable in the event of loss of or damage to the ship but not to her earnings. A ship under construction may be the subject of a hypothèque.

2. Registration

The original hypothèque together with a bordereau in triplicate is submitted to the Receveur des Douanes of the ship's home port by the holder of the hypothèque. The bordereau which must be in the French language, contains a summary of the hypothèque and is drawn up and signed by the holder of the hypothèque to whom one copy is returned annotated with the date and the registration number.

The Registrar charges a fee of 5% of the amount secured plus Frs.5; the register may be searched for a small fee. The registration is effective for only ten years although the hypothèque itself is not subject to any time limit.

3. Discharge

A hypothèque may be discharged by consent, contained in a deed of discharge submitted with the original bordereau for deletion by the registrar, or by order of the Court or by a special procedure enabling a purchaser to get clean title on tendering the purchase price to the holder of the hypothèque. The registrar will check the applicant's power to obtain discharge.

4. Validity and priority

Hypothèques have priority *inter se* according to the date of registration and hypothèques registered on the same day have equal priority.

French Courts determine the validity of a foreign mortgage, applying French rules of Conflict, in accordance with the law where the mortgage is registered, and its priority in a similar way or according to the 1926 Convention. The Court applies French law as far as liens are concerned.

5. Judicial enforcement

A Court may order a sale by public auction if the holder of the hypothèque has a final judgement in his favour from the competent court, or some other entitlement, such as a deed, to have the ship sold. The Court may also grant *saisie conservatoire* to preserve the security until proper judgement is obtained.

The procedure, which follows the ordinary procedure for the auction of movable property, may take as little as six months or as much as two years, if, for instance, the ship is not French or the debtor cannot be served in France or if either the owners or another creditor makes objections.

All creditors have the right to intervene to challenge the qualification of other creditors and the priority given to them in relation to each other. The decision of the Court is subject to appeal.

Mortgagees or holders of hypothèques may bid at the auction, but no set-off is allowed and the full purchase price has to be deposited in Court within twenty four hours for distribution among creditors as ordered by the Court.

6. Non-judicial enforcement

In France, as in other Civil Law countries, there is no statutory right for the holder of a hypothèque or mortgage to take possession of the ship upon the default of the grantor. Such a right may be given by contract, but its enforcement could prove impossible in the face of opposition from other creditors.

A power of sale may also be granted by contract, but this again may be impossible to execute if other creditors object.

7. Restrictions on disposal of proceeds

There are no exchange control restrictions and no taxes on the division of the money realised, but there are court dues to be paid.

8. Insolvency and bankruptcy procedures

After an insolvency order is made the holder of a hypothèque cannot enforce its rights without leave of the court and the court has extensive powers to impose a "recovery plan" which includes the power to reschedule the debts secured by the hypothèque.

The detailed provisions were enacted in January 1985, reinforcing the tendency towards restricting the freedom of the holder of a hypothèque to realise his security.

Holders of hypothèques, like all other creditors, are obliged to declare their debts within the legal time limits. Article 50 provides:

As of the publication of the court order, all the creditors whose debts arose prior to such court order, must file their declaration of debt with the creditors' representative appointed by the court. The creditors benefiting from a registered security are personally informed of such filing requirement.

Article 51 adds:

The declaration must specify the type of security related to the debt: hypothèque, *privège*.

This declaration must be filed within a specified time or the debt will be extinguished – *force majeure* excepted.

The declaration of debt is followed by the verification and acceptance of the debt by a judge appointed by the court (Juge Commissaire). Here again, the holders of hypothèques receive the same treatment as all other creditors and must strive to avoid mistakes. The decision of the Juge Commissaire has the authority of a judgment, a judgment which can confirm, limit or deny the rights of the creditors.

For example, in a decision dated June 15 1983, the French Supreme Court ruled that when the statement of debts drawn up by the Juge Commissaire indicated simply that a claim was privileged – without specifying that the privilege was a hypothèque – the creditor who had failed to object to the erroneous description within the prescribed time limit, was barred from collecting the proceeds of sale to satisfy his hypothèque.

Perhaps the most serious limitation to the rights of the holder of the hypothèque enacted in the bankruptcy law of 1985, is the suspension of individual claims as soon as recovery or liquidation proceedings are begun unless the claims have been accepted by the receiver or liquidator. In that case the creditor so approved is able to arrest and sell the hypothecated asset in priority to all the other creditors who are still subject to the bankruptcy procedures.

This suspension continues during the entire recovery proceedings, and at the end it is decided whether the company shall continue its activities or be liquidated.

If the court orders a continuation plan for the company, the holders of hypothèques must comply with the time limits specified for the payment of debts by the plan, even if they exceed the duration of the plan itself. These time limits must be the same for all creditors, whether secured or not.

If the court orders the liquidation of the company, the holder of a hypothèque cannot get back his right to pursue his claim individually, unless within three months of the liquidation order, the liquidator fails to organise the sale of the hypothecated asset (Article 161).

Another restriction is that debts arising after the date of the Court decision to begin company recovery proceedings are given priority for payment over all other debts, including debts secured by hypothèques created before the decision.

On the positive side, an interesting solution to the problem of a vessel's depreciation is provided by Article 34. The hypothecated assets may be sold under court supervision by the receiver or liquidator, the sum realised being placed in escrow at the Caisse des Dépôts et Consignations which is a state owned banking institution, pending its distribution.

Another interference with the contractual rights of a holder of a hypothec is the fact that the Court can propose, or even impose, alternative guarantees for the creditor (subject to appeal) if it considers it appropriate to sell the hypothecated assets to improve the cash flow of the bankrupt company.

These laws apply if a company has assets or a place of business in France.

On the other hand it is possible to obtain recognition of foreign liquidation proceedings. The foreign liquidator has to apply to the Court for a *commission rogatoire*.

5. Italy

1. Formation and content

A hypothec is formed by unilateral declaration of the owner or by contract between the owner and the person in whose favour the security is granted. Since a hypothec is considered a *jus in rem*, it must be in writing and certified by a notary or in the form of a notarial deed. The deed must contain the ship's name, port of registry, the sum secured, the rate of interest and the date of maturity. It may be executed by the owner alone in favour of the third party.

There are no restrictions on the nationality of either party, except for exchange control regulations so that special permission must be obtained where the hypothec is granted in favour of a non-resident.

Only the ship and appurtenances can be the subject of the hypothec. The holder of the hypothec is entitled to enforce his claim against insurance proceeds if the ship is lost.

A hypothec may be created on a ship under construction. It must be registered in a special register of ships under construction.

2. Registration

A certified copy of the agreement and a formal request for registration (563 Nav. Code) in duplicate, are presented to the registrar of ships at the port where the ship is registered. The copy application is returned.

The hypothec is registered in the register of ships and endorsed on the ship's papers. If this is not done, the hypothec is not only invalid, it does not exist (Article 565/570 Nav. Code).

Re-registration is not required.

A 0.50 per cent tax is payable.

3. Discharge

Repayment of the credit *de jure* extinguishes the hypothèque. The hypothèque may be cancelled by consent or by court order. A purchaser may tender the purchase price to the holder of the hypothèque.

A two year prescription period runs from the maturity date of the debt secured by the hypothèque.

4. Validity and priority

Priority is according to the date and time of registration.

Italian courts apply the law of the ship's flag to determine the validity of a foreign mortgage or hypothèque and to decide its priority. The law of the flag is also used to decide whether to grant recognition of the charge.

5. Judicial enforcement

Judicial sale is the only way of enforcing a hypothèque. The creditor must produce an enforceable judgement or the debtor's acknowledgement of the debt whereupon the ship is attached and the further procedure is the same as for forced sale. In the absence of title of this kind, the claimant may be granted a conservatory arrest while he obtains judgment. Italian courts may permit a sale *pendente lite* if the ship is in physical danger.

The time taken can be as little as six to eight months, but it can take much longer if there are objections.

Third parties have the right to intervene in the proceedings. Indeed, all other creditors must be involved in the proceedings, and registered creditors are notified. The mortgagee or holder of the hypothèque may bid for the ship and set off his claim against the purchase price but he must either pay, or pay into court an amount equal to, any claims preferred above his. Sometimes a bank guarantee is accepted instead of cash.

6. Extra-judicial enforcement

As in other Civil Law countries, the holder of a hypothèque has no statutory right to take possession of the ship. The court may assist him to carry out a contractual term to that effect if there are no objections. He must render an account of the disposition of the sale proceeds.

7. Restrictions on disposal of proceeds

A foreign purchaser must prove that funds are coming from abroad since the ship is considered to have been imported. Exchange control approval is required for the transfer of sale proceeds to a foreign mortgagee. There is a half per cent tax on the purchase price.

8. Insolvency and bankruptcy procedures

The hypothèque is not, in principle, affected by bankruptcy and the holder is not restricted in exercising his right of enforcement. It is the trustee who institutes steps for judicial sale, and the holder of the hypothèque may seek payment out of the proceeds left after settlement of claims ranking ahead of the hypothèque.

However, the trustee or receiver may bring an action to revoke the hypothèque within two years of the bankruptcy.

There are a number of rules formulated to ensure that, within their respective priorities, all creditors are treated in the same manner.

The main rules are:

1. The company's business is run by a trustee and not by the previous management
2. A number of important acts of disposal of the bankrupt's rights must be approved by a committee of creditors and authorised by the judge. Among these acts are: settlement agreements, discontinuance of legal proceedings, stipulation of arbitration clauses etc.
3. All actions arising out of the bankruptcy are to be filed with the court which declared the bankruptcy.
4. No attachment and arrest proceedings (including *saisie conservatoire*) can be commenced or continued.
5. All the creditors – including secured and mortgagee creditors – have to file a claim in the bankruptcy proceedings.
6. Debts which become due and payable at the date of the bankruptcy or after and which were created within a period of two years before the bankruptcy cannot be paid.
7. The protection of the creditors is also achieved by means of a special action (*azione revocatoria*) which is intended to revoke all payments or acts of disposal of the assets of the bankrupt made in the two years or one year (depending on the nature of the act) prior to the bankruptcy.
8. The general rule (with noteworthy exceptions) concerning the existing contracts is that the bankruptcy brings about their termination. In particular:

Bareboat and time charters come to an end in the case of bankruptcy of either party unless the trustee elects to affirm the contract and offers "adequate guarantee" for its performance.

The trustee is bound to declare his intention within 20 days from the date of the judgment adjudicating the bankruptcy.

Under one theory a contract of carriage comes within the same category and is subject to the same rule. Under another theory the contract does not come to an end and the trustee would therefore be bound to perform. In practice, however, this may prove impossible because the vessel is physically or legally prevented from performing or because the trustee does not have sufficient funds to continue the voyage.

In this case negotiations must be started with the trustee to make suitable arrangements for continuation or, more likely, for transshipment or redelivery of the goods, failing which cargo interests must apply to the bankruptcy court to obtain possession of the goods.

9. The proceeds of the liquidation of the bankrupt's assets are distributed to the creditors according to their priorities and in the following order:
 - (a) Expenses incurred in the bankruptcy proceedings and debts incurred in the administration of the company;
 - (b) secured creditors;
 - (c) unsecured creditors.

The laws apply to a foreign company if the company has a place of business in Italy.

A foreign liquidator may be recognised upon application to the court if a judgment from that country would be recognised, but it is unlikely that the foreign liquidator could then prevent actions against the company's assets located in Italy. By contrast, an Italian creditor may be sued for damages for acting against an Italian company's assets located abroad.

Under Italian law, in addition to bankruptcy, there are three other procedures:

the *Amministrazione Straordinaria* to achieve the rehabilitation of major companies under the management of a government-appointed Commissioner and the supervision of government authorities.

the *Concordato Preventivo* to pay the creditors in given percentages, in full for the preferred/secured creditors and forty per cent at least, for ordinary unsecured creditors. The proceedings are under the control of a Judicial Commissioner and of the Court.

the *Amministrazione Controllata* to overcome the company's temporary financial difficulties under the supervision of a judicial commissioner, but under the management of the company's directors.

6. Liberia

1. Formation and content

There is no specific form for the mortgage, but it must conform to the provisions of Liberian Maritime Law and it must state the amount of the debt and the interest, the date of maturity, details of the property securing the mortgage, evidence of the debt such as a loan agreement, the covenants and events of default.

The amount stated to be secured is the maximum permitted to be outstanding at any one time or the aggregate of the advances possible including amounts to provide for fluctuations.

The instrument may be executed by the grantor alone or by both parties. There is no restriction on the nationality of the parties

The property secured is the whole of the vessel. Non-maritime property may be included but as a mortgage on it cannot enjoy preferred status, it must be capable of separate discharge. A fleet mortgage is permitted, but, since January 1985, not a mortgage on a ship under construction.

2. Registration

The mortgage must be registered with the office of the Deputy Commissioner of Maritime Affairs of Liberia in New York City. Re-registration is not required.

3. Discharge

Mortgages are discharged by recording an instrument of satisfaction and/or discharge. No time limits apply.

4. Validity and priority

Priorities *inter se* are chronological unless otherwise agreed among the mortgagees in writing and recorded.

To be recognised by a Liberian Court, the mortgage must have been made in accordance with the law of the country where the mortgage was registered, duly executed as provided therein, and recorded in a public register.

Validity and priority fall to be determined by the *lex fori*.

5. Judicial enforcement

A libel *in rem* is filed by the claimant and the warrant of arrest is then served. The court issues an order for sale to the marshal and the public auction takes place at the marshal's direction. The crucial document at the conclusion of the proceedings is the marshal's bill of sale. The procedure can take between two and eight months.

Third parties such as charterers may intervene as may the holder of a maritime lien. The mortgagee may bid at the auction and set off his claim against the purchase price.

6. Extra-judicial enforcement

A mortgagee may take possession of the ship, and sell it, if the mortgage deed so provides.

7. Restrictions on disposal of proceeds

There are no taxes on the proceeds of sale and no exchange control restrictions. Court costs including marshal's fees, and costs *in custodia legis* must be paid.

8. Insolvency and bankruptcy procedures

Liberia has no provisions for voluntary bankruptcy akin to those contained in Chapter 7 of the United States Code. Voluntary dissolution and winding-up is covered by Chapter 11 of the Business Corporation Act 1976.

7. Netherlands

1. Formation and content

A hypotheque is formed by contract. Statutory mortgages are not known in Dutch law.

The hypotheque is contained in a notarial deed which must state the names of the parties, the reason for the hypotheque, the amount secured, the interest rate which is not necessarily a fixed rate, and the object or property charged.

It is the shipowner who creates the hypotheque. He is not always the debtor. The person in whose favour the security is granted is also a party to the contract. The vessel must be of Dutch nationality, that is, owned by a Dutch subject, and registered in the Netherlands, but there is no restriction on the nationality of the creditor.

The subject matter of the hypothec is the ship and her appurtenances, not her earnings or insurance monies, but a ship under construction may be hypothecated as soon as the hull can be carved.

2. Registration

To be valid between the parties themselves and against third parties, the hypothec must be registered in the register of ships by submission of the deed. A hypothec in a foreign language may be registered if it is accompanied by a Dutch translation.

The hypothec does not need to be endorsed on the ship's papers.

The registration is of unlimited validity and no re-registration is required.

3. Discharge

A hypothec is discharged upon deletion from the register. The deletion may be done by consent; by notarial deed unilaterally; by order of the court in the case of bankruptcy or forced sale.

There are no time limits applicable. However, the interest is secured only for the current year and the two preceding years.

4. Validity and priority

Priorities of hypothecs among themselves depends upon date of registration. If several are registered on the same day they rank equally.

A Dutch court will decide whether to recognise a foreign mortgage by reference to the *lex contractus*, and if the mortgage is similar to a Dutch hypothec it will be accepted as valid.

Priorities fall to be determined by *lex fori* that is Dutch law.

5. Judicial enforcement

A ship may be arrested and sold by the courts in three sets of circumstances. If the secured claimant has a notarial deed of indebtedness, for example, he may make an executorial arrest and request a date for auction. The same applies where the claimant has obtained judgment. The third case is where the claimant makes a conservatory arrest followed by a writ in order to obtain an enforceable judgment.

The sale procedure takes some five weeks after obtaining an enforceable title, but distribution of the proceeds can take years.

Charterers may try to prevent a sale but are unlikely to succeed because a sale does not discharge the charterparty in Dutch law.

The holder of a hypothec may bid for the ship at auction. The purchase price or appropriate security must be provided at the discretion of the executing party.

6. Extra-judicial enforcement

Dutch law expressly forbids the hypothec holder to take possession and he can have no statutory or contractual power to sell the ship.

7. Restrictions on disposal of proceeds

There are no restrictions on the disposal of the proceeds and there are no taxes payable. There are no foreign exchange control regulations restricting the remitting of the sale proceeds abroad.

8. Insolvency and bankruptcy procedures

In principle, neither bankruptcy nor moratorium affects the hypothec. Because Admiralty and insolvency cases are within the jurisdiction of the same court, the holder of the hypothec can pursue his claim as if there were no bankruptcy, provided however that his is a first preferred charge and provided that the deed of hypothecation grants him the right to sell by way of a "voluntary" forced sale as opposed to judicial sale.

If a foreign company has a place of business in the Netherlands, it is subject to the Dutch law of bankruptcy. On the other hand a foreign liquidator may be recognised if application is made to the court for recognition.

8. Spain

1. Formation and content

The hypothec and other documents evidencing the contract must be executed by all parties thereto in the presence of a Spanish notary, and it must be contained in a notarial deed. The document must contain full details of the hypothec and the amount and the currency must be specifically stated (Art. 219 Reglamento Ley Hipotecaria).

Most often, the shipowner and the lending bank or financial institution are the parties to the transaction. In the case of ships under construction, the building yard may also be asked to sign the loan agreement to the extent of those obligations resting on the yard.

There are restrictions on foreign holders of hypothèques on Spanish ships, who need special authorisation by the Spanish Ministry of Commerce after obtaining the approval of the government in cabinet in accordance with the law of 27th February 1939. This procedure was simplified by Circular no. 15 of the Bank of Spain dated 11th November 1980, which provided that a loan by a foreigner in a foreign currency for a term of more than one year required approval by the Bank of Spain only. Where the Bank of Spain's approval has been obtained, no further consents are needed (Order dated 23.1.81).

A ship under construction may be the subject of a hypothèque provided its ownership has been previously registered.

2. Registration

A hypothèque is registered in the third book of the Mercantile Register. The particulars to be recorded are:-

- a. the name, address, occupation and residence of the shipowner and of the holder of the hypothèque;
- b. the capital amount secured by the hypothèque and the interest secured which, unless otherwise agreed, may not be greater than the arrears for two years as well as the current. The maximum which may be covered by the hypothèque is five years' interest;
- c. the date when the capital and interest become due;
- d. whether the hypothèque has been issued to the order of or in favour of a third party;
- e. the name and full description of the ship to be hypothecated;
- f. the value of the ship where the parties have agreed it;
- g. the amount secured by each ship where more than one is hypothecated to secure one loan.

Registration is a condition of the validity of the hypothèque vis-à-vis third parties.

3. Discharge

4. Validity and priority

Spain has adopted Article 1 of the 1926 Convention into domestic law and thus determines recognition of foreign mortgages.

The validity of a hypothèque or mortgage is to be determined by the law of the country where the charge is registered, while its priority is decided by the law of the ship's flag.

5. Judicial enforcement

A hypothecated ship may be arrested and sold by the Court in six circumstances:—

- when the stipulated date for the payment of the principal and interest has expired;
- when the debtor has been declared bankrupt;
- when the ship has suffered damage which will prevent her sailing;
- when the ship is to be sold to a foreign company;
- when the conditions agreed for the termination of the contract have been fulfilled;
- when in the case of the loss of the ship, notice to pay has been served on the debtors through the court or through a notary, and not complied with within three days.

If a vessel is loaded and ready to sail, the arrest may be postponed if security is put up by parties interested in the voyage to the satisfaction of the court for the return of the ship to the jurisdiction within a given time. The security is forfeited even if the ship becomes a total loss through *force majeure*.

An arrest or demand for payment should be recorded in the Mercantile Register by the Registrar to whom the court sends an official document of the order of arrest. This notice must be entered in the special Book of Ships.

Once an order for arrest has been made, the court will proceed to sell the ship by auction. The rules are detailed and complicated. It can take three to four months to accomplish a sale and a further eight to nine months to distribute the proceeds.

Other parties can intervene in the proceedings except under the *procedimento summario* of Articles 130 and 131 of the Ley Hipotecaria.

6. Extra-judicial enforcement

The holder of a hypothec has no right to take possession of or to sell a ship if the debtor defaults. He must follow the judicial procedure. However the law permits the parties to insert in the deed of covenant a clause giving the holder of the security the right to take possession in agreed circumstances.

He may also request and obtain the “judicial administration” of the ship so that she may continue in existing productive employment.

Neither by force of law nor by agreement can a power of sale be conferred upon the holder of a hypothec.

7. Restrictions on the disposal of proceeds

A special permit is necessary to transfer the proceeds of sale out of Spain to the foreign holder of the hypothec. The permit is given by the General Direction of External Transactions of the Ministry of Commerce.

A tax called *Transmisiones patrimoniales* is imposed for non-movable assets and stamp duty (*actos juridicos documentados*).

8. Insolvency and bankruptcy procedures

Bankruptcy law applies if the debtor becomes insolvent, and the rule *par condicio creditorum*. The debtor's trustee may sell the ship and the holder of the hypothec may seek payment out of the proceeds in accordance with his ranking.

9. Sweden

1 Formation and content

The system in Sweden is different from most others. Swedish vessels are registered in a central register called The Ships' Register, which details the owner, the vessel's call sign and description. It is the registered owner who applies to the Ships' Register for a mortgage deed. The amount to be secured and the currency should be stated. The mortgage deed will be issued on the same day the application is made.

The existence of a debt is not a prerequisite and until the deed is pledged as security for a loan and handed over to the creditor, it has effect as a mortgage in favour of the shipowner. Thus the parties to the mortgage may be the shipowner alone or the shipowner with the mortgagee and where appropriate, the debtor.

There are no restrictions on the nationality of the mortgagee.

The ship together with compensation under the insurance policy for damage to the ship are the subjects of the mortgage.

2. Registration

All mortgage deeds are issued by the Ships' Registrar and are thus officially registered under the ship's name

Once a mortgage deed has been issued, it remains alive as long as it remains written in the Register, without having to be renewed.

3. Discharge

A mortgage is discharged when the deed is handed back to the shipowner. No special time limits apply.

4. Validity and priority

The priority of a mortgage follows from the date the deed was issued.

Sweden is a signatory to the 1967 Convention. Foreign mortgages or hypothèques are recognised provided the mortgage or hypothèque has been registered in accordance with the laws of the country of registration of the vessel and provided the information and documents according to the law of the country of registration are public and that extracts from the register can be obtained as well as other relevant documents.

The law of the country of registration is also applied to determine the validity and priority of the mortgage or hypothèque.

5. Judicial enforcement

A ship can be arrested upon the order of the court. A judgment obtained by a creditor against the shipowner is enforced by the Bailiff who distrains against the ship and sells it. The whole procedure takes a few months.

Third parties have no right in principle to intervene in the proceedings; neither has the mortgagee the right to purchase the ship in the Bailiff's sale and set off what is owed to him against the purchase price.

6. Extra-judicial enforcement

The mortgagee is not permitted either to take possession of the mortgaged ship or to sell it without going through the courts, or to make an agreement to that effect.

7. Restrictions on disposal of proceeds

Approval must be sought from the competent authority for the transfer of funds but it is usually given without difficulty. No taxes are charged.

10. United Kingdom.

1. Formation and content

A mortgage is formed by agreement. It is contained in a document as set out in the Merchant Shipping Act 1894 – a statutory mortgage – which is invariably accompanied by a Deed of Covenants which sets out in detail the obligations of the owners to the mortgagee, for instance with regard to the insurance and maintenance of the ship.

A mortgage in account current form can secure all amounts due from time to time and no specified sum need be stated. It is otherwise in the alternative principal and interest form.

The statutory mortgage is executed by the owner alone. Generally the Deed of Covenants is also executed only by the owner but it may also be executed by the mortgagee.

There are no restrictions on the nationality of the mortgagee.

The statutory mortgage encompasses the ship and nothing else. A ship under construction cannot be mortgaged. However the Deed of Covenants often includes an assignment of insurance recoveries and earnings.

2. Registration

The statutory mortgage must be registered with the Registrar of ships at the port of registry.

The statutory mortgage and the Deed of Covenants must be registered with the Registrar of Companies if the owner is a limited company incorporated under the United Kingdom Companies Act or has an established place of business in the United Kingdom.

No re-registration is required.

3. Discharge

The Memorandum of discharge found on the reverse side of the statutory mortgage has to be executed by the mortgagee and registered with the Registrar of Ships.

No time limits apply.

4. Validity and priority

Mortgages rank in the order of their registration.

The recognition of foreign mortgages is determined by applying the law of the flag of registration.

The same is applied in determining the validity and priority of a foreign mortgage.

5. Judicial enforcement

A ship may be arrested and sold through the court. A writ *in rem* is issued against the ship, then an arrest warrant. The ship is arrested by the Admiralty Marshal, and sold by him on the application of the plaintiff, by tender.

It takes only a day to arrest a ship, but some sixty days to effect a sale *pendente lite*. The application of proceeds may take another hundred days.

Third parties must intervene to protect their rights.

The mortgagee is not permitted to buy the ship and set off his claim against the purchase price.

6. Extra-judicial enforcement

A mortgagee is empowered to take possession of the ship upon default under the mortgage.

By virtue of the Law of Property Act 1925 and the Merchant Shipping Act 1894 the mortgagee also has the power of sale.

7. Restrictions on disposal of proceeds

There are no exchange control restrictions on sending monies abroad, and no taxes to pay.

8. Insolvency and bankruptcy procedures

Although a mortgagee can take possession of a ship and exercise his statutory power of sale without leave of the court if a winding up order has been made or if an administrator has been appointed under s.5.8 of the Insolvency Act, 1986 the mortgagee will have to obtain leave of the Companies Court to commence an Admiralty action *in rem* against the ship to enforce its rights.

Under English law (Bankruptcy Act 1917 S.44 as amended by Bankruptcy Act of 1917, S.44, as amended by Companies' Act of 1947, S.92 and 115), a payment or transfer of property made by a debtor with a view of giving preference to a particular creditor may, if he is subsequently adjudged bankrupt, be set aside and the funds or property retrieved by the bankrupt's estate, provided that

- (1) at the time of the giving of the preference the debtor cannot pay his debts as they fall due;
- (2) the payment was made in favour of a creditor;
- (3) the debtor acted with the intention of preferring the creditor;
- (4) the petition under which the debtor is adjudged bankrupt was filed within six calendar months of the transaction complained of.

If there are assets (including a contingent asset such as an insurance claim) or a place of business within its jurisdiction the court will wind up a foreign registered company.

A foreign liquidator has no authority in the United Kingdom unless re-appointed by the Court.

English law does not look to the laws of a foreign state when bankruptcy proceedings are in process in that foreign state, made to determine the fate of assets within the jurisdiction of the English courts. Those assets may consist of vessels, other property, cash etc. and if they are located in England, English law will be applied in determining whether they should be sold and if so when, and to whom the proceeds should be distributed.

An example in practice may be found when a United States company, subject to Chapter Eleven proceedings in the United States, has assets abroad. Individual United States creditors may be restricted from taking action anywhere in the world by virtue of their "presence" in the United States. In particular they may be prohibited from arresting a vessel outside the jurisdiction. However foreign creditors, not subject to the jurisdiction of the United States, may be free to do so. The English courts will permit the arrest of a vessel within its waters despite ongoing Chapter Eleven protection. In that event, if steps are not taken by the United States creditors as a body, the assets or their proceeds within the jurisdiction of the English courts would be distributed only to those creditors who participate in the English proceedings. Thus to avoid such a situation the United States creditors must participate in multiple proceedings when assets are located in England.

It may be considered desirable to move towards a system of uniformity when dealing with the assets of insolvent multinational corporations. However practical difficulties are envisaged. An English court, if it were to release assets to a liquidator or trustee outside its jurisdiction would not be in a position to see that fair play is done. Control could be exercised if the English court were to retain the assets or proceeds but distribute them in accordance with the insolvency/bankruptcy rules of the state with which the corporation has its closest connections and where the primary proceedings are taking place.

11. U.S.A.

1. Formation and content

No particular form is required but to achieve preferred status under the Ship's Mortgage Act, the mortgage must contain:

- a. a statement of the debt including interest, which must exist at the time the mortgage was created, although revolving loans and future advances may be recorded, together with performance and mortgage covenants;
- b. the date of maturity;
- c. a separate statement of the discharge sum.

Further conditions to qualify for preferred status are that the mortgage must be acknowledged before a notary public and that an affidavit of good faith must be executed by the mortgagor. Most significantly the ship must be documented in the United States and owned by a United States citizen. The mortgagee must also be a United States citizen, except in the case of a trustee acting for a foreign lender.

Most mortgages are unilateral but amendments require the signature of both mortgagor and mortgagee.

The whole of the ship including equipment, freight, fuel, drill pipes as agreed by the parties, may be subject to the mortgage, but if property other than the vessel is included, a separate discharge amount must be specified for it. The mortgagee may be named loss payee on the hull policies.

Ships under construction cannot be covered by a preferred mortgage although some states such as Louisiana have provisions for covering them under non-maritime state mortgages.

2. Registration

The mortgage must be recorded with the Documentation Officer of the United States Coast Guard of the home port of the vessel. It becomes effective only when endorsed on the vessel's Certificate of Documentation. The whole mortgage must be submitted for recording including attached exhibits which must also be recorded.

A mortgage does not need to be re-recorded.

3. Discharge

A mortgage is discharged either by payment with a Satisfaction of Mortgage form recorded with the Coast Guard or by order of an Admiralty Court to the Admiralty Marshal to sell the ship free of all liens.

The mortgage remains valid as long as it is on the record and there is no proof of payment of the debt. It would be unusual to strike out a mortgage for delay in enforcing it.

4. Validity and priority

Mortgage priority is established by the date of endorsement on the Certificate of Documentation, although in view of delays in carrying out the formalities, the date of submission may be taken instead.

Renewal or supplemental mortgages are dated from the original mortgage which commenced the lending arrangement.

A preferred ship mortgage takes precedence over all other securities except pre-existing liens and preferred mortgages, crew's wages, tort claims and salvage.

Foreign mortgages are recognised by the Ships Mortgage Act and are given the same validity and priority as they have in their home country, that is according to the law of the flag, but they rank behind all United States maritime liens.

5. Judicial enforcement

The ship may be sold by order of the court. First a complaint is filed then an order for arrest is issued and the ship is arrested. An interlocutory sale is held and the sale is later confirmed.

The procedure takes about sixty days for the sale; distribution of the fund can be completed about thirty days later unless there is a dispute.

Third parties may intervene but must do so within the time set by the Coast Guard, which is usually about twenty or thirty days after publication of the notice. In general a mortgagee may bid for the ship at auction, but the courts of some states do not allow credit bids.

6. Extra-judicial enforcement

A mortgagee may take possession of the ship if it is so provided in the mortgage deed. It is rarely done, however, because of the risk of claims by third parties should the mortgagee damage the ship while it is in his possession.

The mortgagee's power of sale also depends upon the provisions of the mortgage deed, but such a sale does not wipe out liens and the Coast Guard may not register the sale and transfer the title.

7. Restrictions on disposal of proceeds

All sales over U.S. Dollars 10,000 must be reported but there is no foreign exchange control on sending the proceeds abroad.

No taxes are imposed on the proceeds of sale, but a commission must be paid to the Marshal.

8. Insolvency and bankruptcy procedures

The mortgagee must petition the bankruptcy court to disclaim the vessel and permit it to be sold by the Admiralty Court. If the Bankruptcy Court refuses, the trustee or debtor in possession must then furnish "adequate protection" to the mortgagee.

Under U.S. bankruptcy law, any money or lien or attachment obtained by court procedure, by an unsecured creditor within 90 days before the institution of a bankruptcy proceeding, is considered to be a "preference" and may be recovered, or set aside, by the trustee in bankruptcy for the benefit of the unsecured creditors.

It is not a "preference" to collect money in exchange for current consideration, e.g. freight for cargo carried.

In the U.S. comity has been described as the "recognition which one national allows within its territory to the legislative, executive, or judicial acts of another nation having due regard both to international duty and convenience and to the rights of its own citizens or of other persons who are under the protection of its laws."

As a matter of comity, U.S. Courts have often recognised property claims asserted by foreign bankruptcy trustees and deferred to foreign administrators of insolvent estates. In *Cunard Steamship Co. Ltd. v. Salen Reefer Service, A.B.*, 773 F.2d. 432 (2nd Cir. 1985) the Second Circuit stated:

American courts have consistently recognised the interest of foreign courts in liquidating and winding up the affairs of their own domestic business entities.

(See also *Hilton v. Guyot*, 159 U.S. 113 (1885), *Canada Southern Ry. v. Gebhard*, 109 U.S. 527 (1883) and *Victrix Steamship Co. S.A. v. Salen Dry Cargo A.B.*, 825 F.2d. 709 (2nd Cir. 1987)).

Section 309 of the Bankruptcy Code codifies and expands this historical accommodation of foreign bankruptcy proceedings by expressly authorising a "foreign representative" to commence in the U.S. Bankruptcy Court an involuntary case on a proceeding ancillary to a foreign proceeding. Section 304 authorises the U.S. Bankruptcy Court to exercise, withhold or suspend exercise of jurisdiction when a debtor has been adjudicated a bankrupt by a foreign court. (Attachment)

Under general principles of comity as well as specific provisions of the Bankruptcy Code, Federal courts will recognise foreign bankruptcy proceedings provided that foreign laws comport with due process and fairly treat claims of local creditors.

After the U.S. Bankruptcy Court assumes jurisdiction over the assets of the bankrupt, the court has the power to enjoin any party over whom it has jurisdiction (i.e. U.S. citizens and foreign companies doing business within the jurisdiction of the court) from taking steps to enforce this right in a foreign location. For example a person subject to the Bankruptcy Court's jurisdiction cannot arrest a vessel owned by the bankrupt company in a foreign country. The disparity is that a person who is not within the jurisdiction of the U.S. Bankruptcy Court (i.e. foreign nationals or companies) thereby gain an advantage by being able to effect such an arrest and gain or take control over that asset with the other creditors.

In order to avoid this apparent inequity the Court in the U.S. Lines bankruptcy granted an order permitting the U.S. mortgage holders to intervene in proceedings in Hong Kong which had been instituted by creditors who were not under the control of the U.S. Bankruptcy Court. It is assumed that if the mortgage holders recover any proceeds from the Hong Kong sale of U.S. Lines' assets those proceeds will be required to be turned over to the U.S. Bankruptcy Court for distribution in accordance with U.S. law.

It should be noted that if a foreign national takes steps to enforce his rights outside the U.S. Bankruptcy Court proceedings, he will not later be able to file a claim in the U.S. proceeding for any deficiency because by doing so he would subject himself to the U.S. Bankruptcy Court's jurisdiction.

12. Venezuela

1. Formation and content

A hypothec may be formed by contract or by the unilateral declaration of the registered owner of the vessel, but only has legal existence on registration.

By Article 23 the following particulars must be included in the document:—

- 1 the identity, domicile and nationality of the debtor and of the owner; the identity and address of the creditor:
2. the identity and description of the ship:
3. the type of credit guaranteed:
4. the amount secured, the agreed interest, the period of the hypothec, the place and mode of payment.

The parties to the hypothec are the owner and the lender. There are no restrictions on the nationality of the holder of the hypothec provided the ship is of Venezuelan nationality.

The hypothèque may cover the ship, her machinery, equipment and rigging but not freight.

A ship and equipment under construction may be hypothecated provided at least a quarter of the estimated cost has been invested. Article 24 provides that the document is to be signed by the shipbuilder and the principal or proprietor, and that it must describe the ship and the stage of construction.

2. Registration

Article 20 provides that the hypothèque is to be registered at the Subsidiary Registry Office which has jurisdiction at the ship's port of registry. Article 22 provides that the document constituting the hypothèque is to be taken to the Port Captain at the port of registry within thirty days after the registration. He will file a copy of the document and mark the ship's certificate of registration.

When a ship under construction is the subject of the hypothèque, the hypothèque must be registered at the registry which has jurisdiction where the shipyard is situated and if it is still in being when the ship is finished, it must be declared on registering the ship at her port of registry.

Once the Deed of Covenants is registered, no re-registration is required.

3. Discharge

The hypothèque may be discharged by agreement, order of the court or by purchase by a third party who tenders the purchase price to the holder of the hypothèque and thereby obtains a clean title.

Any attempt to delete a ship from the register of the National Merchant Marine without the consent of the holder of the hypothèque is not only void but carries the possibility of a prison sentence.

The general prescription period for credit arrangements, ten years, applies.

4. Validity and priority

According to Article 21, hypothèques take effect from the date of their registration and have priority in date order. If more than one is registered on the same day, the one first presented in time has priority.

The law of the flag is applied in deciding whether to grant recognition to a foreign mortgage and also in determining its validity and priority.

5. Judicial enforcement

A ship may be sold through the court to enforce a hypothèque. The procedure set out in Article 32 accords with the Commercial and Civil Procedure Codes, and is the same as for the execution of a judgment.

Before posting public notice of the auction, the court informs holders of hypothèques, privileged creditors of whose claims the court has been told, and, if the ship is registered abroad, the registrar, in this case through diplomatic channels.

The time taken to complete the process to distribution of the proceeds depends upon whether a judgment can be obtained, or whether a bond can be given prior to judgment.

Creditors may intervene in the proceedings and the holder of the hypothèque may bid at the auction.

6. Extra-judicial enforcement

There is no way in which to grant the holder of the hypothèque power to take possession of the ship or to sell it without the intervention of the court. Neither power exists by statute; it would be contrary to the *pactum commissorium*.

7. Restriction on disposal of proceeds

There are no exchange control restrictions on remitting the proceeds of sale to the holder of the hypothèque, and no taxes are payable.

8. Insolvency and bankruptcy procedures

Bankruptcy is regulated by the Commercial Code. There is provision for a moratorium before formal bankruptcy.

SUMMING-UP

Professor J.C. Schultz

It was in the middle of 1986 that four persons sat together in Amsterdam in order to draw up a very first and rough outline of what, in due course, became the present Colloquium. The title "Protection against Insolvency in Maritime Law" was the only thing we had. After a few hours of discussion we decided that the subject could not be handled as one monolithic block. It had to be divided into smaller units which would be more appropriate for discussion and exchange of ideas. We decided to split it up in the way which is now familiar to all participants, i.e. to identify categories of parties in the maritime market and look at each set to see whether it had sufficient protection against the insolvency of other parties.

It is clear that, in doing so, we created the risk that we would end up with seven (or four, as it came out at the end) little colloquia with hardly any relationship between them other than the fact of being convened simultaneously in the same building.

With due respect and in all fairness, it is my personal impression that it has not been possible to avoid this danger completely. For each working group, taken separately, the list of subjects was already sufficiently heavy for one and a half days of discussion. What we were unable to do was to confront each working group with the reports of all the others in an endeavour to come up with recommendations that could be presented to the outside world as the outcome of a full exchange of views of all the interests operating in the marine market either for the subject of the Colloquium as a whole or on more limited aspects. I mention as an example bareboat charters which played an important role in the discussions of more than one working group.

It is true that given such a confrontation some of the recommendations would disagree with other recommendations, sometimes even from the same working group. It is in the interest of the shipowner for example that no right should be given to the charterer to sign bills of lading, so this is one of the recommendations in the first part of the report of Group IV. At the same time it is in the interest of charterers that they are the only ones who may sign bills of lading and that only their forms are used, and that is therefore one of the recommendations later in the same report. It may be that some participants had hoped that the C.M.I. might recommend that only shipowners, or only charterers, as the case may be, should sign bills of lading. They will then be disappointed.

But, in reality, not many participants will have had such expectations. The C.M.I. may be the place where the different interests meet to see whether a compromise can be reached – one needs only to mention the Hague Rules as an example – but this does not mean that a colloquium of barely three days could be the proper venue for such an effort.

On the other hand, this does not mean that there are no subjects on which a working group reached a unanimous opinion. Take, for example, the outcome of the discussions in Group III with respect to the ship repairers' protection. Granting to the shiprepairer a "right of retention" should be preferred to a maritime lien in order to meet the requirements of long-term financing institutions not to have to face further hidden encumbrances than the maritime liens now existing. That is a clear and apparently unanimous statement which will not escape being noticed in international circles as proof of a tendency to restrict maritime liens especially when added to the conclusion that an insurer should not be given a lien for unpaid premiums. At the same time the working group proceeded with the utmost caution in the minefield of direct action by claimants against a P & I Club, which could be to the detriment of the other members of a P & I Club when the tortfeasor member has not paid his calls. This shows the diversity of situations which came up for discussion in our Colloquium.

Mr. Chairman, in my opening speech I referred to the three-faced diamond of maritime law, general law and bankruptcy law. Personally, I have greatly benefited from the knowledge and experience of colleagues in the maritime field, for example on the subject of leasing of ships, and many participants told me the same thing as their own impression of the Colloquium. With your permission, I would mention two phenomena which struck me particularly outside the strict maritime law.

Firstly, the impact of bankruptcy law on maritime rights and liens is much greater than some of us had realised and certainly needs a lot of further research. We were greatly assisted by the French participants who provided us with a translation of their surprising new legislation on bankruptcy which jeopardizes the mortgagee's rights and runs counter to all reasonable expectations in the maritime field.

Secondly, to an even greater extent than I expected, the participants expressed their misgivings with respect to the lack of international uniformity in the field of conflict of laws. Why is nothing done to rectify this? The answer is twofold: so far, it has often been thought in maritime circles that conflict of laws is an unpleasant and mainly theoretical side issue which does not really matter. Perhaps it is now recognised that it has great practical importance. On the other hand, particularly in the field of bankruptcy, experience has shown that harmonization of law, not only domestic laws, but also of conflict of laws, is rendered extremely difficult by the very highly privileged position of which the tax authorities take advantage in many countries. However, this does not preclude an exercise, for example, in the more limited field of conflict of laws in liens and mortgages.

Now, leaving it to you Mr. Chairman to say a few final words on our future work, may I end by expressing my gratitude to everybody, Chairman, Rapporteurs and participants, who took part in the work in such a positive and pleasant way.

C.M.I.
COMITE MARITIME INTERNATIONAL
COLLOQUIUM
ON
PROTECTION AGAINST INSOLVENCY
IN MARITIME LAW

CHAIRMAN: PROFESSOR F. BERLINGIERI

GENERAL RAPPORTEUR: HONORABLE C. S. HAIGHT

CONVENER: PROFESSOR J. SCHULTSZ

TULANE LAW SCHOOL — MARITIME LAW CENTER
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OF THE UNITED STATES AND
THE MARITIME LAW CENTER OF THE TULANE LAW SCHOOL

Insolvency and the fear of insolvency have become a major threat to the smooth running of international commerce. There is, in general terms, no confidence that even long established enterprises will remain solvent in the foreseeable future or that machinery exists in national and international legal systems to deal fairly and satisfactorily with the numerous practical problems and competing interests of the business connections of the suddenly insolvent venture.

It is anticipated that during the Colloquium:—

1. the problems which arise on the insolvency of a maritime enterprise will be identified and examined from the points of view of those whose business interests are directly affected;
2. the means by which those interests are at present protected in different legal systems will be compared and their practicality and effectiveness assessed;
3. the ways of reconciling competing interests with each other and with the overriding interests of commerce will be explored;
4. recommendations for the immediate and longer term improvement of the legal framework will emerge.

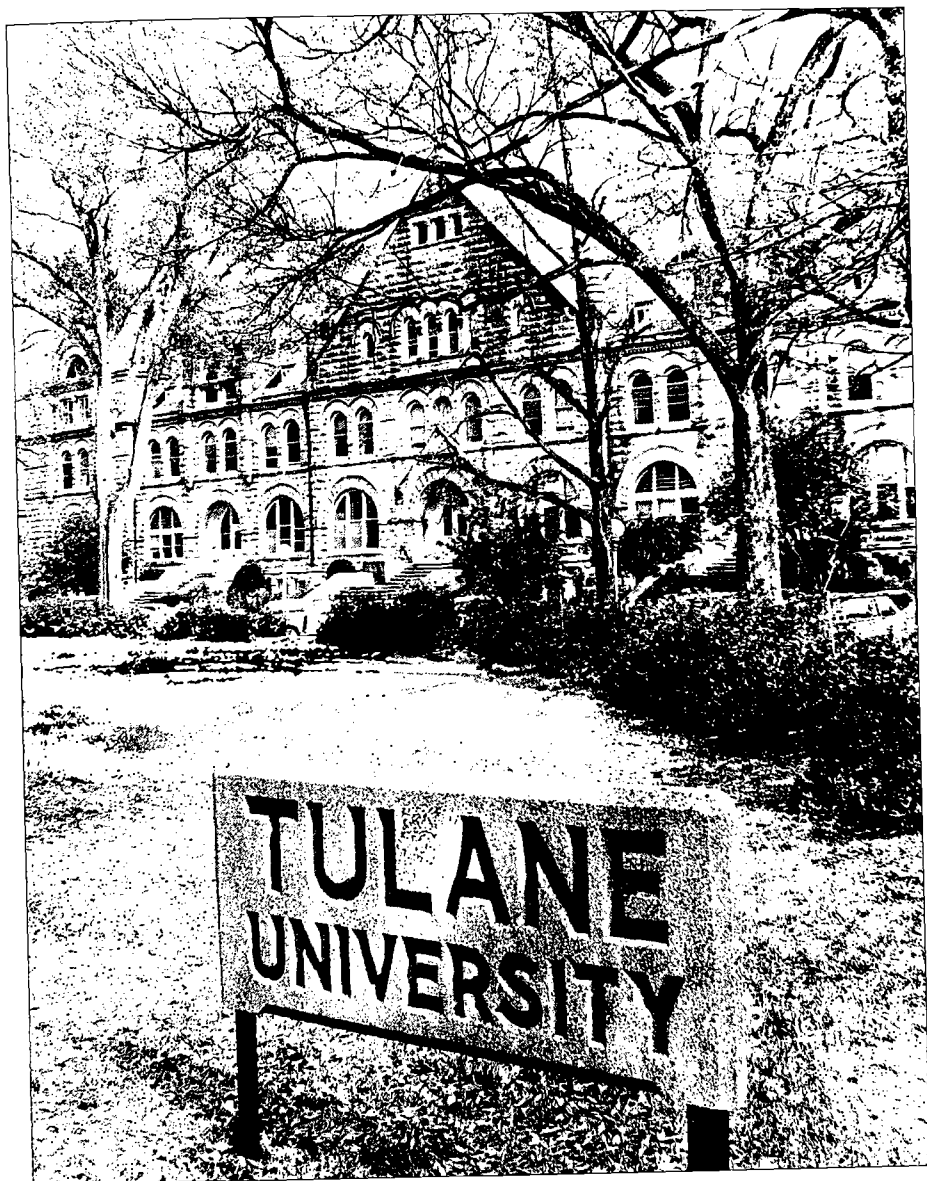
Papers, written by the Speakers listed below, will be circulated in advance and will cover some of the problems and current solutions encountered by:—

- | | |
|---------------------------------|---|
| A. Banks, including mortgagees: | Graeme Bowtle, Solicitor, Richards Butler, London;
Emery Harper, Attorney, Lord, Day & Lord, New York;
Roger Wilman, Lloyd's Bank Export and Project Finance Ltd, London; |
| B. Lessors: | Richard Barnett, Attorney, Haight, Gardner, Poor & Havens, New York; |
| C. Shipbuilders: | Professor Ralf Richter, University of Rostock; |
| D. Shipowners: | Takeo Kubota, Advocate, Braun, Moriya, Hoashi & Kubota, Tokyo; |
| E. Charterers and cargo owners: | Ole Lund, Advocate, Lund and Partners, Oslo; |
| F. Insurers: | John Honour, lately General Manager, West of England P & I Association, London. |

The Chairman of the Colloquium will be Professor Francesco Berlingieri, the President of the C.M.I., while Judge Charles S. Haight, Judge of the U.S. District Court Southern District of New York, will be General Rapporteur and will supervise the discussions and present a summing up at the final session.

GENERAL

- (A) The full documentation, including a programme and the papers referred to above will be made available to delegates before the commencement of the Colloquium. After the Colloquium, they will receive a report on the conclusions and recommendations.
- (B) The participation fee for the Colloquium is \$650. to include the two Receptions given by the C.M.I. and by the Maritime Law Association of the United States on the evenings of Monday November 9th and Tuesday November 10th respectively, lunch, coffee and tea on the 9th, 10th and 11th November. There is also a fee of \$75. for any person accompanying a delegate to the Colloquium.
- (C) It has been decided that in view of the nature of the Colloquium and the plan to use Workshop Groups, and because of the numbers that can be accommodated in the rooms in the conference center where the Colloquium is to take place, the number participating should be limited to 200. All those wishing to participate are therefore invited to make early application on the attached enrolment form and to complete the attached hotel reservation form. Both forms should be sent to Mr. John Sims at the address given hereafter.
- (D) It will be noted that the Registration and assignment to Workshop Groups commence at 0900 hours on the morning of November 9th. It is for this reason that the hotel reservation form covers the period 8th — 12th November.



Gibson Hall, Tulane University (main building)

COLLOQUIUM PROGRAMME

At the beginning of the Colloquium each participant will be assigned to one of four Workshop Groups. These four Groups will consider the Papers — and any additional points thereon made by the Speakers — during six Workshop Sessions which will be held under a Chairman assisted by a Rapporteur. On the third day of the Colloquium there will be a concluding Workshop Session in the morning followed by a meeting in the afternoon of the Chairmen of each of the Workshop Groups and the Rapporteurs, who will work out with the General Rapporteur an overall view of the conclusions reached by the four Groups.

The programme itself will be as follows:—

- 9.11.87 0900 Registration and assignment to Workshop Groups.
1000 Plenary Session: Introductory speeches by Professor Francesco Berlingieri, President of the C.M.I. and Professor Jan Schultz, convener of the Colloquium. Keynote speech by Judge Haight, rapporteur general.
1100 COFFEE
1130 Plenary Session: Presentation of first three Papers.
1230 LUNCH
1430 Plenary Session: Presentation of five further Papers.
1610 TEA
1630 First Workshop Session.
to 1730
1900 Reception given by Comité Maritime International.
- 10.11.87 0930 Second Workshop Session.
1100 COFFEE
1130 Third Workshop Session.
1300 LUNCH
1430 Fourth Workshop Session.
1600 TEA
1630 Fifth Workshop Session.
to 1730
1900 Reception given by the Maritime Law Association of the United States.
- 11.11.87 0930 Concluding Workshop Session.
1230 LUNCH
1430 Report back to Judge Haight from all Workshops.
- 12.11.87 0930 Plenary Session: Discussion of recommendations. Concluding Statement by Judge Haight.
Closing speeches.

Steps are now being taken to obtain information with respect to tours and other matters of interest to the ladies and further information will be made available at a later date.

PROTECTION AGAINST INSOLVENCY IN MARITIME LAW
COLLOQUIUM AT TULANE LAW SCHOOL MARITIME LAW CENTER,
NEW ORLEANS, LOUISIANA, U.S.A.
9TH — 12TH NOVEMBER, 1987.

ENROLMENT FORM — BLOCK CAPITALS PLEASE

NAME (MR/MRS/MISS)

ACCOMPANIED/UNACCOMPANIED
ADDRESS:

TELEPHONE NUMBER:

TELEX NUMBER:

I wish to attend the Colloquium.

I enclose Dollar cheque/draft for \$650 (plus \$75 for accompanying Person, if applicable) payable to C.M.I./TULANE COLLOQUIUM, ACCOUNT NO. 812036920

SIGNED.....

1. PLEASE RETURN THE COMPLETED FORM TOGETHER WITH YOUR REMITTANCE TO:

MR. JOHN SIMS,
MESSRS. PHELPS, DUNBAR, MARKS, CLAVERIE & SIMS,
30TH FLOOR, TEXACO CENTER,
400 POYDRAS STREET,
NEW ORLEANS, LA. 70130,
U.S.A.

2. CLOSING DATE 15TH SEPTEMBER 1987.

THE MANAGER,
WINDSOR COURT HOTEL,
300 GRAVIER STREET,
NEW ORLEANS,
LOUISIANA 70130,
U.S.A.

**C.M.I. COLLOQUIUM TULANE LAW SCHOOL,
MARITIME LAW CENTER**

RESERVATION FOR NIGHTS 8TH TO 12TH NOVEMBER 1987 INCLUSIVE

GUEST NAME..... TELEPHONE NO.

ADDRESS

CITY.....STATE.....ZIP

ARRIVAL DATE.....NOVEMBER

CREDIT CARD TYPE..... NUMBER.....

EXPIRY DATE

\$125 PER NIGHT ONE BEDROOM SUITE
 SINGLE AND DOUBLE OCCUPANCY

ONE NIGHT'S DEPOSIT REQUIRED TO GUARANTEE RESERVATION.
PLEASE MAKE CHEQUE OR MONEY ORDER PAYABLE TO WINDSOR COURT
HOTEL.

CHECK OUT TIME 13.00 HOURS.

PLEASE RETURN THE COMPLETED FORM TOGETHER WITH DEPOSIT TO:

MR. JOHN SIMS,
MESSRS. PHELPS, DUNBAR, MARKS, CLAVERIE & SIMS,
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