

MARINE
M O N E Y

ACADEMY

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Default, Enforcement & Remedies

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Default and Acceleration

- First step is to confirm an Event or Events of Default under the financing documents. Second, confirm that any notices of default and/or acceleration of the loan have been properly prepared and transmitted under terms of the agreement.
- During good economic times, ship lenders don't hesitate to arrest vessels when a particular ship owner is in default under the ship mortgage.
- Unpaid suppliers may also arrest a vessel, and thereby force ship mortgagees to appear in the proceedings to protect their mortgage loan and perhaps even to pay suppliers' claim to arrange release of the vessel so that it may continue operations.
- Financial institutions cannot sit back and watch their assets deteriorate while borrowers are not performing according to the terms of their loans. The important thing is to move cautiously and carefully, yet without unnecessary delay.
- A Mortgagee should conduct due diligence as to the vessel's trading patterns and what likely jurisdictions at which the vessel may call are "arrest friendly" (i.e., the law and the procedures of the forum make an arrest a worthwhile endeavor).

Jurisdiction *in rem* (vessel) and *in personam* (shipowner)

- Admiralty and maritime jurisdiction is part of the judicial power conferred upon the courts of the United States by the Constitution which provides "[t]he judicial power shall extend ... to all cases of admiralty and maritime jurisdiction" (Article III, Section 2).
- The United States recognizes two main methods for seizure of a vessel in a U.S. port: Rule C arrest and Rule B attachment.
- Generally, the vessel, itself, is responsible for payment of liens, mortgages or any other maritime lien that may arise. When the owner encumbers a vessel with a First Preferred Ship's Mortgage, it is the ship that guarantees payment rather than the owner. However, the owner may separately contract by a personal promise to pay or other type of guarantee to be personally liable.
- Rule C arrest allows a creditor to seize a debtor's vessel to enforce a claim against that particular vessel. In general, the creditor only needs to establish that it has a maritime lien or other statutorily authorized claim against the vessel prior to arrest.

Procedure in Arrest Action

- Verified complaint in the U.S. district court within whose jurisdiction the vessel is or is expected to be at the time of arrest. Primary papers to be filed:
 - Verified complaint
 - Supporting declaration (not present if Rule B attachment)
 - Proposed arrest / attachment order
 - Proposed warrant of arrest / writ of attachment
 - Motion and Proposed Order for substitute custodian
- The authority of a district court is generally limited to the geographical limits of the district, including the territorial waters bordering the district.
- Court issues warrant of arrest and court directs U.S. Marshal to arrest the ship – usually same day or day following application.
- Monetary requirements (for U.S. Marshal costs) and security arrangements (such a substitute custodian) that must be shown before arrest warrant may be issued.

Remedies: private sale; stock pledge

- Private sale: will not extinguish liens against the vessel.
- Stock pledge: in the case of default, the lender can foreclose on, and sell, the LLC or share interest that owns the shipowner of the mortgaged vessel instead of directly foreclosing on the mortgaged vessel itself.
- Alternatively, the lender, using its share proxy, can remove and replace the existing directors and management of the shipowner. Special caution is needed as the Lender, in the latter case, will be managing the shipowner, and exposed to both operational and commercial risks and heightened lender liability risks.

Remedies: Judicial Sale

- Mortgagee may move for the interlocutory sale of the vessel. An interlocutory sale of property is usually done in situations where the goods seized are perishable or are susceptible to deterioration. Thus, in unavoidable situations courts allow the res to be sold even prior to completion of the action in which it has been arrested or attached.
- Mortgagee must allege one or more of three permissible grounds: first, the vessel is liable to deterioration, decay or injury while in custody; or second, the expense of keeping the property is excessive or disproportionate; or third, there is an unreasonable delay in securing release of the property. Rule E(9)(a).
- Legal Effect of a Judicial Sale on an *in rem* (Rule C) maritime lien claim versus an *in personam* (Rule B) maritime attachment claim = a judicial sale based on an *in rem* maritime lien serves to extinguish claims of those existing liens not asserted in proceeding. Title passes free and clear to the buyer. In contrast, the sale of a vessel as part of a Rule B maritime attachment proceeding does not extinguish existing maritime lien claims – the buyer at auction takes the vessel “as is.”

Judicial sale (continued)

- Based on the estimated value of the Vessel, the Mortgagee will seek the Court's permission to set a minimum bid price.
- If and when the Court orders the sale, the Court will set a date for the auction. An experienced broker will be engaged to advertise and promote the sale. The broker will advertise the sale widely, including in international maritime trade publications. The expenses of the broker may be recovered from the sale proceeds.
- Mortgagee will seek the Court's authority to bid in the debt (and so take ownership of the Vessel). In order to be granted this relief, the Court will require the Mortgagee's undertaking that it will pay any maritime liens that prime the Mortgage as well as the related expenses of the action.
- The sale will be conducted by the U.S. Marshal and will be a public auction (usually at the Courthouse). If there is a winning bidder, the payment will be made within the time set by the Court (usually a few days) and the proceeds will be deposited into the Court's Registry.

Priority Ranking of Maritime Liens

- Expenses of justice ("*custodia legis*")
- Preferred maritime liens (maritime liens arising before a preferred mortgage was filed or arising out of a maritime tort, general average, or salvage or for wages of the crew of the vessel – some claimants try to claim contract dispute is tort to increase priority of claim)
- A valid preferred mortgage on a U.S. flag ship or a preferred mortgage on a foreign vessel with mortgage guaranteed under Title XI of the Merchant Marine Act of 1936
- The claims of suppliers who furnished necessaries, repairs, and the like to the vessel in the United States
- A valid preferred mortgage on a foreign flag ship
- State created liens of a maritime nature
- Maritime liens for penalties / forfeiture for violating federal law (penalty wage issue)
- Preferred non-maritime liens including tax liens
- Other non-lien maritime claims in causes of action within the admiralty and maritime jurisdiction (Rule B attachments)
- Liens in bankruptcy

Determination of Priorities

- Liens attach to the proceeds of the judicial sale and vessel is transferred free and clear to the purchaser.
- Court will distribute the sales proceeds in the order of priority accorded under the law of the forum to specific types of claims.
- Sale proceeds of the judicial sale usually not sufficient to satisfy all claims; priority of a particular claim is very important.
- Timing = default could be as quick as 2-3 months; priority dispute can easily last over a year (amount of competing creditors and amount at issue will determine the length).
- Examples:
 - MANATEE – 18 months/27 creditors
 - Millenium Seacarriers Bankruptcy – dozens of creditors/over 5 years

Summary/Takeaways

- A Mortgagee facing the need to act against a defaulting borrower must ensure that the necessary procedures (typically set out in the Mortgage) are carried out prior to acting against the vessel.
- While there are private types of recourse that exist, the overwhelming majority of actions taken to enforce against defaulting Mortgagors are mortgage foreclosures and vessel arrests
- If a Mortgagee is contemplating arrest, it is advisable for the Mortgagee to determine where an arrest is feasible (i.e., where the vessel appears to be trading) and then determine which of the feasible jurisdictions are favorable for arresting parties.
- A motion for the interlocutory sale of the vessel is an effective way to ratchet up pressure on the Mortgagor if there is a desire to maintain ownership of the vessel. It also effectively reduces the *custodia legis* (expenses of custody) charges that may accrue against the vessel.
- A Mortgagee should be prepared to encounter competing maritime lien claims that may prime the mortgage lien; these will have to be paid off through sale proceeds.

Questions?



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