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Navigating Your Lease Through a Sea of Liens

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Equipment lenders and lessors face specialized issues when the asset is a vessel. How is the lender secured in its collateral? Can a lessor be secured in a vessel titled in lessor's name? How does a lessor perfect its security interest in the vessel? Where does the lessor stand in relation to competing creditors? This article addresses these questions within the U.S. legal system and describes proposed legislation to expand opportunities for lease financing of vessels.

Creditors who rely on vessels to secure debt must be concerned with the legal environment in which the vessels operate. For centuries, if not millennia, a vessel has been regarded as a separate legal entity apart from its owner. The vessel can incur debts and obligations independent of its owner. In the United States, when a supplier provides fuel (known as "bunkers") to a vessel, the vessel itself is liable for payment. By operation of U.S. admiralty law, the supplier has a maritime lien against the vessel to secure payment. The same is true for repair yards, stevedores, the master and crew, and other providers of goods and services directly to the vessel. If the vessel causes harm, the injured party may have a maritime tort lien against the vessel to secure its claim. A maritime lien claimant may bring an action against the vessel without suing or even bringing a claim against the owner. Modern federal law has long incorporated, and often refined, these historic maritime lien concepts. Today they are reflected in the provisions of 46 U.S.C. Chapter 313 and an extensive body of U.S. case law.

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The 'Preferred Maritime Lien' and Preferred Mortgage

A "preferred maritime lien" is defined as any maritime lien on a vessel arising before filing of a preferred mortgage, or any maritime lien, regardless of when it arises, stemming from a maritime tort, for wages of a stevedore directly employed by an authorized person, crew wages, general average or salvage. Other types of maritime liens, such as those arising in favor of suppliers of necessaries to a vessel, are not considered "preferred maritime liens." In a foreclosure scenario, the only claims that come ahead of the preferred mortgage are "preferred maritime liens" and the costs of the foreclosure action assessed by the court. 46 U.S.C. §31326 (b)(1).

Since its creation by statute in 1920, the preferred mortgage is, by far, the most valuable protection a secured creditor can have in a vessel. The preferred mortgage primes not only certain maritime liens, but also all of the liens and interests created by operation of state or federal law, including tax liens and forfeiture claims for violation of federal law (unless the mortgagee was complicit in the violation). 46 U.S.C. §31327. However, a preferred mortgage under U.S. law may only be granted by the owner of the vessel.

Federal law provides for the documentation of vessels of not less than five net tons (46 U.S.C. §12103(a)(2)) and provides specific requirements for the filing, recording, and status of a "preferred mortgage." 46 U.S.C. Chapter 313. Unlike Article 9 of the Uniform Commercial Code ("UCC"), the preferred mortgage device is not flexible enough to protect a financing lessor under a charter party that is determined to constitute a security agreement. Section 9-202 of the UCC specifically provides that Article 9 applies to a security interest, regardless of whether title itself resides in the debtor or in the secured party. So, what is a lessor/secured party to do in a vessel leasing transaction when that transaction does not constitute a "true lease" of the vessel?

The lease financing transaction itself will be documented as a demise or bareboat charter party, the marine analogue to the equipment lease or an aviation dry lease. Assuming the vessel is at least five net tons, the lessor will document the vessel in its name, unless the vessel falls within one of the exemptions for documentation. For example, barges that operate in the inland waterway system of the United States may be exempt from documentation, although even in those circumstances, lessors may choose to document barges to make title in the vessel publicly visible to the world and to make it easier for subsequent sales or transfers of the vessels.

Additional Concerns for Financing Lessors

Financing lessors have additional concerns under U.S. vessel documentation law. As presently written, only "owners" are permitted to apply for documentation. What is an "owner" and what does "ownership" mean in the case of a charter intended as a security agreement? The current statute and regulations do not address these profound questions although, in practice, "owner" appears to be regarded as the requirement of "title holding" by the Coast Guard's regulations as a bill of sale or written transfer document is needed to apply for documentation. Nonetheless, reasonable persons might be concerned about whether a title holder without any significant indicia of ownership can legally apply for a certificate of documentation in its own name.

If the transaction is a leveraged lease, the vessel will invariably be documented, as documentation under Chapter 121 of Title 46 is a predicate to placement of a preferred mortgage under Chapter 313 of Title 46. In the leveraged lease scenario, of course, the debt holders secured by a preferred mortgage are in a favored position in competition with all other claims, save preferred maritime liens and assessed court costs. The equity, on the other hand, is at the mercy of all other claims on the asset. Maritime lien claims may come from surprising circumstances as painfully evidenced in a case ultimately decided in the U.S. Supreme Court, *Exxon Corp. v. Central Gulf Lines, Inc.*, 500 U.S. 603 (1991).

Exxon arose out of a Chapter 11 proceeding commenced by Waterman Steamship Company.

Waterman had leased several vessels on a bareboat basis from Central Gulf Lines and operated the vessels in Waterman's liner service. By the time Waterman filed in bankruptcy, Waterman and the vessels had accumulated significant unpaid obligations to a number of vendors and service providers, including the bunker supplier, Exxon. The Central Gulf vessels were not the property of the bankrupt debtor, and the charters were eventually rejected by the estate. While Exxon was an unsecured creditor as to the property of the debtor, the Court held that Exxon had valid maritime lien claims against the Central Gulf vessels themselves under the admiralty concept that the vessels had incurred the obligations for service and supplies provided to the vessels.

As noted above, under U.S. law, a vessel may only be documented in the name of the person holding legal title. Even a lessee (known as a "bareboat charterer") with substantially all of the indicia of ownership has no way to register or document a vessel, or its interest in a vessel, in bareboat charterer's name. In the leasing context, this requirement can yield unintended results. The most noted case in this area is *In re: Lykes Bros. Steamship Co., Inc.* (U.S. Bankruptcy Court for the Middle District of Florida, 1996 AMC 1488 decided April 18, 1996). In *Lykes*, the court found that the economic substance of a very complicated structure was a financing transaction and not a "true lease." As a result, the ownership interest in four ships remained in the bankrupt Lykes, even though Lykes was the bareboat charterer of these ships from equipment lessors. As a result, the lessors were held to be unsecured creditors.

If a charter is indeed a security agreement, the title holder/lessor has few good options to protect its collateral. Although a security interest in a U.S. bareboat charterer's rights to the vessel's earnings from charters or other contracts can only be perfected by a UCC Financing Statement and perhaps an account control agreement (UCC §9-102(a)(2)(vi)), it is unclear — at least as to a documented vessel — whether a financing statement filed under the UCC, showing the bareboat charterer as debtor and the title holder as secured party, would perfect such a security interest, in light of UCC §9-311(a)(1). Even if a security interest in the vessel was found to be perfected by filing of a UCC Financing Statement, the value of the security interest might well drown in a sea of superior maritime lien claims as well as all the other priming liens and rights that can overwhelm security interests in personal property generally.

Some benighted souls have resorted to the curious language in 49 U.S.C. §11301, which permits security interests in vessels as well as rolling stock to be filed and recorded with the Surface Transportation Board ("STB"). Unlike Chapter 121 of Title 46, §11301 has no tonnage qualification for vessel filings and no restrictions on filing of agreements creating security interests in favor of title holders. The STB runs separate docket systems for rolling stock and for vessels. The latter docket system is relatively rarely used. While rolling stock recordations number into the high six figures, vessel recordation numbers are so far less than 100. While this filing system permits financing lessors to file either entire charters or memoranda of charters, and arguably confers "perfection" of security interests embodied in the charter, the STB statute is silent on the priority of such security interests in competition with other claims on the asset. In a maritime bankruptcy, that silence, measured against the priority of maritime and other lien claims under long-established federal admiralty and bankruptcy law, leaves those who rely on STB filings near the bottom of the heap. Moreover, the last sentence of §11301(a) stating that "This section does not change chapter 313 of title 46" leaves open the question of what benefit, if any, is afforded to lessors who file at the STB. The STB provisions are, therefore, a nearly toothless remedy for the financing lessor.

Because of the inability to perfect security interests in vessels, many equipment lessors have been unwilling to enter into charters intended as security agreements. When the bareboat charterers are exceptionally strong credits, some lessors have nonetheless entered into these charters, it is hoped with knowledge of the risks involved.

A Current Initiative

A current initiative of the Marine Financing Committee of The Maritime Law Association of the United States ("MLA") seeks to modify the ship mortgage laws by permitting the filing of charters with the National Vessel Documentation Center of the U.S. Coast Guard ("NVDC"). Under the proposed statute (referred to as the "Leasing Amendment"), a financing lessor would be permitted to document the vessel in its name. A charter that is determined to create a security interest conforming to certain enumerated requirements and filed for recordation with the NVDC would be deemed a preferred mortgage, according the title holder preferred mortgage status as to the vessel documented in lessor's name. The objective of the proposal is to bring the ship mortgage laws in line with Article 9 of the UCC as to personal property generally, as well as with the Federal Aviation Act (for aircraft and engines) and the Surface Transportation Act (for rolling stock), all of which allow perfection of security interests in collateral, regardless of whether or not the secured party also holds title.

The Leasing Amendment contains specific requirements for filing such charters. For ease of administration, the drafters of the Leasing Amendment patterned the filing requirements on those for conventional ship mortgages. The proposed statute also permits a financing lessor to leverage any residual interest it may have in the "investment" by allowing the lessor to grant a traditional preferred ship mortgage on the vessel. Of course, the lessor and bareboat charterer always retain freedom of contract to restrict or prohibit any such back-leveraging in any particular structure.

Other provisions of the Leasing Amendment would recognize foreign-flag financing charter filings as enforceable in the U.S. courts, much the same as U.S. law currently accords nearly equal weight to foreign preferred mortgages as to U.S. preferred mortgages in the U.S. courts.

The MLA Board of Directors approved the Leasing Amendment on April 28, 2008. The drafting committee representatives have already circulated the proposal and commentaries to maritime companies and trade groups, government regulators, and congressional staff members in an effort to have this initiative further vetted and it is hoped passed into law in the near future.

The Leasing Amendment and commentary are designed to remain neutral on the "hot button" issues of coastwise trade eligibility under the Jones Act, since its purpose is specifically to address perfection of a security interest in favor of a financing lessor. Financing lessors would continue to be subject to the strict citizenship requirements for owners of U.S.-flagged vessels operating in the coastwise trade or would need to qualify as passive owners under the so-called foreign leasing provisions of Chapter 121 (46 U.S.C. §12119). Vessels subject to these charters would be required to be built in the United States if they are to be operated in the coastwise trade.

Conclusion

Bareboat charter financing of vessels can be a treacherous undertaking for those financiers more accustomed to perfection of security interests on dry land. Knowing the difference between perfection and priority of non-mortgage security interests under current U.S. law can at least help the investor appreciate the risks involved. It is hoped that the Leasing Amendment will succeed in filling the gap to allow perfection of security interests in favor of documented owners evidenced by security agreements masquerading as charters.