An excerpt from *Equipment Leasing*, Chapter 34, “Financing of Vessels,” LexisNexis Matthew Bender (2012).

¶ 34.05 Mortgage Financing Of Vessels

MORTGAGE FINANCING OF VESSELS

[1] Why Mortgage Financing?

Uniform Commercial Code (“UCC”) Section 9-202 states a concept that is key to the development of equipment leasing in the United States and which so far is not accommodated in ship mortgaging. UCC Section 9-202 combines the older concepts of consensual liens and title retention in the UCC concept of a security interest and specifically states that a person may be a secured party notwithstanding that it holds title in the collateral.[1] The UCC recognizes that there are other interests in property than mere legal title and that the holder of these other interests may grant a security interest in such interests. Taken in the bankruptcy context, a financing lessee may be found to be the true “owner” of the property and a title-holding lessor may be found to be a secured party.[2] In such case, the title holder must perfect his security interest by filing in the appropriate place in order to secure his priority rights in the property. This requirement is an axiom of equipment leasing generally. The same result is achieved in perfection of security interests in aircraft and engines by filing with the Federal Aviation Administration (“FAA”) under 49 U.S.C. Sections 44107-11 and, with respect to railcars and related equipment, with the Surface Transportation Board (“STB”) under 49 U.S.C. Section 11301. It is important to remember that FAA and STB recordations establish only perfection of a security interest. All issues of creation, attachment and priority of that security interest are determined under applicable state law.[3]

The perfection and priority of security interests in vessels are, however, far more complicated. There are a variety of means to perfect such interests, with varying levels of effectiveness.

UCC Section 9-311(a)(1) carves certain security interests out of the coverage of its perfection requirements. Among these exceptions are security interests in property subject to “a statute, regulation, or treaty of the United States, whose requirements for a security interest’s obtaining priority over the rights of a lien creditor with respect to the property preempt § 9 310(a).” This Code Section recognizes federal constitutional pre-emption as to such property. To the extent that the CIMLA sets forth a perfection and priority ranking as to preferred mortgages on documented vessels, CIMLA pre-empts UCC Section 9-310.[4]

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[1] UCC § 9-202 (2011).

[2] American President Lines v. Lykes Bros. S.S. Co. (*In re* Lykes Bros. S.S. Co.), 196 B.R. 574 (Bankr. M.D. Fla. 1996).

[3] *See, e.g.*, Aircraft Trading & Services, Inc. v. Braniff, Inc., 819 F.2d 1227 (2d Cir), *cert. denied*, 484 U.S. 856, 108 S. Ct. 163, 98 L. Ed. 2d 118 (1987); *In re* Gary Aircraft Corp., 681 F.2d 365 (5th Cir. 1982), *cert. denied*, 462 U.S. 1131, 103 S. Ct. 3110, 77 L. Ed. 2d 1366 (1983).

[4] 49 U.S.C. § 11301 (2006) also contains a provision for the registration of security interests, including financing leases, in vessels as well as railcars, in each case “intended for a use related to interstate commerce.” The provision has no threshold requirements as to size or tonnage. The section is silent as to the priority of any security interest filed with the STB and also states that its provisions do not require a filing as to any mortgage on a documented vessel governed by CIMLA. The provision is occasionally used

Of great importance is the fact that filing of a preferred mortgage can only perfect a lien on the vessel itself and its appurtenances, but does not establish perfection against all things which might be considered "proceeds" of the vessel. In particular, a mortgagee should strive to obtain security interests in charter parties, charter hire, freights and other earnings, insurance proceeds and other property, claims or rights to which the vessel owner or charterer may become entitled over time. Since security interests in those classes of property cannot be perfected under CIMLA, the UCC is not entirely displaced, and the secured party must file in accordance with Article 9 of the UCC as to the proceeds and other non-vessel collateral. The applicable perfection rules as to such collateral would be the same as in a non-vessel transaction and vary by collateral type and debtor location.[5]

The foregoing approach is also used in perfecting against non-vessel collateral in the case of foreign-flag vessels, although the security device and "perfection" requirements may vary, remembering that the concept of "perfection" is a construct of the UCC and not necessarily a universally understood or applied term.

Even in the case of FOC registration and mortgaging regimes based on the U.S. legal system and often drafted by American lawyers, there is not always a well-developed regime for perfecting security interests in non-vessel collateral. This is in large part due to the fact that vessel mortgages must perforce be filed, registered or recorded where the vessel registry is maintained. However, that is hardly ever where the owner or charterer is found. Even when the vessel owner has a registered address in Monrovia, Liberia, or the Marshall Islands, the owner's tax strategy invariably dictates that it be a non-resident of such country and that it not conduct any business in such jurisdiction.

In the so-called "Red Ensign" flags—British Commonwealth countries or territories—there are generally requirements for at least some citizen ownership or management and the maintenance of company records in the jurisdiction. So, for example, a Cayman Islands flag vessel must be owned by a Cayman Islands entity which is formed and maintained by Cayman Islands residents and company administrative organizations. To be effective against a Cayman entity, an assignment of an interest in its property should be registered as a "charge" in the entity's company register in the Caymans.

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for filing of chattel mortgages on undocumented vessels and is used with greater frequency to file against bareboat charters. As of November 1, 2011, there appear to have been only "water" recordations primarily reflecting security interests in undocumented vessels and security interests in bareboat charters of both documented and undocumented inland and coastal vessels (as compared to many thousands for railcars and other rail-related equipment). The provision has never been used for private non-commercial vessels, primarily pleasure yachts and smaller craft, all of which, if not large enough to be federally documented, are presumed to be registered or titled under provisions of individual state law with security interest perfection and priority governed accordingly and not intended for interstate commerce. *See infra*, ¶ 34.05[5].

[5] It should be noted that, counter to most expectations, charter parties are deemed "accounts" under UCC § 9-102(a)(2) (2011), and not "chattel paper." *See* UCC § 9-102(a)(11) (2011), which specifically excludes "charters or other contracts involving the use or hire of a vessel." In practice, however, some secured parties hedge their bets and file against charters as accounts while treating the charters as chattel paper under UCC § 9-313 and by taking possession of a designated original.

[2] Evolution of the Preferred Mortgage

In the long history of maritime liens, the preferred mortgage is a relatively recent arrival. Maritime liens evolved through centuries of decisions by admiralty courts recognizing the needs of various participants in the maritime world for security when dealing with the most mobile property of the time, be they masters of vessels needing provisions and supplies far from home, vulnerable crew members, suppliers, chandlers, longshore workers, or others. Vessels were most often financed by partnerships and shares, generally tied to specific voyages and often by an instrument known as a bottomry bond.[6] Due to the substantial risks inherent in shipping in the age of sail, bottomry bonds bore very high interest and were generally exempt from usury statutes in the United States.

Prior to 1920 in the United States, chattel mortgages on vessels did exist. However, they were of little effect, as the mortgage was deemed a personal contract of the shipowner and not the subject of admiralty jurisdiction. Such instruments had no maritime lien status and were unenforceable in U.S. admiralty courts.[7]

Over the course of the nineteenth century, several maritime nations, notably Britain,[8] France, and The Netherlands, developed the concept of a device for securing loans to vessels and their owners for terms of years, not for specific voyage durations. In Britain, this was the statutory mortgage, and on the Continent it was a hypothecation, the "hypotheque," each with elevated lien priorities *vis-à-vis* other claims against the vessel.

The need for this new device arose out of a combination of legal history and technological change. The law of admiralty had never recognized the claim of one who lends to the shipowner as creating a maritime lien against a vessel. For example, in the U.S., a chattel mortgage on a vessel securing a loan to the shipowner had no priority status against any type of maritime lien.[9] Bottomry bonds were, at least in theory, loans to the vessel itself to finance a particular voyage. This also comported with the nineteenth century view that an advance to the vessel to enable a specific voyage or venture was a necessary element of a maritime lien. Even so, bottomry bonds ranked low in priority. This made bottomry a poor prospect to finance the needs of the technological revolution giving birth to steam engines and iron and steel construction, the costs of which exponentially exceeded the cost of wooden sailing vessels and could never be repaid out of a single voyage or two. Economics of scale in shipping, even in the nineteenth century, were held in check by the limitations in the materials used in wooden hulls. Steel offered the longitudinal rigidity and strength to open the door to longer, more capacious vessels. Moreover, the early applications of steam engines on wooden vessels provided regularly gruesome reports of fires at sea caused by sparks and cinders belched from primitive engines onto wooden decks, with dreadful losses in life and property. Steel hulls addressed this problem as well.

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[6] A few state statutes still survive reflecting the position of bottomry bonds in state lien or insurance law. *See, e.g.*, California Harbors and Navigation Code, §§ 450–462. None of the statutes appear to be in active use and the last reported U.S. case construing bottomry bonds or their effects appears to be The Katherine, 15 F.2d 387 (D. La. 1926); *see* Tetley, Maritime Liens and Claims, at 205.

[7] Bogart v. The S.B. John Jay, 58 U.S. 399, 15 L. Ed. 95 (1855).

[8] The first advances in Britain appear to have been to allow the mortgagee to act in an admiralty foreclosure without specific improvement to the mortgagee's priority position. *See* Admiralty Court Act of 1840, 3 & 4 Victoria c. 65 (1840).

[9] Bogart v. The S.B. John Jay, 58 U.S. 399, 15 L. Ed. 95 (1855).

Over the latter third of the nineteenth century, there were several legislative attempts in the U.S. Congress to create a preferred mortgage. Finally, the SMA was enacted.[10] The SMA and its successors were based on the concept of elevating a chattel mortgage to the equivalent of a maritime lien, provided that it not only satisfied the laws of a state in constituting a chattel mortgage, but also met a rather short list of additional requirements as to form, content, and filing. Only a "registered," later "documented" vessel could be made subject to a preferred mortgage. The "preferred mortgage" had to state the amount it secured, the date the indebtedness matured, the name and official number of the vessel, the addresses of the mortgagor and mortgagee, and be filed in substantial compliance with federal law. This filing originally was made in the Customs District where the vessel was home ported but is now required to be made centrally with the NVDC.

At the same time, the FMLA[11] was revised, setting out the ladder of maritime lien priorities recognized by federal courts sitting in admiralty. The two statutes together made clear that claims against and rights in vessels could only be finally and effectively settled in the United States by federal courts exercising constitutional admiralty jurisdiction. These enactments were accompanied by the Merchant Marine Act of 1920, the first of a series of maritime promotional efforts by the federal government.[12]

Unlike congressional enactments requiring centralized filing and recording of security interests on aircraft and rolling stock, SMA and its successor provisions in CIMLA establish not only a perfection regimen, but also a framework of priorities of claims in vessels and certain other maritime property.[13] Substantively, CIMLA also exercises federal pre-emption by providing that an obligation secured by a preferred mortgage may bear any rate of interest as the parties may agree.[14] This provision no doubt grew out of the concept reflected in various state statutes that excluded bottomry bonds from the coverage of state usury laws, in recognition of the attenuated risks of repayment.[15]

But then, as now, the SMA did not resolve all issues of security interests and rights in property that is ancillary to a vessel. As the modern successor to state statutes creating liens and other rights in most personal property, the UCC governs the creation, attachment, and perfection of security interests in property not secured by a preferred mortgage. In most cases, it is clear which other property related to a vessel or the shipping enterprise is not a "vessel." But not always.

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[10] Ship Mortgage Act of 1920, 41 Stat. 1000 (codified as amended at 46 U.S.C. § 31301–31343) (2006). As noted above, the SMA, as amended, was codified into CIMLA.

[11] Federal Maritime Lien Act of 1910, 36 Stat. 604 (as amended and codified at 46 U.S.C. § 31341–31343) (2006).

[12] The FMLA concluded a raucous century of conflicting state and federal court decisions on the nature of various maritime liens and the authority of individual states to create, circumscribe, and enforce maritime liens, most commonly in respect of the rights of claims by builders, repairers, or suppliers of necessaries to the vessel. Ultimately, the U.S. Congress in the FMLA settled this issue in favor of exclusive federal admiralty jurisdiction. *See* 46 U.S.C. § 31307 (2006), "[46 U.S.C. Ch. 313] supersedes any state statute conferring a lien on a vessel to the extent the statute establishes a claim to be enforced by a civil action *in rem* against the vessel for necessaries."

[13] 46 U.S.C. § 31326 (2006).

[14] 46 U.S.C. § 31322(b) (2006).

[15] It is noteworthy that Marshall Islands law, for example, disallows usury as a defense to a member's payment obligation to Marshall Islands limited liability companies, an increasingly common vehicle for international blue water marine interests. Limited Liability Company Act of 1996, § 82 Marshall Islands Revised Code 2004 Title 52 Associations Law, Part IV.