SAFEGUARDING LESSOR RIGHTS IN MARSHALL ISLANDS FLAG VESSELS

By Francis X. Nolan

Leasing, in the context of shipping, means bareboat or demise chartering of a vessel. Time charters, voyage charters and other contracts of affreightment are operating and servicing agreements, rather than leases.

Lease financing is a favored form of equipment finance in most sectors of the transportation and logistics industries, but not in ship finance. There are a number of reasons for this, including the strict tort liabilities attaching to ownership of vessels, the primacy of many maritime liens over equity interests and the absence of any legal device to protect the lessor's claim in the event of a "recharacterization" of the charter. The last of these reasons—which raises the question, when is a lease not a lease?—is of particular concern if the charterer has access to U.S. bankruptcy courts.

When is a lease not a lease? When, by its defining economic characteristics, it is a security agreement. At least under U.S. law, an agreement in the form of a lease which vests most of the economic benefits in the lessee may be recharacterized by the courts, particularly in bankruptcy, as in reality a security agreement. If the courts determine that the named lessor does not truly retain the economic benefits of the property ownership, but rather appears to be a creditor secured by its possession of title to the assets, the nominal lessee may be deemed the owner of the asset.[1] Generally speaking, courts will focus on the residual value of lessor's interest, taking into account whether or not the lease term exhausts the remaining economic life of the vessel. In this analysis, lease terms, coupled with charterer options to extend at fixed or nominal rates for the remainder, have the same effect. The process of concluding that the property ownership interest is vested in the lessee and not the lessor is commonly referred to as "recharacterization" of the lease. This issue arises most commonly, but not exclusively, in sale and leaseback arrangements.

A great many legal systems around the globe look simply at title transfer and not at the transfer of economic interest. As a result, they do not engage in recharacterization. However, the choice of law adopted by the parties to a lease does not necessarily allow an easy escape from the risk of recharacterization. For example, if a non-U.S. lessee with some assets in the U.S. were to file for Chapter 11 reorganization in a U.S. bankruptcy court, the court would assert worldwide jurisdiction over the reorganizing debtor's assets. This maneuver often places the ownership of a leased vessel at risk of recharacterization. Moreover, a bankruptcy court has a greater responsibility than looking at how the lessor and lessee agree to order their affairs. The characterization by the court will affect other creditors. Bankruptcy is the ultimate zero sum game.

What does this mean to the lessor? It means, first of all, that the court may rule that the lessor does not own the asset, but, instead, is a lender with a title retention security interest. But how good is the lessor's security interest? Unless that lessor has "perfected" that security interest by filing or by other means under the Uniform Commercial Code or another applicable statute, the lessor's security interest is unlikely to have any real value, and the lessor would be treated as an "unsecured creditor" in a U.S. bankruptcy court given the Bankruptcy Code's "strong arm powers."[2] Some lessors have tried to address this concern in the past by filing precautionary state or U.C.C. financing statements to perfect their security interests. However, such filings are not worth much because such liens rank lower in priority than all maritime liens, tax liens and other tort liens in any vessel foreclosure. Moreover, the value of such filings in a foreign proceeding might be even less. This issue has long inhibited the use of leasing structures in ship finance unless the lease (bareboat or demise charter in shipping vernacular) is a "true lease", well outside the bounds of recharacterization risk, or the lessee credit is so compelling

that the transaction would have been done on an unsecured basis in any case. Until now, no flag state legal system afforded a means for a ship lessor to perfect a security interest in vessels to which it held title.

This has not been the case with commercial aircraft finance, where leasing structures predominate. Aircraft lessors have long been able to record leases or memoranda of leases with governmental authorities for purposes of establishing the priority of rights in the aircraft. Similarly, railcar leases, at least in North America, have been recordable with governmental agencies for the same purpose.

The Marine Financing Committee of the Maritime Law Association of the United States ("MLA") considered the difficulties facing ship leasing under current law and drafted proposals for adoption by the U.S. and certain open registry flags to address the risks of recharacterization.

On March 6, 2013, the Marshall Islands became the first flag state to adopt the MLA proposal and passed important legislation to mitigate some of these lessor risks. Nitijela Bill No. 25 amends and adds to the Republic of the Marshall Islands Maritime Act (the "Act") to create new definitions for "documented owner," "financing charter" and "finance charterer":

- A "documented owner" is the fellow who appears in the application for documentation, even if he may hold only legal title and not the full benefits and indicia of ownership.
- A "financing charter" is "a demise or bareboat charter, regardless of duration, between the documented owner and the finance charterer, which is agreed by the parties to be or is determined in judicial or arbitral proceedings to create in favor of the documented owner a security interest in the vessel" in favor of the finance charterer.
- A "finance charterer" is the person identified as the charterer in the financing charter.

New Section 302A of the Act allows either party to file a financing charter with the Marshall Islands registry. A properly-filed financing charter will enjoy the status of a preferred mortgage on the vessel in favor of the documented owner. There are certain inclusions in the charter and execution formalities which must be made to allow filing as a preferred mortgage as well. Renewals, extensions and assignments of the financing lease may also be filed with the Registry.

Does this mean that any bareboat charter may be declared a financing charter and elevated to the status of preferred mortgage? The short answer is "no". The new law provides that, even if the owner and charterer agree in the charter that the charter constitutes a "financing charter," this declaration alone is not binding on third parties or courts hearing the question. This reservation is necessary to avoid fraud or inequitable conduct where parties to a charter might try to defeat creditors by seeking to elevate a true lease to a preferred mortgage, thereby defeating the rightful priority of third-party claims.

So what are the practical benefits of the new law? The most immediate benefit of the new law is that lessors can hedge against the risk of recharacterization by entering into charters which meet the filing requirements of the new law and avoid the dire consequences of having a lease recharacterized as a security agreement. Existing charters can be amended or restated to bring them into compliance to achieve the same benefit. Obviously, charters which are in substance installment sales contracts, including many done with variants of the BARECON forms, would be in fact financing charters.

Under the new law, the documented owner may itself grant conventional preferred mortgages on the vessel, subject to whatever restrictions may exist in prior agreements entered into by the documented owner. This permits some flexibility in back-leveraging transactions and settles the question of whether a mortgage issued by one who merely holds titles is indeed valid. Priority among mortgages should otherwise follow the order of filing or other intercreditor arrangements.

Must one have to claim absolutely that a charter is a financing charter to take advantage of the new law? The answer again is "no". As in aircraft and rail finance, it should be possible to assert the intention of the owner and charterer that the charter be a true lease, but that, in the event it is determined in any court or tribunal or by any governmental authority not to be a true lease, then the charter is agreed to be a financing charter entitled to the status of a preferred mortgage under Marshall Islands law.

What if the owner needs to enforce this new preferred mortgage outside the Marshall Islands? Results may vary by jurisdiction of arrest. U.S. law, for example, allows the enforcement of foreign mortgages meeting certain minimum requirements of central filing and availability for inspection.

While this Marshall Islands law is so new that no court has ruled on its enforceability, there is no reason that a court would not permit enforcement of a mortgage predicated on a financing lease, although the court might entertain challenges as to whether the charter is truly a financing lease as opposed to a true lease. Perhaps more likely is the assertion of the owner's claim in bankruptcy, where the court should look to the rights and priorities of claimants based on the status of their claim under U.S. and Marshall Islands law.[3]

An owner may likely find himself claiming in the alternative: my charter is a true lease and I own the vessel or, if my charter is a financing charter, I am a preferred mortgagee of the vessel. If the owner is found to be the owner, he can press the charterer to accept or reject the lease and all that flows from that status. If the owner is found to be a secured lender, the owner can claim the benefit of his preferred mortgage in the bankruptcy case, which will be impacted by his perfection status.

As a practical matter, choice of New York or other U.S. law in the charter itself is a benefit to the owner as the concepts underlying recharacterization are for the most part products of American jurisprudence and in the bankruptcy scenario will most likely be played out in U.S. bankruptcy courts.

Francis X. Nolan, III, is a shareholder in Vedder Price P.C., resident in the New York Office. A member of the Firm's Global Transportation Finance Practice, he has been active in ship finance for four decades and is the current chair of the Marine Financing Committee of the Maritime Law Association of the United States and a member of its Board of Directors. Mr. Nolan is author of "Financing of Vessels" in the Matthew Bender Treatise EQUIPMENT LEASING (Revised 2013).

---

[1] *See, e.g., In re Pillowtex, Inc., 349 F.3d 711 (3d Cir. 2003) (applying New York Law, including the UCC); see also In re Lykes Bros. S.S. Co., 196 B.R. 574 (Bankr. M.D. Fla. 1996).*

[2] *See Bankruptcy Code Section 544(a)(7) (debtor or trustee can avoid an unperfected lien, leaving creditor's claim unsecured).*

[3] *See, e.g., In re Kors, Inc., 819 F.2d 19, 22-23 (2d Cir. 1987) ("Once the trustee has assumed the status of a hypothetical lien creditor under § 544(1)(1), state law is used to determine what the lien creditor's priorities and rights are.").*

Incident Response • Media Training • Drills • Reputation Building • Litigation Support

PROTECTING REPUTATION

The leading global communications network for the shipping industry

MTI Network is the world's leading media response and public information service dedicated to the shipping industry. Today some 6,000 vessels including gas carriers - tankers – bulkers – reefers – roros - offshore rigs and support vessels and passenger ships are directly registered with the MTI Network, offering 24/7 global reputation protection services. The Network provides a range of media training courses and drills in support of OCIMF's TMSA initiative and works closely with leading P+I Clubs, Maritime Law Firms, Class Societies and Maritime Organisations.

MTI Network Web Site Address: http://www.mtinetwork.com

MTI UK • MTI USA • MTI Benelux • MTI Italy • MTI Spain • MTI Greece • MTI Scandinavia • MTI South Africa • MTI Brazil • MTI Canada • MTI Hong Kong • MTI Singapore • MTI Japan • MTI Australia • MTI India • MTI Middle East • MTI Turkey

Incident Response • Media Training • Drills • Reputation Building • Litigation Support