LEGAL PROBLEMS ARISING OUT OF THE FINANCIAL COLLAPSE OF A CONTAINER LINE SERVICE

As a result of the very poor shipping market in the last few years, numerous legal and commercial problems have been thrown up for all shipping interests consequent upon the financial collapse of various container lines. This inevitably seems to happen when ships are in loaded condition in the middle of the voyage so that enormous extra expenses are incurred by the need to position the vessel and the cargo in the appropriate places. All too often, these extra expenses seem disproportionate and yet at the same time must be borne by innocent parties with little or no prospects of recovery. This paper will endeavour to look at some of the problems that arise following such a financial collapse and some of the legal considerations that may apply.

1. Liner Service Using Its Own Vessels

There are in the world today a number of global intermodal liner services either using vessels directly owned by the liner company itself or using "in-house" vessels time-chartered in from group subsidiaries. This situation is therefore concerned with the collapse of the "shipowner" in one form or another. If this occurs in the middle of a loaded voyage, then immediately considerable operational problems arise because of course the organisation directing the vessel would probably collapse as well. The protagonists in such a situation will be the cargo

interests, the shipowners' trade creditors e.g. bunker suppliers and the shipowners' mortgagee banks or finance houses. Where do they all stand?

Usually, it will be the mortgagee bank who will be the first to be aware of the financial collapse of the shipowner which will of course present it with an enormous financial burden. The bank has two options; either it can go into possession of the vessel and take over the vessel and its commitments under the powers of foreclosure contained in the usual form of mortgage or, alternatively, it can act on the event of default which will have invariably taken place due to the failure to repay mortgage instalments and arrest the ship and force a sale through the Court in order to liquidate the asset and realise its security. Almost invariably, the bank will choose the latter course. It will wish to avoid the former course in most cases because it will not wish to assume any possible personal liability for accrued or accruing debts arising on the ship as well as the cargo commitments represented by the outstanding bills of lading. However, the bank may be faced with a difficulty here if the vessel is some distance away from a convenient or friendly jurisdiction in which the ship can both be sold in practical terms as well as offering the mortgagee priority over trade debtors in respect of the sale proceeds. If the shipowners' financial collapse occurs at a time when the ship is in an unfriendly jurisdiction, the bank may have no alternative but to fund and direct the crew to bring the vessel to an appropriate port. In

so doing, the bank may expose itself to the liability of a mortgagee in possession and render itself vulnerable to third party claims or to losing its priority, see (e.g.) the "PICKANINNY" [1960] 1LLR 533. In practice, however, this seems to be avoided in most cases probably because the bank will often have a pledge of the shares in the owning company and is therefore able to exert influence by means of its control of the owning company rather than by the use of its powers of foreclosure. This seems in practice effectively to insulate the mortgagee against any claim for assuming personal liability or losing priority, at least when the exercise is limited to a relatively short voyage to the nearest convenient jurisdiction for arrest and sale.

We are therefore in a position where usually the bank will have the initiative over trade creditors and cargo interests and will exert its influence accordingly. What then is a suitable or convenient jurisdiction so far as it concerns the bank?

Obviously there are two principal factors involved:-

(i) The jurisdiction must offer a swift and economic court administrative system to achieve the physical sale of the vessel;

(ii) The relevant jurisdiction must offer protection to the bank by way of priority over the sale proceeds as against as many other creditors as possible.

The first factor speaks for itself. With regard to the second factor, it can be said that the traditional common law jurisdictions tend to attract the banks. In these jurisdictions, the mortgagee will be ranked ahead of all trade creditors and will only be ranked behind the very restricted class of "maritime liens" which will include crew wages together with collision and salvage claims; the latter will normally be covered to a greater or lesser extent by insurance in any event. Jurisdictions such as the U.S. offer a different approach in that the modern common law distinction between the strict "maritime lien" and the "statutory lien" does not seem to exist.

The cargo interests and trade creditors therefore find themselves in a very vulnerable position. The bank will normally be able to force a sale pendente lite and of course the market value of the ship on a distress sale will usually be below the value of the outstanding debt so that once the bank has recouped itself by redeeming the outstanding loan from the sale proceeds, there will be nothing left over for the other parties. The trade creditor, if for example he is a U.S. bunker supplier or Japanese repairer, may try to assert a maritime lien based on the law of the place where the relevant contract was made. In the "HALCYON ISLES" P.C. [1980] 2LLR 325 the Privy Council held that this was inappropriate for a Singaporean or an English Court; and that the law of the jurisdiction where the arrest and sale action is taking place must also determine the existence or otherwise of any maritime liens. It is interesting to note that in the

"Marlex Petrolem" case, the Canadian Courts have gone the other way, no doubt under the influence of their U.S. neighbour. (See "In defence of the Halycon Isle "May 1987 LL.M Quarterly")

As for the cargo interest, he is then in a totally exposed position! To add insult to injury, it has now been held in the "MYRTO" [1984] 2LLR 341 that he must bear the expenses of discharging cargo from the ship under arrest prior to her sale; he will then be obliged to on-forward the goods at his own expense with only a claim over for damages for breach of the contract of carriage against the defunct shipowner which is unlikely to produce any dividend after the mortgagee has taken back his loan.

A useful ploy for the bank, if it is concerned that a court sale may reduce the sale price below that obtainable on the open market on a private basis, is for the bank to bid for the vessel through a nominee at an amount equalling the outstanding loan. This will ensure that the vessel is not sold for a lower amount by the Court and, if the bank is successful, then it will be in a position to take the vessel and sell it on the open market with clean title free of debt, following the court sale.

It is of course possible that a bank will not be actively involved and the contest takes place between the Liquidator of the insolvent shipping company (seeking to gather in and realise the assets) and the creditors of a particular ship. The Liquidator's weapon is of course to issue a second winding-up petition in the jurisdiction to which the vessel is proceeding

(ancillary to his own winding-up proceedings probably in the country of incorporation or residence). He may have difficulty in establishing jurisdiction in the absence of any other connection with the place of arrest prior to the vessel's arrival: re Compania Merabello San Nicholas S.A. [1972] 2LLR 268. He cannot of course "arrest" his own vessel in Admiralty; he has no cause of action against it. (See also Re "A COMPANY"No. 00359 of 1987 Ch.D.)

A race may then develop since it appears that the issue of a writ in rem (as opposed to either service or the issue of the warrant of arrest) is the trigger by which the Plaintiff accrues the security by way of charge represented by the Writ in rem (assuming the Admiralty jurisdiction is properly invoked): see the "MONICA S" [1968] P.74. If therefore the Writ is issued before the winding-up Petition, then the Plaintiff assumes the status of a secured creditor in the winding-up and, indeed, the Admiralty jurisdiction of the Court will be allowed to prevail to enable the Plaintiff to sell the vessel and realise his security, leaving any surplus to be distributed in the winding-up: re Aro [1979] 2 WLR 150.

If, of course, the Plaintiff is too late and does not issue his writ in rem until after the issue of the winding-up Petition, then the in rem action can be stayed upon application by the Liquidator in favour of the winding-up proceedings.

The insolvency of a shipping company does of course produce considerable jurisdictional problems if the company is being

wound up in its place of incorporation with its assets (the ships) scattered throughout the world. However, the ancillary winding-up in one jurisdiction subservient to the principal winding-up elsewhere appears to be a well accepted concept, at least in common law jurisdictions. (See (eg) Re the Australian Fed. Life and Gen. Ass. Co. Ltd. (1931) VLR 317)

However, the bank may have to beware of a possible "Slavenburg" attack on its security: see N.V. Slavenburg's Bank v. INR [1980] 1 AER 955. Under the Company Law provisions of Hong Kong and U.K., a foreign company with ...... "an established place of business" ..... within those jurisdictions must deliver various documents to the local Registrar of Companies for registration and if it fails to do so in respect of (e.g.) charges (such as a floating charge or a charge on a ship or any share thereof), then such charges will be void as against any liquidator and creditor.

Although at first sight far-reaching in its implications, this decision is restricted to overseas companies that establish a place of business within the jurisdiction with assets charged within that jurisdiction. The ordinary shipping company that simply trades its ships worldwide using local agents therefore seems to me to have little to fear from this decision. However, a large integrated liner company that sets up local offices under its own name now will have to register locally all its ship mortgages to ensure priority to the mortgagee if the ship should be arrested within that jurisdiction.

Restructuring

As a result of recent events in U.S. and Hong Kong and elsewhere, the idea of "restructuring" has taken hold in the shipping world and a brief word about it may be appropriate.

The concept seems to have arisen in the U.S. in particular as a direct result of the use of Chap. XI bankruptcy proceedings by which an insolvent company can seek Court protection against its creditors. The breathing space gained thereby can enable the company to sell off assets or re-arrange its business to a point where it can hope to trade again on a profitable basis. The dire consequences of a straightforward winding-up are thereby avoided to some degree at least.

In Hong Kong, no such process exists in law, although it may be introduced shortly if the U.K. Insolvency Act 1985 is implemented. This incorporates a "rehabilitation" scheme by way of a Court "Administration Order". The management of the company is placed in the hands of an administrator and for the relevant period, no proceedings can be enforced against the company, including winding-up proceedings, without the leave of the Court.

Thus the major restructurings of the last two years in Hong Kong have been accomplished entirely by commercial forbearance without any legal protection. The key to success in the shipowning context, given the forebearance of the lending banks, was the continued payment of trade creditors to avoid legal action against the ships. Thereafter, debt was converted into

equity and assets sold or redeployed to a point where the business could service the resultant level of debt out of current cash-flow.

On this basis and with insurance arrangements fully maintained and paid for, trade creditors and third party claimants have usually been paid with perhaps appropriate discounts allowed in the unusual circumstances and where the restructurings have ultimately succeeded.

2. The Time Charter Operator

A very different sort of animal frequently seen in liner services is the operator who time-charters vessels in on the open market from third party shipowners either on a "trip-time" basis or "period" basis. The operator will be fully responsible for all the booking of cargo and the issue of bills of lading and the arrangements for loading and discharging the cargo. The financial default of such an operator produces a very different situation because the protagonists here will be the shipowner on the one hand and the cargo interests and the operators' trade creditors on the other.

Usually upon the operators' default a situation will arise where the shipowner will be entitled to terminate the C/P either by reason of the operators' repudiatory breach in (eg) failing to pay hire or arrange discharge etc. or alternatively to exercise a

right of withdrawal of the vessel from the operators' service by reason of such default.

For shipowners, it is worth bearing in mind the technical difference between these two avenues of termination. The first depends on a repudiatory breach of contract by the operator so that the shipowner is entitled to claim damages for loss of hire in addition to freeing his vessel from time charter. The second arises out of an express contractual right granted in most forms of time charter and hence does not of itself permit an additional claim for damages for loss. Where, however, cargo remains on board and is carried to destination, Scrutton Art. 174 states ...... "no doubt (the shipowner) is entitled to remuneration for that service but the exact nature of this right has not been judicially determined". Reference is made to Soc Franco Tunisienne v. Sidermar [1960] 1LLR 594 where, following a frustration, a quantum meruit claim by Owners upon Charterers was accepted by the Court.

If, therefore, such a right does exist, it clearly only does so in this situation against the Charterers. Given that we are talking about a situation where the Charterers are insolvent, such a right becomes academic.

It is probably for this reason that shipowners will frequently not be advised to withdraw their ship from the Charterers' service, upon his financial default since this adds nothing legally to the Shipowners' rights and could arguably

worsen his position if the Charterers' financial position is not as bad as may initially appear to be the case.

So far as concerns the cargo interests, they will be holding the bills of lading which invariably will be contracts between themselves and the shipowner made through the agency of the Master or of the operator acting pursuant to his authority under the time charter. The cargo interests therefore hold a contract of carriage under which the shipowner is committed to take the goods to destination and to discharge them at his expense (assuming "liner" terms). If the bills of lading are endorsed "freight prepaid" then the shipowner has no right under the bills to claim any further freight even though he may be suffering heavy losses by reason of the operator failing to pay him time charter hire. He will have no lien over the cargo for freight by reason of the endorsement. The cargo interests will be in a position to enforce the commitment if there is any deviation by the shipowner by arresting the vessel and/or suing in personam for damages. The shipowner is therefore almost invariably forced to complete the voyage at his own expense with no legal right to recoup the losses from cargo interests he may encounter by so doing. What are his remedies in such a situation?

Firstly, if there are any outstanding freights, he can of course seek to collect these by virtue either of his status as the contractual partner under the bill of lading (see: Wehner v. Dene) (1905) 2KB 92 and withdrawing the authority granted to the

operator to collect such freights or, alternatively, to exercise the right commonly given to him under such time charters to lien any sub-freights by giving notice.

Secondly, he can "pass the hat around" and go to the cargo interests on a voluntary or ex gratia basis seeking some sort of contribution towards the expenditure involved in completing the voyage. I am bound to say that, in my experience, where this situation occurs with a container vessel with a vast number of quite small cargo interests, I am doubtful whether this exercise ever produces a worthwhile result. The time and cost of making a fair calculation and negotiating with all the various interested parties all too often outweighs the cost of delaying the ship to permit such negotiations to take place. Nevertheless, it is an option open to the shipowner.

Thirdly, I have heard it argued that a shipowner may have some right of "quantum meruit" against cargo interests. However, I know of no authority which supports this approach legally and I find it almost impossible to envisage how it can arise. The remedy of "quantum meruit" is quasi-contractual but the position we are talking about here is one which is governed by an express contract between the parties, namely the bill of lading which will be conclusive as to the parties' rights and liabilities inter se. I would therefore discount this possibility.

As for the operator's trade creditors, the divergent approach I mentioned before between the traditional common law

jurisdictions and the U.S. will normally apply. Under U.S. law, it appears that the supplier of goods and necessaries to the vessel may have a direct claim upon the vessel which would enable him to arrest and sell in a jurisdiction which recognised that right. However, in the common law jurisdictions, he would have no claim upon the ship since there would be no personal indebtedness by the shipowner to the supplier if he had merely supplied the ship at the order of the operator. This would normally be the case with the time charter operator for e.g. bunker supplies or stevedoring services. The geographical location of the ship at the time of the collapse is therefore fundamental and if the shipowner is unfortunate in having his vessel in a U.S. port at the time of the collapse of the operator, then he can expect to have to pay the outstanding debts incurred by the operator on the vessel herself before he can trade her freely.

Remarkably enough, I can recall very few instances where the shipowner in this situation has literally taken the law into his own hands and simply discharged the cargo at the nearest convenient port (to him) and sailed away, leaving the cargo interests to their own devices. No doubt this would certainly be followed by a change of ownership designed both to avoid subsequent identification for arrest purposes as well as trying to insulate the new owner from the potential liabilities for failure to perform the bill of lading contract. Time is of the essence and I suspect that if the shipowner acts quickly enough

in a situation where he may be aware of the operator's collapse whilst the cargo interests may not, he might occasionally hope to get away with such a manoeuver. However, it is not to be recommended since the shipowner would then be wholly liable for all the cargo interests' losses without the benefit of any of his insurances and, in today's modern world, would be at risk both personally and as regards his assets. I would, however, say that it is striking how slowly cargo interests can be to respond in such a situation and the possibility of a pre-emptive strike by the shipowner can never be ruled out.

We are all familiar with the very wide-ranging "liberty" clause in modern liner bills of lading entitling the shipowner to deviate in all manner of ways in given sets of circumstances (e.g.) blockades or epidemics, war zones and outbreaks of war or hostilities without breaching the contract of carriage by way of deviation.

I have often wondered whether the time is ripe for shipowners to incorporate some form of "liberty" clause in the event of a financial default by the operator during the voyage, enabling them to discharge the cargo at the nearest convenient port and to lien it for outstanding expenses. Properly drafted, such a clause should be capable of withstanding any attack on it based upon Renton v. Palmyra [1956] 2LLR 379 as either nullifying the contract or being repugnant to the Hague Rules.

For the sake of completeness, I should allude to the possibility that the bills of lading might be the charter operator's own bills under which he would appear as "carrier", although I am bound to say that I do not think I have ever seen a bill of lading without a demise clause having the effect of making the bill of lading a contract with the shipowner. What would be the effect upon the shipowner where the bill of lading was a contract with the charterer is a much debated question and there is authority to suggest that by some unknown mechanism (probably a bailment on terms), the shipowner would continue to have the protection of the bill of lading. See Elder Dempster v. Paterson Zochonis [1924] AC 522. However, I suppose it is possible that in this vacuum, there could be room for a quantum meruit claim against cargo owners if the shipowner was to continue the voyage at his own expense in order to complete delivery of the cargo under the original bills of lading. However, in practice, I cannot envisage a shipowner in such a situation volunteering to complete the voyage without further notice to the cargo interests. I would have thought he was more likely to delay his ship and negotiate terms for completing the voyage; based on the fact that he was not bound by any contract as to either freight or destination, he would be in a position to dictate terms to the cargo interests.

3. Container Leasing Companies

A brief mention should be made of container leasing companies who are often significant creditors at the time of a

collapse of a container line. However, their position would appear to be that of a trade creditor. There has been some controversy in England about whether such companies even have a statutory right in rem against the vessel but it has now been established they do not: see "RIVER RIVA" (LLMN 7 May) where they simply lease to the shipowning company without any particular connection to any individual ship.

4. Insurance

It is pertinent to enquire how far marine insurance for ships, time charterers and cargo interests may respond in meeting the various claims that the various assured may have, arising out of a financial collapse. Unfortunately, however, the answer very quickly comes that it has little or no direct application. Marine insurance is traditionally directed towards making good losses to the insured property arising out of physical loss or damage caused by particular marine perils. Marine underwriters have always tried to avoid indemnifying assured for ordinary trading losses which will have to be covered under some form of credit insurance. Loss of earnings or freight insurance is available.

It is therefore very difficult for a shipowner to look for any recovery under his traditional policies on the vessel for losses incurred in completing a voyage. Cargo interests should bear in mind that if they find themselves suing the shipowner for damages and breach of the contract of carriage (traditionally covered by the P & I insurance) for extra expenses caused by (e.g.) discharge of the cargo short of destination, then this is

a matter for which the owner will not be insured by his P & I club since deviations are expressly excluded. Recovery on such a claim may therefore be difficult in the absence of security.

Likewise, under marine cargo policies, such losses are not covered. Under the Institute Cargo Clauses of 1.1.82 there is now an express exclusion in Paragraph 4.46 for ....

> "loss or damage or expense arising from insolvency or financial default of the owners, manager, charterers or operators of the vessel."

This provision was written into the new clauses after claims have been made upon Underwriters under the old form of "All Risks, FPA or WA Cargo Clauses" in situations arising out of financial collapse. The assured were able to argue with some conviction that sums either voluntary paid over to the shipowner to procure the completion of the voyage or paid to recover cargo discharged short of destination by the shipowner, were in the nature of Sue and Labour expenses paid to avoid a total loss of the cargo. Whilst this was resisted, it did provoke considerable discussion and hence the need in the New Cargo Clauses to write inthe express exclusion. This of course has had the effect of undermining the owners' negotiating position with cargo interests since he can no longer suggest to them that if they pay him an additional sum by way of freight to complete the voyage, they stand a chance of recovering from their own marine cargo underwriters.

In summary, therefore, a financial collapse exposing innocent parties to extra expenses is unlikely to lead to any claim by those parties upon their marine underwriters under their respective marine policies of insurance.

5. Position under the Sale Contract

For cargo interests who find themselves saddled with a defunct shipping operator, it may be worth looking at the sale contract for a remedy. For FOB buyers, of course, no such possibility will arise since it will be the buyer who will be responsible for organising, fixing and nominating the shipping tonnage. However, for the CIF purchaser, there is legal authority to the effect that the seller of the goods must procure a bill of lading or contract of carriage for him on terms which are normal and reasonable in the trade and enable the seller to comply with the express terms of the contract of sale. It may therefore be arguable that if a seller of goods ships on tonnage which is in fact unable to complete the contract of carriage, then he may have a liability to his buyer for extra expenses. If at the time of fixing the contract of carriage, the seller had some knowledge that the shipowner was in financial difficulties (eg) because he was accepting extremely low freights as a desperate means of obtaining cargo or assigning the freights to third party trade creditors, then the buyer might have recourse against him. However, I am bound to say I have never seen this tested in practice and, of course, in many cases the CIF purchaser will lay down stringent terms about the nature of the

tonnage to be employed in carrying the cargo to destination. The burden of proof would also be very onerous and difficult to discharge so that it would take an extreme case to enable a buyer to succeed.

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