THE INTERSECTION OF BANKRUPTCY LAW AND MARITIME LAW

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This article will provide a short overview of selected topics regarding the intersection of bankruptcy law and maritime law. Specifically, it will cover the basics of the bankruptcy process as it relates to the interests of ocean cargo carriers as creditors or other parties in interest in a bankruptcy case filed in the United States.

The United States Bankruptcy Code is a federal body of law that governs the rights of debtors and creditors when an entity files a bankruptcy petition in this country. The entity in bankruptcy is called the "debtor." Parties that are owed money by the debtor are called "creditors." Creditors may be either secured creditors, meaning that they hold collateral for the debts owed them, or unsecured creditors, who do not have any collateral or security for their claims.

Some other important possible parties in interest to a bankruptcy case are a creditors' committee and a trustee. The entire bankruptcy process is administered by a bankruptcy court judge, with the input and oversight of the Office of the U.S. Trustee, which is a branch of the U.S. Department of Justice.

The two main types of corporate bankruptcy, as opposed to personal or individual bankruptcy, are Chapter 11, reorganization, and Chapter 7, liquidation. In addition, Chapter 15 governs the proceedings in the United States when a foreign entity with assets in the United States files a bankruptcy proceeding in a foreign country and an "ancillary" or cross-border bankruptcy case in the U.S. to protect its U.S. assets.

Under Chapter 11 of the Bankruptcy Code, a debtor-in-possession or a trustee attempts to reorganize a debtor company's business. The reorganization is generally consummated through confirmation of a plan of reorganization or a sale of substantially all the debtor's assets out of the ordinary course of business. Under Chapter 7, a trustee is appointed or elected who sells or otherwise liquidates the debtor's assets, with the proceeds of sale distributed to creditors according to the priorities of distribution established in the Bankruptcy Code.

In addition, a creditor or a group of creditors may file an involuntary bankruptcy petition against a debtor, which forces the "alleged debtor" entity into bankruptcy. Generally, an involuntary bankruptcy petition can be filed by a group of eligible creditors when the debtor is not paying its debts as they become due.

The filing of a voluntary or involuntary bankruptcy petition under Chapter 7 or 11 creates what is called a bankruptcy "estate." Further, the filing of a voluntary or involuntary bankruptcy petition under Chapter 7 or 11 invokes a "stay" against certain creditor actions to collect debts that were incurred prior to the bankruptcy filing, called the "pre-petition" period, as opposed to after the bankruptcy filing, called the "post-petition" period. The automatic stay is one of the fundamental purposes of bankruptcy, because it gives the debtor breathing room to try to solve its financial problems and difficulties.

THE AUTOMATIC BANKRUPTCY STAY

Section 362(a) of the Bankruptcy Code states in pertinent part that "a petition filed under … this title … operates as a stay, applicable to all entities, of—

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;
(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;
(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;
(4) any act to create, perfect, or enforce any lien against property of the estate;
(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;
(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;
(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor…."

When a company, such as a shipper or consignee of goods, files for bankruptcy protection, there is an automatic, legal stay or prohibition against attempting to collect a debt that was incurred before that company filed for bankruptcy. Likewise, there is a stay against acts to sell or otherwise take possession of cargo that is property of the debtor's bankruptcy estate. An ocean cargo carrier should file a motion for relief from the automatic bankruptcy stay in order to allow the carrier to execute its maritime lien on cargo, or to reconsign the cargo per the shipper's instructions.

RELIEF FROM THE AUTOMATIC BANKRUPTCY STAY

Section 362(d) of the Bankruptcy Code states in pertinent part that "[o]n request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest;
(2) with respect to a stay of an act against property under subsection (a) of this section, if—
    (A) the debtor does not have an equity in such property; and
    (B) such property is not necessary to an effective reorganization…."

As a general rule, ship owners have a lien upon cargo for freight charges. Consequently, ship owners may retain the goods after the arrival of a ship at the port of destination until payment of the freight charges is made. Such a lien is regarded in the jurisprudence of the United States as a maritime lien, because it arises from the usages of commerce, independently of the parties, and not from any statutory regulations. Legal effect of such a lien is that the shipowner, as carrier by water, may retain the goods until the freight is paid.

The parties to a maritime contract may also employ words in their contract to affirm the existence of the maritime lien, or even to extend its reach. Further, the intervening insolvency of either party to a maritime contract cannot change the terms of the parties' agreement.

Generally, an ocean bill of lading includes a lien clause that affirms or extends the possessory maritime lien by contract. Some ocean carriers even include a general lien clause and a lien survival clause in their bills of lading, which extends the lien to other cargo shipments and preserves the lien even after delivery or release of the subject cargo.

An ocean carrier who has goods in its possession at the time that a shipper or consignee files for bankruptcy should seek relief from the automatic bankruptcy stay to allow it to execute its maritime lien or to reconsign the cargo, either for cause or because the debtor may not own the goods and the cargo is not necessary for an effective reorganization, especially if the debtor is liquidating.

PROPERTY OF THE ESTATE

Section 541(a) of the Bankruptcy Code states in pertinent part that: "[t]he commencement of a case under … this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held:

(1) … all legal or equitable interests of the debtor in property as of the commencement of the case."

Property of the estate is broadly defined and interpreted. However, the question whether property of the estate extends to assets that are outside the territorial limits of the United States is a disputed issue. Thus, it is usually prudent to assume that such property is property of the debtor's estate and seek stay relief before diverting cargo or executing a maritime lien on the cargo.

STOPPAGE OF GOODS IN TRANSIT

When a shipper, usually the seller of the goods, learns that its buyer, usually the consignee, has filed for bankruptcy, it is not unusual for the shipper to send a notice to the carrier to stop the goods in transit. The shipper does not have to obtain bankruptcy stay relief to do so. However, before the carrier may return the goods to the shipper or reconsign them to a new consignee, it may need to obtain relief from the automatic bankruptcy stay.

Even assuming that cargo was ever property of a debtor's bankruptcy estate, the stoppage of cargo in transit by a shipper takes the cargo out of the debtor's bankruptcy estate. Since cargo that has been stopped in transit was never or is no longer property of a debtor's bankruptcy estate, the automatic stay of Bankruptcy Code Section 362(a) arguably does not apply.

CRITICAL VENDOR STATUS

When a company files for bankruptcy, especially a manufacturer or retailer, it will often file a "first day motion" for authority to pay critical vendors, including its carriers. Without such a critical vendor order, the debtor is not allowed to pay its pre-petition creditors. In order to ensure uninterrupted service from its carriers, a debtor will obtain one or more critical vendor orders. Critical vendor status allows a debtor in bankruptcy to pay a carrier for pre-petition charges immediately after filing, despite the fact that it violates the absolute priority rule, whereby pre-petition claims are usually paid pursuant to a confirmed plan of reorganization.

SERVICE CONTRACT REJECTION DAMAGE CLAIMS

Another issue that often arises is rejection of minimum volume quantity service contracts in bankruptcy by the debtors, who are often the shippers.

Section 365(a) of the Bankruptcy Code states that "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." An executory contract is generally defined in bankruptcy as a contract under which the obligations of the debtor and the other party to the contract are so far underperformed that the failure of either to complete

performance would constitute a material breach excusing the performance of the other. A service contract, including a minimum quantity commitment contract, is an executory contract.

Under the Bankruptcy Code, a debtor in bankruptcy can reject an executory contract or unexpired lease. The damages flowing from the rejection, which is considered a breach of the contract, are deemed a pre-petition, general, unsecured claim. Although the contract rejection actually occurs after the bankruptcy filing, or post-petition, the breach occasioned by the rejection is deemed to have occurred immediately prior to the filing, or pre-petition.

PREFERENCE PROCEEDINGS

A debtor in bankruptcy or a trustee may seek to avoid or recover payments made by the debtor within 90 days before the debtor filed bankruptcy, if the debtor was insolvent at the time of the transfer, the payment was made on account of an antecedent debt, and the transfer allowed the creditor to receive more than it would receive in a Chapter 7 liquidation.

The manner by which a debtor or a trustee attempts to avoid or recover allegedly preferential payments is through an adversary proceeding, which is a lawsuit filed in the context of the underlying or main bankruptcy case.

Section 547(b) of the Bankruptcy Code states that “the trustee may avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made--
  (A) on or within 90 days before the date of the filing of the petition; or
  (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
(5) that enables such creditor to receive more than such creditor would receive if--
(A) the case were a case under chapter 7 of this title;
(B) the transfer had not been made; and
(C) such creditor received payment of such debt to the extent provided by the provisions of this title.”

A carrier may defend a preference proceeding on the basis that the plaintiff, which could be the debtor, a trustee, or unsecured creditors’ committee, cannot prove the elements of the preference cause of action.

DEFENSES TO PREFERENCE PROCEEDINGS

One common defense to proof of the elements of the preference cause of action is that there was not an antecedent debt to begin with, because the carrier received payment of its freight charges before it delivered or released the cargo for which it was paid the freight charges. If there is a pre-payment or a cash-on-delivery (COD) payment, then there was arguably not an antecedent debt at all, and the transfer was not a preferential payment in the first instance.

A carrier may also defend a preference proceeding on the basis that the carrier was fully secured at the time of the preferential payment transfers by virtue of its maritime lien on the cargo in its possession. Thus, the plaintiff cannot make out one of the elements of the preference cause of action, that is, that the creditor received more from the preferential transfers than it would receive in a liquidation. The reason is that, in liquidation, a fully secured creditor would receive its collateral or the value thereof.

Even if the plaintiff in the preference adversary proceeding can prove the elements of the preference cause of action, there are also several affirmative defenses to a preference proceeding, under Bankruptcy Code Section 547(c). The three most important affirmative defenses are contemporaneous exchange for new value, subsequent new value, and ordinary course of business.

Contemporaneous exchange for new value defense

Contemporaneous exchange for new value means that the debtor and the creditor intended that the payment was in simultaneous exchange for provision of new goods or services, and the payment was substantially contemporaneous.

An ocean carrier has a lien on all cargo in its possession to secure unpaid freight and accessorial charges. The debtor is presumed to understand that it had to pay the carrier in order to receive its cargo, based on the lien clause in the bill of lading and the customs and usage of maritime commerce. Thus, any preference payment was made in contemporaneous exchange for the carrier releasing its lien on the cargo. Therefore, carriers have a contemporaneous exchange for new value defense to avoidance of preference payments.

Subsequent new value defense

Subsequent new value means that, after the preferential payment, the creditor provided the debtor with new goods or services. The creditor is entitled to a new value credit for the price or value of the new goods or services provided.

A carrier might have a subsequent new value defense to a preference demand if it provided shipping services to the debtor subsequent to receipt of the preferential transfers but before the bankruptcy petition filing date. The services

that were provided after the transfers but before the petition date constitute subsequent new value, to which a carrier defendant is entitled to a credit.

Ordinary course of business defense

Ordinary course of business means that the debt was incurred in the ordinary course of business of the debtor and the creditor, according to ordinary business terms between the debtor and the creditor, or according to ordinary business terms in the creditor's industry.

Generally, the debt that was paid by a preferential transfer was incurred in the ordinary course of business of the debtor, as shipper or consignee, and the creditor, as carrier. However, a carrier, defendant in a preference proceeding, may argue that the payment was made in the ordinary course of business between the debtor and the creditor, based on the number of days from invoice or cargo delivery date to freight charge payment date, usual manner of payment by check or wire transfer, lack of extraordinary collection efforts, etc. Also, a carrier may argue that it has an ordinary course of business defense according to the ordinary business terms in the shipping industry, since the terms and manner of payment of freight charges are often similar across the shipping industry.

KNOWLEDGE IS POWER

As a representative of an ocean cargo carrier, it is good to know the basics of the bankruptcy process. Such knowledge can help you to collect your company's debts, even from an apparently insolvent debtor, avoid violating the automatic bankruptcy stay, and maybe even help you defend against having to return a preferential payment to the bankruptcy trustee or other party in interest.