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Does Chapter 11 Work for Foreign Shipping Companies?

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In the past two or three years, we have seen a wave of shipping companies file Chapter 11 bankruptcy cases in the United States. This latest wave started hitting the street in about 2011 and has included such names as General Maritime, Omega Navigation, Marco Polo, TBS International, B&H, and OSG. The timing is no mystery to anyone who has been following our industry, and I do not think it is too controversial to suggest that what we are seeing now are the continuing effects of the precipitous collapse of freight markets starting in 2008 which, in turn, caused a significant and probably long-term drop in ship values.

After 2008, owners were finding themselves with huge mortgage payments on significantly devalued vessels generating substantially reduced revenue streams, and even those owners who had been fortunate enough to lock in high value long-terms charters were finding themselves under immense pressure, either because their charterers were demanding significant concessions or were defaulting altogether. Lenders, reluctant to mark down losses and become owners of large fleets of foreclosed vessels, have done what they could to work with vessel owners to get through this difficult period. But the banks themselves have come increasingly under pressure, and forbearance can only go so far.

Most of the recent maritime filings have involved foreign shipping companies, some with arguably only tenuous contacts with the United States. Why have they come?

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1. Automatic Stay

Perhaps the most obvious advantage is the automatic stay provided for in Section 362 of the bankruptcy code. This is an automatic injunction which comes into immediate effect upon the filing of a Chapter 11 petition. It bars any party from taking steps to pursue or enforce claims against the debtor or property of the estate outside the bankruptcy proceedings. It has worldwide effect, and the consequences for violating it can be severe.

Does this mean that every claim everywhere in the world will be immediately stopped and drawn into the bankruptcy action? No. The power of the bankruptcy court to enforce its orders extends only so far as its jurisdiction over parties and property. But importantly – particularly in this latest crisis – nearly every international shipping bank has at least some presence in the United States, which means that they would run a high risk in ignoring a U.S. bankruptcy court's orders.

2. Critical Vendors

Somewhat the flip side of the automatic stay is the ability of the debtor to make an application in the very early stage of the case for leave to allow it to pay its "critical vendors" even for pre-petition obligations. The purpose, of course, is to ensure that the company can continue its day to day operations while it attempts to restructure. With a shipping company, this is likely to include paying agents' fees and costs, managers' fees, bunkers, supplies, maintenance and repair costs, port costs, and so forth. Clearly, if the company cannot ensure that those kinds of suppliers will continue to do business with it after the bankruptcy filing, then there will be no chance of saving the company as an ongoing concern. The combination of the automatic stay and the ability to pay critical vendors is essential to "stabilizing the patient," so to speak. In the shipping company context, for instance, one can easily imagine the great reluctance of cargo interests to ship cargo aboard a vessel where they perceive a very high risk that the vessel will be arrested at every port of call by mortgage lenders or suppliers of necessaries. They will take their business elsewhere and leave the debtor to die on the vine.

3. Debtor in Possession

One distinguishing aspect of Chapter 11 is that in most instances the debtor actually retains control of the company after the action is commenced. It is referred to in this circumstance as the "debtor in possession." This is in contrast to most foreign insolvency proceedings, where a trustee is appointed to manage the affairs of the company until it is wound up.

From the debtor's perspective this approach has obvious appeal because it allows for the possibility that it may yet emerge from Chapter 11 in control of a functioning, reorganized company. But why on earth would the other parties to a bankruptcy want the debtor to retain control of the company – after all, isn't the debtor the one who drove the company into bankruptcy in the first place?

Obviously, if there are signs of fraud or incompetence, then appropriate applications can be made to appoint a trustee or to otherwise protect the estate. But, in many instances the estate as a whole will benefit from the debtor's continued participation in the running of the company. They are, after all, the ones with the contacts, the market experience, the institutional knowledge, and the technical expertise to run the company. If a trustee has to start from scratch, the company would be at an immediate disadvantage in all these respects.

4. DIP Financing

Chapter 11 affords special protections to lenders who provide post-petition financing to the company to allow it to continue operations during the reorganization process. This is referred to as debtor-in-possession – or DIP – financing. Such lenders, who are often the same parties who have provided pre-petition financing to the company, are given high priority for repayment as an inducement to advance funds to the company. In many instances, this may be the only source of short-term financing available to the company, and thus it can be critical to providing sufficient cash flow while the company works to restructure its obligations.

5. Rejection of Executory Contracts

One incredibly powerful tool of Chapter 11 is the right of the debtor to reject executory contracts. Charterparties are a good example of "executory" contracts – i.e., contracts in which each side continues to perform in an ongoing manner. Following commencement of Chapter 11 proceedings, the debtor has the option to "assume" or "reject" executory contracts. Where the contract is favorable to the debtor, the debtor can ordinarily be expected to assume the contract. This is effectively a post-petition commitment to perform under the charter by its existing terms. But where, on the other hand, the contract is not favorable to the debtor – e.g., where it is above-market from the debtor's perspective – it may reject the contract. If it does so, then any further obligations arising thereunder become immediately accelerated and are treated as a pre-petition claim.

OSG has used this power to great effect over the past few months. It had chartered in a great number of vessels, some at rates that had become favorable because of market swings, but quite a few others at rates that were decidedly not favorable. It has been able to use the rejection powers under Chapter 11 to weed out the unfavorable charters. And perhaps just as importantly, it has been able to use the threat of rejection to persuade vessel owners to renegotiate rates that might have been on the borderline.

6. Preference Payments

The bankruptcy court has significant power to "reverse" preference payments, which are payments made outside the ordinary course of business within the 90 days prior to the bankruptcy filing (and within one year for payments to insiders). This can be extremely valuable to the estate where large sum settlements or other payments were made shortly before the decision was made to file for bankruptcy.

Why Not Chapter 11?

We have talked about some of the powerful tools that Chapter 11 provides to a debtor, but what about its disadvantages? There are several, and these must be carefully weighed before a company can make the decision to start Chapter 11 proceedings.

EXPENSE

There is no way around it, Chapter 11 is expensive. Take first the legal fees the debtor must incur simply to prepare for and file a Chapter 11 petition. There are a significant number of disclosures and motions that must be made on the first day – or, at least, in the very early stages of the case – and the litigation only expands from there. Every creditor, with its own interests at stake, is a potential monkey wrench that must be addressed – seemingly all at once.

On top of that, a unique feature of Chapter 11 is that the unsecured creditors are entitled to form their own committee and to have separate legal representation, with the fees paid out of the estate. The purpose of this is to give a potentially large body of small individual claimants an opportunity to present a collective voice in the proceedings. It is a valuable tool for the unsecured creditors, but it is a potentially significant additional expense for the estate. And of course, the ultimate goal of the proceedings is to develop a workable reorganization plan that all parties can stomach, and invariably this means the involvement of any number of financial advisors, all of whom likewise must be paid out of the estate.

INVASIVE

Chapter 11 is an invasive process. Although the debtor typically remains in possession of the company, Chapter 11 is very much an "open book" exam as creditors and advisors pore over the company records looking for value and opportunities to turn the company around. For a company accustomed to keeping its financial information close to the vest, Chapter 11 can be a shocking experience, and full disclosure is very much the quid pro quo for the opportunity to reorganize.

LOSS OF TRUST IN THE MARKETPLACE

Chapter 11 inevitably carries with it a stigma, and it is always a concern that the simple fact of filing will cause the company to lose customers and clients. That is certainly a risk, and in many cases it is an early imperative for the debtor to convince the marketplace that a Chapter 11 filing is not the end of the world. As mentioned earlier, important stabilizing tools are the automatic stay and critical vendor motions which, when used together, can help stop the world from spinning out of control while the debtor catches its breath, but equally important are the simple non-legal steps of talking to the market place and persuading potential counterparties that the company has a viable path to reorganization. And this discussion does not end when the reorganization plan is confirmed.

A company emerging from Chapter 11 will still have serious perception issues that it will have to be prepared to persuasively address after it comes out of bankruptcy.

LOSS OF CONTROL

There is always the risk that the debtor will lose control of the company in Chapter 11 proceedings. This can happen is various ways, such as the appointment of a trustee if the creditors can persuade the court that this is appropriate; the acquisition of a controlling interest in the company by creditors or white knight investors; or the conversion of a Chapter 11 action to a Chapter 7 liquidation if it turns out that no viable reorganization plan can be approved.

What About The Creditors

SECURED CREDITORS

If the secured lenders otherwise had a clear path to foreclose upon and resell the vessels at somewhere near their market value, then they are not going to be very happy about being in U.S. Chapter 11 proceedings. But Chapter 11 is not necessarily all bad news for the banks.

A bank competing with other creditors to foreclose on a fleet of vessels is not likely to realize anywhere close to the full market value of the fleet in foreclosure sales. And while foreclosure actions are pending, the owner is unlikely to be committing additional funds to maintain the vessels or to keep them in class or, for instance, current with their oil major vettings.

UNSECURED CREDITORS

There's probably no good place to be when you are an unsecured creditor of a company that cannot meet its financial obligations. Efforts to arrest vessels or seize property are easily defeated by secured claimants with liens that typically exceed the value of the asset, and finding unencumbered assets quickly becomes an impossible task. \

In Chapter 11, at least, the unsecured creditors have their own collective voice and representation through the creditors' committee, and ultimately they must sign off on any reorganization plan. In practice, however, the unsecured creditors committee's leverage often comes more from being in a position to throw its modest weight in favor of the debtors' or the secured lenders' position on collateral issues, rather than being able to directly force a deal that is favorable to its constituents. In a reorganization, the unsecured creditors will often play for (or be stuck with) an equity stake in the debtor, but where the case is converted to a liquidation, they remain last in line at the trough.

Conclusions

No one would say that Chapter 11 is perfect, and like any other tool in the toolbox, its full utility is only realized when it is used properly and at the right time. Ultimately, a Chapter 11 case is most likely to succeed where all the significant players involved perceive that there is something worth saving in the debtor. If all parties are generally on board with the process, then they can expend the significant portion of their time and energy working towards a solution. Indeed, the cases that have had the most success – at least as measured by the time between petition and confirmation of a plan – are cases where all parties come to the bankruptcy court with a plan already largely in place. This kind of "prepackaged" bankruptcy can be a powerful tool to help set a fundamentally worthy company back on track after an unfortunate misstep or turn in the market.

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