The Realities and Myths of Chapter 11

There has been much discussion and commentary recently about non-US shipping companies using US Chapter 11 proceedings.

Chapter 11 is seen as either as the scourge of international maritime finance or as a rescue option for distressed shipping companies. In truth, it is neither. This article aims to address four of the most common myths about Chapter 11. It is strictly the last option for distressed shipping companies. But under the right circumstances, it can benefit both companies and lenders.

Myth: it is an abuse for non-US shippers to file for Chapter 11.

Reality: distressed shipping companies file for Chapter 11 for two reasons. First, they have run out of options to keep their businesses as going concerns, because forbearance discussions with their lenders have broken down and lenders have started to arrest vessels and freeze cash.

Second, as Judge James Peck noted in his Marco Polo Seatrade decision, Chapter 11 may be the only insolvency regime that allows a shipping company to reorganise its vessels and operations around the world.

Dutch law only protects assets in the Netherlands, the location of Marco Polo’s headquarters, while English law, which typically governs ship finance documents, prevents a company neither domiciled or headquartered in the UK filing for insolvency.

Similarly, for a company such as Omega Navigation Enterprises headquartered in Greece, Greek insolvency law does not allow reorganisation of businesses as a practical matter. This is also the case under Marshall Island and Liberian law.

Myth: Chapter 11 is unfair to ship lenders.

Reality: Chapter 11 contains many provisions to protect secured lenders, including the right to “adequate protection” of their interests and to seek relief from the court at any time. It also requires the debtor company to seek court permission to engage in any transaction outside the ordinary course of business.

The Marco Polo Seatrade Chapter 11 case is a good example of this. While Judge Peck denied motions by the ship lenders to terminate the Chapter 11 cases, he focused on protecting the economic interests of the ship lenders and put the debtor on what he called “a really tight leash — this case will not be an opportunity for the lenders to be abused in any way”.

Judge Karen Brown in the Omega Navigation Enterprises case gave the debtor a longer leash to reorganise. But as Lloyd’s List reported at the time, (‘Outrage after judge accuses German lender of “reckless disregard for the truth”’, December 20, 2011), part of her rationale was based on perceived misconduct by the lenders themselves.

Myth: there are few consequences if a shipping company files for Chapter 11.

Reality: distressed companies turn to Chapter 11 as the last option. The publicity surrounding a Chapter 11 filing can damage the company’s business as charterers, trade vendors, shipyards, seafarers and others are less likely to extend credit or enter into any contracts other than short-term ones.

Chapter 11 is also a very expensive exercise, as the shipping company must pay substantially increased professional fees to its own advisory team and the professional fees for an “official committee of unsecured creditors” appointed to protect the interests of all unsecured creditors of the company.

Chapter 11 sets a relatively brief period for the shipping company to propose a plan of reorganisation. The initial ‘exclusivity’ period is four months and can only be extended if the company can satisfy the court that it has “cause”. Once the exclusivity period expires any party in the case, including the ship lenders and the unsecured creditors’ committee, can file their own plans of reorganisation or seek other remedies.

Myth: US bankruptcy judges are pro-debtor and anti-lender.

Reality: the Marco Polo Seatrade decision clearly dispels this myth. Judge Peck put Marco Polo on a “really tight leash” to ensure that ship lenders did not suffer material harm while the Chapter 11 case continued. He told Marco Polo’s counsel: “The good news is that I’m keeping the case, and the bad news is that I’m keeping the case.”

The Omega Navigation Enterprises decision suggests nothing different. Judge Brown emphasised, referring to the assertions made by Omega’s secured lenders, that: “United States bankruptcy courts take such claims very seriously and ordinarily schedule a hearing quickly to determine whether there is a threat to the bankruptcy estate... These claims are very important and, if proven, may well justify dismissal, conversion, or relief from stay.”

The reason the judge denied the Omega lenders’ claims was not pro-debtor bias but her belief that the lenders did not prove their claims.

US bankruptcy judges are neither pro-debtor nor pro-lender — they are pro-reorganisation. Chapter 11 offers distressed companies a reasonable opportunity to reorganise their businesses. If they can do so by maintaining the debtors as going concerns, Chapter 11
maximises value for the company and ensures that the ship lenders, unsecured creditors, employees and trade vendors continue to have a viable customer.

The Marco Polo Seatrade and Omega Navigation Enterprises cases have established Chapter 11 as a viable option for global shipping companies.

In the words of the Lloyd’s List article, the Omega Navigation Enterprises decision has set “an extraordinary precedent for other foreign shipping companies seeking refuge from unpaid banks through the US bankruptcy courts”.

However, companies should consider Chapter 11 only as a last resort, having exhausted all other options to address their financial problems outside the courts. Chapter 11 is best compared to a hospital emergency room: it offers emergency surgery, but not a miracle cure.

For a distressed company with a viable business, Chapter 11 provides a chance to return to health — at a price. But for a company whose business is unsustainable or that has waited too long to seek protection, the chances are it will die on the operating table. Perhaps deservedly so.

Evan Flaschen, Robert Burns and Trey Wood are partners with Bracewell & Giuliani, who are counsel to Omega Navigation Enterprises and Marco Polo Seatrade in their Chapter 11 filings www.lloydslist.com/regulation Chapter 11 is seen by some as the scourge of international maritime finance.