CHAPTER 13

(Revised August, 2018)

Bankruptcy

This Practice Guide is about vessel arrest, custody, and sale. The only reason to even mention bankruptcy is that foreclosures and the related vessel arrests are initiated because debts have not been paid and failures to pay debts often lead to petitions for relief under the Bankruptcy Code. As stated in the Introduction, this Chapter and its Figures are limited to getting the matter out of Bankruptcy Court.

It is not uncommon to have a situation where a vessel is arrested in accordance with a Warrant for Arrest and shortly after the arrest the owner of the vessel files a petition under the Bankruptcy Code. That brings up the Automatic Stay of Bankruptcy. The Automatic Stay of Bankruptcy has been an important element of bankruptcy law since the enactment of the Bankruptcy Act.[1] The concept, that upon filing of a petition in bankruptcy, actions against the bankruptcy estate or its property are stayed, was carried forward and somewhat simplified under the Bankruptcy Code[2].So, because, under Section 362 of the Bankruptcy Code,[3] a creditor may not initiate or continue any action to proceed against the property of the estate without further order of the court, the federal court case against the vessel under arrest would stop, at least temporarily.

In 1984, in one of the cases involving the bankruptcy of Hellenic Lines, Ltd., the United States District Court for the Southern District of New York entered an Order that if the bankruptcy petition is for a liquidation, i.e., under Chapter 7 of the Bankruptcy Code, then the vessel under arrest is not property of the bankruptcy estate and the arrest, custody, and sale can proceed in federal court, but, if the bankruptcy is a reorganization, i.e., filed under Chapter 11 or 13, then the Automatic Stay of Bankruptcy applies.[4]

The *Hellenic Lines* approach was generally followed until March, 2018, when, in *Barnes v. Sea Hawaii Rafting LLC*, the Court of Appeals for the Ninth Circuit held that the District Court erred in staying a vessel arrest case when the vessel owner declared

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[1] 30 Stat. 544, (July 1, 1898).

[2] Pub.L. 95-598, 92 Stat. 2549 (November 6, 1978).

[3] 11 U.S.C. § 362(a).

[4] *Morgan Guarantee Trust Company v. Hellenic Lines, Ltd.*, 38 B.R. 987, 1984 A.M.C. 1073 (S.D. N.Y. 1984), cited with approval in *In re: Millenium Seacarriers, Inc. et al.*, 419 F.3d 83 (2nd Cir. 2005).

bankruptcy and in dismissing the seaman's claims against the vessel for lack of in *rem* jurisdiction.[5] The court concluded that the District Court obtained jurisdiction over the vessel in *rem* when the seaman filed a verified complaint and a Warrant for Arrest was issued. According to the *Barnes* court, even though the vessel was not arrested, once jurisdiction in *rem* was obtained, because the defendants appeared generally and litigated without contesting in *rem* jurisdiction, they waived the right to do so. Although the Court of Appeals did not mention it, the District Court case file does not include a filing of a verified statement of right or interest and the case law would indicate that, as a result, the defendants did not have standing to contest the in *rem* case [see page 96]. The court also held that the District Court did not lose in *rem* jurisdiction when the company that owned the vessel filed a petition in bankruptcy under Chapter 7 or when the owner of that company filed a petition in bankruptcy under Chapter 13.[6] The Court of Appeals based this on its holding in *United States v. ZP Chandon*[7] and did not even mention the *Hellenic Lines* or *Millenium Seacarriers* cases. Moreover, the court held that the automatic stay of bankruptcy did not affect the seaman's maritime lien against the vessel and that the bankruptcy court had no authority to dispose of that lien through the application of bankruptcy law. Thus, without saying so, the *Barnes* court affirmed the holding in *Hoquiam Boat Shop, Inc. v. Wendell L. Jones* discussed at the end of this chapter.

To try to summarize, if an arrest is under consideration although the verified complaint has not yet been filed, a petition for relief under the Bankruptcy Code will stay the filing of the arrest lawsuit and it will be necessary to go the Bankruptcy Court and file a Motion for Relief from Automatic Stay or for Withdrawal of the Reference as discussed below and shown in the Figures of this chapter. But, in the Ninth Circuit, if the verified complaint has been filed and the Warrant for Arrest issued, then the filing of a petition for relief under the Bankruptcy Code would have no effect on the arrest case. The same situation in the Second Circuit would probably be handled under the guidelines of *Hellenic Lines,* i.e., Chapter 7, the federal court admiralty arrest case proceeds, Chapter 11 or 13, go to Bankruptcy Court for Relief from Stay or Withdrawal of the Reference. With the arrest suit and bankruptcy petition in other than the Ninth or Second Circuits, Relief from Automatic Stay, Withdrawal of the Reference and Turnover of Property must be considered.

The same section of the Bankruptcy Code that establishes the Automatic Stay, also provides for relief from it. Such relief is granted

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[5] 889 F.3d 517 (9th Cir. 2018).
[6] 889 F.3d 517, 533 (9th Cir. 2018).
[7] 889 F.2d 233 (9th Cir. 1989).

by an Order of the court upon the motion of a creditor and, if contested, a hearing. The basis for relief which the creditor must establish is either "cause," including "adequate protection," which, for vessels, really means insurance, or that the debtor has no equity in the property and the property is not necessary for a reorganization.[8] In a liquidation, Chapter 7, case, because there is no reorganization, the latter does not apply. Adequate protection can also be a question of "equity cushion," the value of the property after deducting the claims of the creditor seeking relief from the automatic stay and all senior claims.[9] Where the vessel that is the subject of the motion for relief from automatic stay has been arrested in the foreclosure of a preferred marine mortgage, if the promissory note which the preferred marine mortgage secures provides for attorneys' fees and expenses then they have the same priority as the mortgage.[10] Since many lawyers who specialize in Bankruptcy law and procedure are unaware of admiralty law, it may be necessary to defend a "turnover motion."[11] It is submitted that it is wholly appropriate to not turn the vessel over to the bankruptcy trustee until the bankruptcy court orders turnover in ruling on a turnover motion. Defense of such a motion, although in Bankruptcy Court, gives the creditor, the plaintiff in the vessel arrest case, the opportunity to raise both the adequate protection and the no-equity-in-the-property and not-necessary-for-reorganization issues and should be straightforward.

There is, however, a provision for what can be called "Automatic Relief from Automatic Stay." If the situation is the foreclosure of a preferred marine mortgage on a pleasure vessel which secures a promissory note for the money borrowed by an individual to purchase the vessel, a very common situation, and if the borrower files a petition under Chapter 7, then the borrower, the debtor in the bankruptcy, has 45 days from the First Meeting of Creditors[12] to either reaffirm the debt under 11 U.S.C. § 524 or redeem the property under 11 U.S.C. § 722.[13] Reaffirmation is a complicated procedure requiring court approval and, interestingly, requiring a certification by the debtor's attorney that reaffirmation of the debt is in the debtor's best interests. In a case of foreclosure of a preferred marine mortgage on a pleasure vessel, a thoughtful attorney is unlikely to provide such a certification. Redemption basically means paying off the loan. If the debtor does not reaffirm or redeem within the 45 day period, then, by statute, the automatic stay is terminated and the creditor may proceed with the vessel arrest, custody, and sale.

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[8] 11 U.S.C. § 362(d).

[9] *In re Indian Palms Associates*, 61 F.3d 197 (3rd Cir. 1995); *Pistole v. Mellor* (*in re Mellor*) 734 F.2d 1396 (9th Cir. 1984).

[10] *General Electric Credit Corp. v. O/S Triton VI*, 712 F.2d 991 (5th Cir. 1983). See the discussion in Chapter 20, Administrative Expenses and Attorneys' Fees and Costs.

[11] See 11 U.S.C § 542 Turnover of property of the estate.

[12] A court supervised, statutorily-required proceeding, see 11 U.S.C. § 341.

[13] 11 U.S.C. § 521(a)(6) and (7).

There is an alternative to proceeding in Bankruptcy Court. An important aspect of Congress' response to the Supreme Court's decision in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co*[14] in the 1984 amendments to the Bankruptcy Code is codified at 28 U.S.C. § 157. In that statute, the Federal District Courts are given authority to refer cases arising under Title 11 of the United States Code to Bankruptcy Judges. Further, Bankruptcy Judges are given authority to hear and determine all cases under Title 11 and all "core proceedings" arising under Title 11 subject to review (appeal) under 28 U.S.C. § 158. Core proceedings are defined in the statute and, in general, are traditional bankruptcy matters such as case administration, allowance of claims, approval of plans and "determination of the validity, extent or priority of liens."[15] The second important part of this statute is a provision for withdrawal of the reference to the Bankruptcy Judges. Under the statute, withdrawal of the reference is mandatory, on motion of a party: "if the court determines that resolution of the proceeding requires consideration of both Title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce."[16] Interestingly, even though the motion for withdrawal of the reference to the Bankruptcy Court is decided by the District Court, under local bankruptcy rules or policies the motion is filed in the Bankruptcy Court and then referred to the District Court.[17] Since any court action concerning maritime liens or preferred marine mortgages requires consideration of the Ship Mortgage Act and the cases interpreting it, and since the Ship Mortgage Act is a law regulating activities affecting interstate commerce, withdrawal of the reference would appear to be mandatory. District Judge Robert Bryan found that to be precisely the case in *Hoquiam Boat Shop, Inc. v. Wendell L. Jones.*[18] On the other hand, in one of the many reported opinions concerning the *Millennium Seacarriers* bankruptcy, District Judge Haight, relying on two earlier District Court cases and without explaining why the plain language of the statute does not mean what it says, held that withdrawal of the reference was not mandatory.[19] Clearly, if a motion for withdrawal of the reference is necessary, the holding of the Ninth Circuit in the *Barnes* case would be important in support of the motion.

[14] 458 U.S. 50, 73 L. Ed. 2d 598, 102 S. Ct. 2858 (1982).
[15] 28 U.S.C. § 157(b)(2)(K).
[16] 28 U.S.C. § 157(d).
[17] Bankruptcy Rule 5011, Advisory Committee Notes, motions are filed with the clerk.
[18] W.D. Wa. C91-5068B, Order, February 13, 1991, Docket No. 3
[19] 275 B.R. 699 (S.D. N.Y. 2002).