Ship Lease Finance: The Jurisdictional Challenge

By John E. Bradley

Traditional marine finance largely consists of ship mortgage finance and ship lease finance. In the former, a lender makes a loan or other financial accommodations to a borrower, whether for the purpose of a vessel acquisition or other purposes, and those loans and accommodations are evidenced by standard debt instruments, such as a promissory note and loan agreement. The borrower's obligation to repay the loan is secured by a preferred ship mortgage granted in favor of the lender against one or more documented or registered vessels owned by the borrower.

Ship lease finance[1] also involves a loan from a lender to a ship owner, although the structure of the loan is different for accounting, tax and commercial purposes. In ship lease finance, the lender purchases the vessel from the owner – or from a third party from whom the owner has the right to acquire the vessel (such as a shipyard in the case of a new construction). Upon the lender's purchase of the vessel, the vessel is registered or documented in the name of the lender, and immediately chartered back to the owner on bareboat terms. The owner-lender will assign all operational risk and liability to the demise charterer (the borrower)[2] and will require the charterer to pay charter hire to the lender – calculated to cover the lender's acquisition costs plus its desired return – on hell-or-high-water terms.

When a shipping loan goes into default (in whatever form it is documented), and the lender takes a decision to commence enforcement proceedings, the choice of judicial forum becomes one of critical importance, particularly in the United States where the state and federal courts operate in parallel. In the United States, the federal district courts are the preferred forum for maritime-related claims given the availability of unique maritime remedies which are only available in those courts. Those remedies are housed in the Supplemental Rules for Admiralty Claims and Asset Forfeiture Actions (the "Supplemental Rules") and include prejudgment attachment and garnishment,[3] actions *in rem*,[4] and possessory actions.[5]

Unlike their state counterparts, the federal district courts of the United States are courts of limited jurisdiction, which means that access to these courts for an aggrieved marine lender requires the existence of subject matter jurisdiction. Diversity jurisdiction[6] and federal question jurisdiction[7] are popular forms of subject matter jurisdiction, but they are not always available to maritime litigants. In the absence of diversity or federal question jurisdiction, most marine lenders will invoke the admiralty and maritime jurisdiction of the federal courts as an independent basis of subject matter jurisdiction. Such jurisdiction is prescribed by the United States Constitution[8] and federal statute[9] and is typically founded upon the existence of a maritime claim, which is usually based upon a maritime contract or a maritime tort. For marine lenders seeking to enforce their shipping loans, this means having an enforceable maritime contract in the jurisdictional sense.

What is a Maritime Contract?

The answer is not always intuitive or obvious. The U.S. Supreme Court has stated that courts cannot look to "whether a ship or other vessel was involved in the dispute" or "to the place of the contract's formation or performance" in deciding whether a contract is a maritime one.[10] Rather, courts must examine "the nature and character of the contract" with a focus on whether the contract has "reference to maritime service or maritime transactions."[11] Although "maritime commerce" must be the principal focus of a contract, the Supreme

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[1] Ship lease finance has been in common usage since the Second World War. *See e.g.*, Interpool Ltd v. CharYigh Marine (Panama) S.A., 890 F.2d 1453, 1459 (9th Cir. 1989).

[2] The charterer becomes the owner *pro hac vice* of the vessel.

[3] Supplemental Rule B.

[4] Supplemental Rule C.

[5] Supplemental Rule D.

[6] 28 U.S.C. § 1332. Diversity jurisdiction exists when the amount in dispute exceeds a certain threshold (currently $75,000) and the lawsuit is between citizens of different states or citizens of a state and a foreign country.

[7] 28 U.S.C. § 1331. Federal question jurisdiction extends to all civil actions arising under the Constitution, laws or treaties of the United States.

[8] Article III, Section 2 of the Constitution provides that "The judicial power shall extend . . . to all cases of admiralty and maritime jurisdiction."

[9] 28 U.S.C. § 1333.

[10] Norfolk Southern Railway Co. v. Kirby, 543 U.S. 14, 23-24 (2004).

[11] *Kirby*, at 24, *citing* North Pacific S.S. Co. v. Hall Bros. Marine Railway & Shipbuilding Co., 249 U.S. 119, 123 (1919).

Court has rejected the notion that "only contracts embodying commercial obligations between the 'tackles' . . . have maritime objectives."[12] As maritime commerce has evolved over time, the Supreme Court has made it clear that the shore line no longer provides a bright-line test between maritime and non-maritime contracts.

For purposes of marine finance in the United States, several long-established jurisdictional principles remain true. Shipbuilding contracts are thus far not viewed as maritime contracts[13] and neither are contracts for the purchase and sale of ships.[14] Although agreements to borrow money are typically viewed as non-maritime in nature, a preferred ship mortgage is a maritime contract[15] and can be enforced by statute in federal court along with the underlying loan agreement that is secured by the mortgage.[16] In addition, contracts for the carriage of cargo – including voyage charters, time charters, and bareboat charters – have been long recognized as maritime contracts for jurisdictional purposes.[17]

Are Ship Financing Charters Maritime Contracts?

As explained above, a ship financing charter is a debt structure employed by a lender and borrower to finance the use and acquisition of a vessel by the borrower. However, unlike a preferred ship mortgage, there is no federal statute recognizing the charter as a maritime contract or permitting the enforcement of a financing charter in the federal district courts. So the question is whether a ship financing charter is a maritime contract for jurisdictional purposes. That was the issue in *Icon Amazing L.L.C. v. Amazing Shipping, Ltd.*, 951 F. Supp. 2d 909 (S.D. Tex. 2013) ("*Icon Amazing*"), a case decided by a federal district court in Texas in 2013, and one that is of considerable importance to marine lenders who offer charter financing products.

Facts of *Icon Amazing*

The *Icon Amazing* case involved a sale and leaseback financing of the supramax bulk carrier AMAZING (the "Vessel") – constructed in 2010 for the Turkish shipping company Geden Holdings Limited ("Geden") at a cost of $33,500,000.00. The 100% financing provided by ICON Capital ("ICON") replaced construction financing previously provided by DVB Bank. The financing structure required the sale of the Vessel from Geden to a special purpose entity owned by one or more investment funds managed by ICON (the "Owner"), with a simultaneous charter back to a special purpose entity owned by Geden (the "Charterer") on a demise basis. The principal structuring agreements were heavily amended versions of the standard Norwegian Saleform 1993 and the BIMCO Standard Bareboat Charter "BARECON 2001" (the "Charter").

The Charter was for a seven-year term with intermediate purchase options in favor of the Charterer and an end-of-charter purchase obligation requiring the Charterer to purchase the Vessel. Charter hire was to be paid on a hell-or-high-water basis. Credit support was provided in the form of an on-demand corporate guarantee provided by the Charterer's parent (the "Guarantor"). The Charter also contained numerous financial covenants to be observed by the Guarantor, as well as top-off provisions requiring the Charterer to provide additional security or pay additional charter hire in the event that the Vessel's fair market value fell below certain agreed thresholds.

Due to market conditions prevalent at the time, the transaction failed. As the Vessel's market value declined, the Owner required additional charter hire and security under the Charter's top-off provisions. Freight rates that the Vessel was able to secure in a soft market were insufficient to pay basic charter hire (principal and interest) under the Charter. The Charterer defaulted under the Charter and, after a period of unsuccessful negotiations, the Owner commenced an action against the Charterer and Guarantor in a federal district court in Texas.

Federal Court Jurisdictional Analysis

The Owner sought access to the court on grounds that the court possessed admiralty and maritime jurisdiction because the Charter was a maritime contract. Having invoked the court's admiralty jurisdiction, the Owner

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[12] *Kirby*, at 25.

[13] Kossick v. United Fruit Co., 365 U.S. 731 (1960).

[14] The Ada, 250 F. 194 (2d Cir. 1918); *but see* Kalafrana Shipping Ltd. v. Sea Gull Shipping Co., 591 F. Supp. 2d 505 (S.D.N.Y. 2008) (holding post-*Norfolk Southern Railway* that a ship sale and purchase agreement is a maritime contract for jurisdictional purposes).

[15] *See e.g.*, Preben v. Jensen, 2014 U.S. Dist. LEXIS 127121 at 5 (W.D. Tex. 2014) ("Prior to the enactment of the Ship Mortgage Act of 1920 . . ., a ship mortgage was not considered a maritime contract and, therefore, did not fall within the purview of a federal court's admiralty jurisdiction.").

[16] *See* 46 U.S.C. § 31325; *see also* Detroit Trust Co. v. The Thomas Barlum, 293 U.S. 21 (1934).

[17] Marine Logistics, Inc. v. England, 265 F.3d 1322 (Fed. Cir. 2001).

sought and obtained a writ of maritime attachment under Rule B of the Supplemental Rules to secure its claims against the Charterer and Guarantor. The property that formed the object of the maritime attachment was another vessel (the M.V. HERO) allegedly owned by Geden or one of its subsidiaries. On a successful motion by the defendants to vacate the attachment, the court determined that it lacked admiralty jurisdiction because the Charter was not a maritime contract.

The court found that the Charter required the Charterer to purchase the Vessel at the end of the term.[18] The court also found that charter hire payments were not market-based but rather installments of the full purchase price for the Vessel.[19] Finally, the court found that the Owner's claim was not only for unpaid charter hire, but also for additional security under the top-off clause.[20] On the basis of these findings, the *Icon Amazing* court determined that the Charter was not a "conventional maritime charter party" but, instead, an "inseparable component of a larger non-maritime vessel sale/financing transaction."[21] In short, the court ruled that the Charter was nothing more than a sale and purchase contract in charter party clothing and, as such, could not be recognized or enforced as a maritime contract.[22]

Although the Charter clearly had non-maritime aspects, such as the purchase option and obligation, it also had distinct maritime provisions that could be found in many "conventional" charter parties. Other courts have had no trouble separating the non-maritime from the maritime aspects of a charter party, and enforcing the latter.[23] Moreover, it is clear from its complaint that the Owner was seeking to recover unpaid charter hire, and was not suing to enforce any of the Charterer's purchase options or obligations. Regardless of how it was determined and agreed between the parties, the payment of charter hire formed the basis of the distinctly maritime bargain by which the Owner agreed to demise the Vessel to the Charterer.

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The *Icon Amazing* decision serves as an important reminder to marine lenders that the enforcement of financing charters in U.S. federal district courts may be an uncertain proposition unless the lender possesses some other jurisdictional key to the court. In this regard, lenders should be mindful that, in 2013, the financing charter initiative developed by the Marine Finance Committee of the Maritime Law Association of the United States became law in the Republic of the Marshall Islands.[24] Under this law, vessel financing charters that are recorded as such against ships registered in the Marshall Islands will be treated as preferred ship mortgages as a matter of law. Although principally designed to mitigate re-characterization risks associated with finance charters generally,[25] the law also creates a wholly independent basis of admiralty jurisdiction for the enforcement of finance charters in the United States. Thus, any financing charter recorded against a vessel registered in the Marshall Islands will have the status of a preferred mortgage under Marshall Islands law, thereby allowing enforcement as such in a U.S. district court,[26] regardless of the maritime characteristics of the charter itself.

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John Bradley is a shareholder of Vedder Price P.C., a 300 lawyer firm with offices in New York, Chicago, Washington, D.C., San Francisco, Los Angeles and London. John is resident in the firm's New York Office where he is a member of the Global Transportation Finance team, which provides finance solutions across

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[18] Icon Amazing L.L.C. v. Amazing Shipping, Ltd., 951 F. Supp. 2d 909, 917 (S.D. Tex. 2013).

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] Although the Geden transaction was not subject to or determined under New York law, its essential characteristics were such that a court applying New York law would have inevitably concluded, under authority of Section 1-201(37)(a)(ii) of the Uniform Commercial Code, that the transaction created a "security interest" and not a true lease of the Vessel.

[23] Jack Neilson, Inc. v. TUG PEGGY, 428 F.2d 54 (5th Cir. 1970).

[24] *See* P.L. 2013-5 Nitijela Bill No. 25, March 6, 2013, "to amend Sections 112 and 317 of the Republic of the Marshall Islands Maritime Act (the "Act"), and to add a new Section 302A to the Act."

[25] *See e.g.*, American President Lines v. Lykes Bros. S.S. Co., 196 B.R. 574 (Bankr. M.D. Fla. 1996).

[26] Under U.S. law, a mortgage, hypothecation or similar charge against a foreign flag vessel will be recognized as a preferred ship mortgage in the United States if it "was executed under the laws of the foreign country under whose laws the ownership of the vessel is documented and has been registered under those laws in a public register at the port of registry of the vessel or at a central office." 46 U.S.C. § 31301(6)(B).

all major transportation sectors, including aviation, aerospace, rail, marine, and ports and terminals. John specializes in marine finance and seaport development and successfully closed the first two Public-Private Partnership marine terminal concessions in the United States. John is a member of the Marine Finance Committee of the U.S. Maritime Law Association and is the current Chairman of the MLA's Committee on Maritime Bankruptcy and Insolvency. John also advises lenders and transportation clients on export control and sanctions regimes and is a member of the American Bar's Association's Section on International Law, Committee on Export Controls and Economic Sanctions.