Bankruptcy Courts' power on disposal of maritime assets

Owan Tang

Department of Logistics and Maritime Studies, The Hong Kong Polytechnic University, Hong Kong.

Abstract

This article investigates jurisdiction on US bankruptcy courts relates its power on disposal of a maritime asset. Global financial tsunami makes transportation companies short of liquidity, and the disposal of underutilized assets would be a sensible way for bankruptcy courts to bring cash inflow for both the reorganization or liquidation objectives.

However, when a shipping company files bankruptcy in the US, the assets treatments will involve two exclusive federal court systems: the admiralty and the bankruptcy court systems.

This article, through a study on relevant bankruptcy cases, investigates whether a bankruptcy court (a legislative court) can administer the debtor's maritime assets, which traditionally could only be dealt with by the admiralty court (a judicial branch of the government).

Key words: Bankruptcy Code, disposal of a maritime asset by bankruptcy court, maritime lien, admiralty jurisdiction, doctrine of Custodia Legis

1. Conflicts between Bankruptcy and Admiralty Jurisdiction

When a shipping company files bankruptcy in the US, the assets treatments will involve two exclusive federal jurisdictions: admiralty and bankruptcy.

In the US, by referring to the article of the US Constitution from which the court's authority stems, courts can be divided into Article III courts and Article I courts. The Article III courts are "constitutional courts," which were first created by the Judiciary Act of 1789. Article III courts constitute the judicial branch of the government (which is defined by Article III of the Constitution). Under the US Constitution, Article III protects the courts against influence by the other branches of government; for example, the salaries of judges from Article III courts may not be reduced during their tenure in office, and their appointments are for life, only subject to impeachment for bad behavior. Examples of Article III Courts are:

- Supreme Court of the United States
- United States courts of appeals
- United States district courts
- United States Court of International Trade

Article I courts, which are "legislative courts," which are regulatory agencies. Since Article III courts are the only courts with judicial power. Accordingly, the decisions of regulatory agencies remain subject to review by Article III courts. However, cases not requiring "judicial determination" may come before Article I courts. Article I judges are not subject to the Article III protections. For example, judges from Article I courts do not enjoy life tenure, and their salaries may be reduced by Congress. The existence of Article I courts has been controversial, and their power has been challenged before the US Supreme Court. The US Supreme Court has determined that Article I courts may exist, but that their power and their decisions are subject to ultimate review in an Article III courts. Examples of Article I Courts are:

- United States Tax Court
- United States bankruptcy courts
- Board of Patent Appeals and Interferences
- Trademark Trial and Appeal Board

The bankruptcy and admiralty jurisdictions serve different objectives, and the compliance of the two jurisdictions has generated a significant amount of confusion. The confusion centers on whether a bankruptcy court (Article I court) can administer the debtor's maritime assets.

In *Murray's Lessee v. Hoboken Land & Improvement Co*. (1856), the US Supreme Court ruled that cases involving admiralty inherently involves judicial determination, and must come before Article III courts. Other cases, such as bankruptcy cases, have been held not to involve judicial determination, and may therefore go before Article I courts. Then, whether a bankruptcy court (Article I court) can have judicial power to determine the maritime assets of a shipping company when it was filed for bankruptcy?

One line of cases held that federal bankruptcy courts have no jurisdiction to determine the validity of maritime liens or its enforcement against a debtor's ship. For example, in *Taylor v. Carryl*,[1] the US Supreme Court opined that the maritime lien for seamen wages is prior to all other claims on the vessel, and must be first paid. By the US Constitution, the only court that has jurisdiction over maritime lien, or authorized to enforce it, is the court of admiralty. It is the duty of the admiralty court to, and no court of common law can, enforce the maritime lien.

In *Moran v Sturges*,[2] the US Supreme Court held that admiralty court possesses exclusive power to enforce and execute maritime liens for in rem proceedings. In *Moran*, a vessel was attached by process from a court of common law. The US Supreme Court opined that the only interest this process could seize was a subordinate interest, which subject to the superior claims for seamen's wages. The court of common law could not know what the amount of those claims will be. The nature of the maritime claims must first be heard and decided in the court of admiralty.'[3]

In *re Interocean Trans. Co*.,[4] the federal district court decided that if a creditor used admiralty process to attach the assets of a shipping company, and such shipping company had already filed its bankruptcy petition before the admiralty attachment process, the creditor divested bankruptcy court of jurisdiction over the assets. Accordingly, it seems that the only US court that may sell a vessel free of maritime liens is the admiralty court.

Yet other line of cases upheld the jurisdiction of a bankruptcy court in administering maritime assets. This line of cases showed that when an individual lien holder submits himself voluntarily to the equitable jurisdiction of another court, his right to enforce the maritime lien would be extinguished. For example, in *Hudson v New York & Albany Transportation Co*.,[5] the issue was whether a federal district court, in administering an equity receivership, has the power to sell a vessel free of maritime liens. The federal district court held that a receivership court could adjudicate maritime liens if the maritime lien holder voluntarily submits to the court's jurisdiction. In *Hudson,* the Circuit Court of Appeals affirmed the general principle in *Moran v Sturges* by saying that: "It is undoubtedly true that proceedings against vessels in rem to enforce maritime liens are vested exclusively in the District Courts of the United States… and there are many other authorities… all holding that no court other than the admiralty court can exercise jurisdiction over maritime liens or divest or extinguish them."[6]

---

[1] 20 How. 583 (1857).
[2] 154 U.S. 256 (1894), at pp. 277-78.
[3] Id., at p. 278.
[4] 232 F. 408 (1916), at p. 410.
[5] 180 F. 973 (1910), at p. 978.
[6] Id, at p. 975.

Then the Circuit Court of Appeals discussed the scenario of "consenting creditor"; if a maritime lien holder consents to a sale free of lien, a court of equity will have the right to make such decree. However, the appearance of a maritime lien holder in court to prove the amount of his claims cannot be construed as a consent.[7]

In *James Rees & Sons Co. v Pittsburgh & Cincinnati Packet Line*,[8] the court opined that by virtue of being a plaintiff in a receivership proceeding, the maritime lien holders who consented to the sale of boats, the purchasers would acquire the boats free of liens and encumbrances.

In re *Millenium Seacarriers, Inc.,*[9] a US Court of Appeals case decided in 2005, held that the maritime lien holders had consented to the sale, free of their liens, by appearing in the equity proceeding and placing the lien before the court for adjudication. The US Court of Appeals opined that when a maritime lien holder places his maritime lien claim for adjudication before the bankruptcy court by (1) filing his notice of objection, (2) remaining in the action, and by (3) litigating his lien actively through the adversary proceeding, the maritime lien holder assents to the equitable adjudication of the bankruptcy court under principles of admiralty law.[10]

In re *Millenium Seacarriers*, the maritime lien holder contends that the bankruptcy court could enjoin him from seeking subsequent attachment and enforcement proceedings in foreign admiralty courts, but the bankruptcy court could not extinguish his rights wholly. The US Court of Appeals rejects this contention by holding that maritime lien holder was not allowed to enforce his maritime lien in the foreign admiralty court; the maritime lien itself has been extinguished as a matter of admiralty law.

In order to harmonize the two lines of cases, the US Supreme Court has traditionally been adopted a judicial approach that if the bankruptcy petition was filed before the admiralty action, the bankruptcy court will obtain its jurisdiction over the debtor's vessel and all claims related to it. For example, in *The Philomena*,[11] the federal district court held that if the vessel had been seized under the admiralty process, before the bankruptcy proceeding begun, the admiralty court shall not surrender the vessel to the bankruptcy court.

In *The Bethulia*,[12] after the institution of the bankruptcy proceedings, but before the adjudication, the admiralty court took possession of the vessel. The receiver made a petition in bankruptcy court in seeking the proceeds of the sale of the vessel. The federal district court denied the receiver's petition in bankruptcy court, and decided that the sale of the vessel shall be proceeded with the admiralty case.

In *Casco*,[13] a maritime lien holder had rendered salvage services to dredge Casco. The dredging company which owned the dredge Casco was being instituted for involuntary proceedings in bankruptcy. The bankruptcy court appointed a receiver, and he at once took possession of the dredge. One month later, the maritime lien holder filed an in rem action against the dredge, which was in the custody of the receiver. The maritime lien holder made a motion to seek the dredge be arrested by the marshal, so that the salvage claim could be tried out in the admiralty court. The receiver opposed the motion. The federal district court did not let the case proceed in admiralty because all actions against the dredge had been previously stayed. *Casco* represents a scenario where the admiralty court is urged to seize vessels in the custody of bankruptcy court.

---

[7] Id.
[8] 237 F. 555 (1916).
[9] 419 F.3d 83 (2005).
[10] Id., at p. 103
[11] 200 F. 859 (1911)
[12] Id.
[13] 230 F. 929 (1916).

However, the US courts did not adopt such a judicial approach consistently. For example, in re *Waldeck-Deal Dredging Co*.,[14] the Circuit Court of Appeals made its decision without regarding to the time of the bankruptcy petition and admiralty action. In *Waldeck-Deal,* a Florida dredging corporation contracted with the US federal government to dredge a section of the Waterway. The work was carried out in North Carolina. Subsequently, an involuntary petition in bankruptcy was filed against the dredging corporation in Florida, and receiver was appointed. The receiver took possession the dredging equipments in North Carolina. Then seamen and supplies providers of the dredge made claims for maritime liens for the wages due and supplies furnished to the dredge. The seamen and supplies providers seek to enforce the maritime liens against the dredge in the possession of the bankruptcy receiver. The trustee moved to dismiss on the ground that Florida court had exclusive jurisdiction on the liens claimed. The court denied the trustee's motion, and the trustee appealed. The Circuit Court of Appeals held that a bankruptcy court could adjudicate maritime liens regardless of when the bankruptcy case was brought.

Even the courts have acknowledged that the law on whether a bankruptcy court could adjudicate maritime lien is unsettled. In *Empire Stevedoring Co. v. Oceanic Adjusters, Ltd*.,[15] the US government was a shipper of goods on a stricken vessel. After delivered aid to the stricken vessel, the stevedoring company sued for recovery of general average contributions from government. The federal district court decided that the claim for stevedoring services representing valid general average expense. However, it did not have lien on general average fund, even company's claim was listed on general average statement. In regarding the jurisdiction on bankruptcy, the federal court pointed out that a bankruptcy court's power to adjudicate maritime liens is unsettled.

Therefore, a bankruptcy court's power to adjudicate maritime liens remained unsettled even during the 70s, over 76 years after the principle established in *Moran v Sturges*. For example, when J. Landers published his article *The Shipowner Becomes a Bankrupt* in 1972, he indicated that US courts are unsettled on whether a bankruptcy court is empowered to extinguish maritime liens by selling a vessel free and clear of liens and interests.[16]

2. The Doctrine of Custodia Legis

Before the Bankruptcy Reform Act of 1978 (the "1978 Bankruptcy Code"), courts employed the custodia legis doctrine to uphold the exclusive jurisdiction of an admiralty court to administer a vessel when the bankruptcy petition was filed after the commencement of an in rem admiralty proceeding. For example in *Wong Shing v. MV Mardina Trader*,[17] a Hong Kong registered vessel named the Mardina Trader was arrested and seized in the Canal Zone pursuant to an action in rem filed by various crew members for wages. On the same date of arrest, Wong Shing and other seamen filed a complaint in rem in US District Court against the vessel and against the vessel owner Mardina Trader Ltd (a Hong Kong corporation). Thereafter, a judgment was obtained and the vessel was ordered to be sold. Mardina Lines (a Panama corporation) owned 100% of the Mardina Trader Ltd. Subsequently, a trustee was appointed for the the benefit of Mardina Lines' creditors. The trustee immediately obtained a temporary restraining order to postpone the sale of the vessel. The District Judge ordered the judicial sale to proceed and directed the US Marshal to disregard the temporary restraining order. The vessel was sold to a resident of the Republic of Panama. The trustee made an objection to confirm the sale. In appeal, the Court of Appeals held that the federal district court has no jurisdiction over vessel, so that it could not issue the temporary restraining order. The Court of Appeals affirmed an admiralty court's jurisdiction in selling the maritime assets on the ground of custodia legis.

[14] 45 F.2d 951 (1930) at pp. 952-53.
[15] 315 F. Supp. 921 (1970) at p. 925.
[16] J. Landers, *The Shipowner Becomes a Bankrupt*, 39 U. Chi. L. Rev 490 (1972) at pp. 506-07.
[17] 564 F.2d 1183 (1977), at p. 1188.

However, after the enactment of the 1978 Bankruptcy Code, if shipping company files a bankruptcy petition before the admiralty proceeding, section 362 will preclude the application of custodia legis.

3. The Bankruptcy Code

Even after 84 years of the *Moran v Sturges* case, the 1978 Bankruptcy Code still didn't clearly address the issue of whether bankruptcy courts possess jurisdiction over admiralty actions.

The 1978 Bankruptcy Code completely altered US bankruptcy law. It created a codified law on bankruptcy (Title 11 of the United States Code), and created bankruptcy courts which served as adjuncts to the US federal district courts. Under the previous law, the Bankruptcy Act of 1898, the federal district courts served as bankruptcy courts and appointed "referees" to conduct proceedings, so long as the district court chose not to withdraw a case from the referee.

The 1978 Bankruptcy Code eliminated the "referee" system. It allowed the US President to appoint bankruptcy judges for terms of 14 years (as opposed to the life tenure given to Article III judges), with the advice and consent of the Senate. Judges from bankruptcy courts could be removed by the judicial council of the circuit on grounds of incompetence, misconduct, neglect of duty, or physical or mental disability (as compared with Article III judges, who may only be impeached by Congress and are constitutionally forbidden from having their pay decreased while in office). Unlike Article III judges, their salaries were set by statute and subject to adjustment.

The 1978 Bankruptcy Code granted the bankruptcy courts jurisdiction over all "civil proceedings arising under Title 11 or arising in or related to cases under Title 11".

An important case for testing the validity of the 1978 Bankruptcy Code is the *Marathon* case.[18] After Northern Pipeline (Northern) filed a petition for reorganization under Chapter 11 under the 1978 Bankruptcy Code, it brought suit in the bankruptcy court against Marathon Pipe Line Co. (Marathon) for breach of contract. Marathon made a motion to dismiss the suit on the grounds that the 1978 Bankruptcy Act unconstitutionally conferred Article III powers on judges who lacked the career protections of Article III judges. The bankruptcy judge denied Marathon's motion. Marathon made an appeal to US federal district court, the district court agreed with Marathon's argument that the law was unconstitutional. Then the case moved to US Supreme Court, which held that Article III jurisdiction could not be conferred on non-Article III courts (i.e. courts without the independence and protection given to Article III judges).

The US Supreme Court stayed its judgment until October 4, 1982, in order to give the US Congress an opportunity to repair the constitutional flaws in the bankruptcy system. Congress dealt with the problem with the Bankruptcy Amendments and Federal Judgeship Act of 1984. This statute authorized the federal district courts to refer bankruptcy cases to the bankruptcy courts, but the bankruptcy court must submit proposed findings of fact and conclusions of law to the district court for de novo review.

An important case for bankruptcy for a shipping company in the context of 1978 Bankruptcy Code is the *Azioni* case,[19] which decided in 1983, just after the 1982 decision of *Marathon*. The *Azioni* case reviewed once again the issue of whether a bankruptcy court can constitutionally decide admiralty question, but in light of *Marathon*.

In *Azioni*, maritime lien holders filed an *in rem* attachment on a vessel named *Sorrento* in March, 1982, and a bankruptcy petition was filed in May, 1982.[20] The court applied the doctrine of *custodia legis* and demanded that all of the claims against the vessel *Sorrento* be heard and decided by the

[18] *Northern Pipeline Co. v. Marathon Pipe Line Co* ., 458 U.S. 50 (1982).
[19] *Ciel Y Cia S.A. v. Nereide Societa Di Navigazione Per Azioni*, 1983 A.M.C. 1192 (1983).
[20] 1983 A.M.C. 1192 (1983), at p. 1196.

federal district court sitting in admiralty. The court reasoned that the ship in question was within the jurisdiction of the district court at the time of the filing of the Bankruptcy petition. As such, the vessel, and the claims against it, should not have been before the Bankruptcy Court. In terms of procedure, the Marshal attached the *Sorrento* prior to the filing of the Bankruptcy petition, the federal district court sitting in admiralty would be the proper forum to dispose of all claims against the vessel. In summary, the court finds that after the expiration of *Marathon's* stay, the bankruptcy court can no longer constitutionally exercise jurisdiction over an admiralty case, and the debts related to the vessel *Sorrento* were predominantly admiralty in nature; since admiralty questions dominate the issues to be decided, it follows that the bankruptcy court does not have jurisdiction to decide the case.[21]

The *Azioni* decision is consistent with prior case law, which provides that "When a ship has been seized by the Marshal under *in rem* process before the filing of a petition in bankruptcy, the ship does not come into the control of the Bankruptcy Court. The action cannot, therefore, be enjoined and will proceed to final adjudication and a sale of the ship unless the Bankruptcy Trustee has procured its release under bond."[22]

Although section 362 of the 1978 Bankruptcy Code provides that the filing of a bankruptcy petition stays the commencement of an in rem proceeding to foreclose a ship mortgage.[23] Section 362 applies to any collection action against freights of a vessel. The section also applies to cargo in which the shipowner who possesses a lien for unpaid freight. The "determinations of the validity, extent, or priority of liens" are core matters of the bankruptcy court.[24] Judge Friendly observed in *re Penn Central Corp*.,[25]that "There appears to be no doubt that a bankruptcy court can be constitutionally vested with power to resort to its judgment in determining what constitutes satisfaction of the claims of creditors." And F.R. Kennedy showed in his published article *Jurisdictional Problems Between Admiralty and Bankruptcy Courts*[26] that numerous precedents indicate the power of the bankruptcy courts in determining the validity of maritime liens.[27]

However, in *United States v. ZP Chandon*,[28] the federal district court held that that section 362 does not stay an action brought by a preferred maritime lien holder who enforces the claim for seaman's wages, which arise after the shipowner files a bankruptcy petition. The court reasoned that the US Congress did not intend the prohibition mentioned in section 362(a)(4) as against enforcing liens on estate property to include maritime liens.

In *re McLean Industries*[29], U.S. Lines (the debtor) commenced its Chapter 11 case based on the "1978 Bankruptcy Code". The estate includes twelve exceptionally large vessels called "Econships", which were designed to transport a large volume of goods packed in containers. The Econships were constructed under § 615 of the Merchant Marine Act of 1936, and the vessels, according to US Maritime Administration ("MarAd"), constitute 23% of the US flag commercial fleet capacity to carry containers and some 15% of the militarily useful deadweight tonnage of the privately owned US general cargo fleet. According to "MarAd", the Econships are the largest, most fuel efficient, modern and competitive container ships under the U.S. flag. MarAd has declared these vessels to be essential for the national security interests because of their large sealift capacity. Two events happened after the commencement of the Chapter 11 proceedings: (1) secured creditors sought unconditional relief from automatic stay; and (2) foreign creditors commenced arrest proceedings against four United States flag vessels belonging to debtor. The New York Bankruptcy Court held that: (1) the US

---

[21] Id., at p. 1197.
[22] Gilmore & Black, The Law of Admiralty, (2nd Ed. 1975), at p. 807.
[23] 11 U.S.C.A. § 362 Automatic stay.
[24] 28 U.S.C. § 157(b)(2)(K).
[25] 384 F.Supp. 895 (1974), at p. 950.
[26] 59 Tulane L. Rev. 1183 (1985).
[27] Id, at pp.1199-1201.
[28] 889 F.2d 233 (1989), at p. 238.
[29] 76 B.R. 328 (1987), at p. 332.

Shipping Act prohibits transfer of any US flag vessel to noncitizen without the approval from the US Secretary of Transportation, and the bankruptcy court would give such prohibition an extraterritorial effect. This case shows that bankruptcy court has jurisdiction to adjudicate the validity of maritime liens or ship mortgages.

4. Policy in Favor of Vessel Mobility

Admiralty law has a strong policy of maintaining vessel mobility in liquidation scenario. Chapter 7 of the Bankruptcy Code is in consistent with such liquidation objectives of vessel mobility. When a shipowner defaults on its obligations to maritime lien holders or a ship mortgagee, this policy is fostered through sale of the vessel free and clear of such interests.

Given the similar liquidation objectives of admiralty and chapter 7 of the Bankruptcy Code, courts have consistently held that an admiralty court's jurisdiction over a debtor's vessel remains unaffected by the subsequent filing of a chapter 7 petition.

For example, in *Morgan Guaranty Trust Co. of NY v. Hellenic Lines*[30], US marshal in New York arrested the freight collected by Liner Company. The first portion of the freight was arrested before Liner Company filed Chapter 11 reorganization; the second portion was arrested after the Chapter 11 filing. US terminal operator of Virginia applied an order for the payment of the freight. At this point, the court believed that the rehabilitative goal of a reorganization proceeding, and the need for supervising the debtor's assets by a single court, would outweigh any competing admiralty concerns.[31] In other words, once a debtor files a petition for Chapter 11 reorganization, the doctrine of custodia legis would not be applicable.

Subsequently, the creditors of Liner Company voted to move the bankruptcy court for an order converting the Chapter 11 reorganization to a Chapter 7 liquidation. The bankruptcy judge then granted the motion and ordered a Chapter 7 liquidation. At this point of development, the court noticed that, in the absence of a reorganization proceeding, custodia legis is the appropriate rule. The court explained that: "If admiralty jurisdiction is based on an in rem action, it is painfully simple to tell whether a vessel will be administered in admiralty or bankruptcy. The first court to obtain jurisdiction over the assets administers it. Thus, if the marshal, pursuant to admiralty process, has attached the vessel first, the admiralty court administers the asset. If the bankruptcy petition is filed before the marshal reaches the vessel, the bankruptcy court administers the asset."[32]

On the other hand, when a liquidation is contemplated, the principle of comity permits the court that first obtained jurisdiction over an asset to supervise its liquidation.[33] After the case converted from Chapter 11 reorganization to Chapter 7 liquidation, the bankruptcy court would apply custodia legis, and Liner Company should pay all freights collected into the court registry.

The survival of the maritime lien depends on an adequate identification of the freights collected, i.e., a tracing of the freights back to the ships that earned them. An accurate voyage accounting of the freights within Liner Company's custody and control, which were subject to arrest in the admiralty in rem proceeding, is necessary for the protection of other maritime lien claimants.

5. Conclusion

After a lengthy academic discussion on some of the leading bankruptcy cases over various ways on admiralty assets treatments, I would like to present the conclusion by using a story style, so that the readers may get some general principles for practical application.

---

[30] 585 F. Supp. 1227 (1984).
[31] Id., at p. 1228.
[32] Id., at p. 1229.
[33] G. Gilmore & C. Black, The Law of Admiralty, § 9-92, at 807-08 (2d ed. 1975).

Creditor comes to see his lawyer and asks: "I have a maritime lien on a US fishing boat and I am thinking about trying to collect against the boat. What if the owner of the fishing boat files bankruptcy? Does that keep me from getting paid?"

Lawyer explains: "If you have a maritime lien against a vessel, you may file an admiralty action against the vessel in rem in the US District Court to enforce the lien. In the normal situation, neither the state courts nor the bankruptcy courts have jurisdiction to hear such a lien claim."

Lawyer further explains: "If the debtor (the owner of the fishing boat) is insolvent, he may file a petition in the US Bankruptcy Court for protection of himself and his property from any debt collection efforts by the creditors. In the normal situation, neither the state courts nor the US District Courts can proceed with actions against the bankrupt after filing of the bankruptcy petition."

Then Lawyer comes discuss about the relevant legal theories: "If there is a potential for conflict between the admiralty jurisdiction and the bankruptcy jurisdiction. The rule developed by the courts to resolve this conflict is known as custodia legis. Under the custodia legis rule, the court that first secures control of the vessel is the court which administers the vessel. Therefore, if a creditor files his admiralty action in the US district court, after the Judge issues a ship arrest warrant, the US Marshal will serve the process upon the vessel, if the creditor done all these steps before the debtor files a petition in the bankruptcy court, then the US district court will continue to administer the vessel under the admiralty jurisdiction."

Lawyer then gives an alternative scenario: "If the debtor files a petition in the bankruptcy court before in rem process is served on the vessel, then §362(a) of the 1978 Bankruptcy Code will automatically stop any further action to advance claims against the debtor and his vessel, and §362 will deprive all other courts of jurisdiction."

At the end of the day, Lawyer strongly reminds Creditor be prepared to "file early, and file often", and the creditor's rights may change if his debtor files his petition in bankruptcy court.

6. Acknowledgment

This research was supported under **Project Code: G-SAA8** by The Hong Kong Polytechnic University.