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Judicial Sale of Ships – Order of Priorities and Lessons for Mortgagees

The proceeds of a judicial sale of a ship are normally paid according to the following order:

- Sheriff's expenses
- Costs of the producer of the fund
- Maritime liens (i.e. salvage, damage done by a ship, seaman's and master's wages, bottomry, and master's disbursements)
- Possessory liens (unless accruing before maritime liens in which case it will rank ahead of such maritime liens)
- Mortgages
- Statutory liens

This order is not invariable but challenges are rare. However, in the recent case of "The Posidon" bunker suppliers who could assert a statutory lien over a vessel for unpaid bunkers tried to argue that they should be paid in priority to a mortgagee.

Facts

The plaintiff, Piraeus Bank SA ("**the Bank**") applied to court, *inter alia*, for determination of the order of priorities of various *in rem* claims against the proceeds paid into court following the judicial sale of the *Posidon* and the *Pegasus* ("**the Vessels**").

Entities belonging to the World Fuel Services group of companies ("**the Interveners**") intervened in the action to oppose the applications. The Interveners had supplied bunkers to the Vessels for which they had not been paid. As the funds in court were insufficient to meet the *in rem* judgments obtained by both the Bank and the Interveners the question of priorities arose.

Normally, the answer would be that the mortgagee is paid in priority over a bunker supplier. However, the Interveners argued that this order should be inverted in their favour. The question for the court was whether the facts and circumstances of the case would permit a departure from the recognised order of priorities so that the Interveners' claims take precedence over the mortgage claims.

The Decision

As a preliminary point, the court highlighted that the question of the right to proceed *in rem* against a ship as well as the question of priorities in the distribution of the sale proceeds are to be determined by the *lex fori* as if the events that gave rise to the claim had occurred in Singapore.

Applying Singapore law as the *lex fori*, the starting point was that the established order of priorities is well-recognised and that the ranking of different classes of claims should be followed and not be readily departed from. The Interveners' main contention is that the equities of the case (derived from the particular features of the case) justify an alteration of the order of priorities such that their claims would rank ahead of the Bank's claims.

The court recognised that in spite of the established order of priorities, equity shall be done to the parties based on the circumstances of each particular case and where the demands of justice warrant a departure from the usual order of priorities. However, this should only be done where there is a "powerful reason" to do so or where there are truly exceptional or special circumstances and the departure must be essential to prevent an obvious injustice. Having reviewed the case law, the court summarised that the cases drew out three main factors that cumulatively go to the equities of the particular case to warrant a departure from the established order of priorities such that a mortgagee's claim is ordered to rank behind that of a necessaries man:

a. First, knowledge that the mortgagor was insolvent has to be shown;

b. Second, the mortgagee must be fully aware, in advance, of the nature and extent of the expenditure incurred by the competing claimant; and

c. Third, any such expenditure must bring about some benefit to the mortgagee.

These three factors are not listed in order of descending importance and the overarching consideration remains the justice of the case.

With these principles in mind the court examined the particular circumstances of the case on which the Interveners' based their claim to priority over the Bank's claims.

Benefit to the Mortgagee

The Interveners argued that the bunkers it supplied provided motive power to the Vessels thereby ensuring the physical safety of the Bank's security by enabling the Vessels to move out of harm's way and avoid physical hazards at sea while the Vessels were operational and enabling the Vessels to trade and generate earnings like freight or charter hire to the benefit of the Bank.

The court was not convinced by this argument. First, a mobile ship as a trading asset is exposed to a wider spectrum of risks. Had the Interveners not supplied bunkers to the Vessels, they would have become immobile and therefore less exposed to the risks inherent in ocean voyages. Secondly, as the borrower retained possession of the Vessels, any benefit in the form of charter hire or freight went to the borrower not the mortgagee.

The court concluded that the Interveners' benefit argument was ill-founded and that they had not shown that any benefit had accrued to the Bank and/or its security because it had supplied bunkers to the Vessels.

Knowledge of the borrower's insolvency

The court spent considerably more time on this factor by examining the facts as to whether and when the borrower had become insolvent; and, if so, when the Bank became aware of such insolvency. The court applied the test in the form of the question: "when was the company unable to pay its debts as they feel due?". This is an enquiry to be answered by focusing on the company's financial position taken as a whole by reference to whether a person would expect that at some point the company would be unable to meet a liability. A temporary lack of liquidity does not amount to insolvency. Regard is to be given to all evidence that appears relevant to the question of insolvency. Such evidence would include loans from financial institutions or shareholders.

In brief, the Interveners argued that the borrower was insolvent and the Bank was aware of it when the borrower missed interest payments ("**the interest payment argument**"). Additionally, as the Bank was in control of the borrower's financials at the material time the Bank should be taken to have knowledge of the borrower's dire financial situation ("**the control argument**").

In respect of the interest payment argument, the court examined the facility agreement and the evidence of the Bank's Director of Shipping Finance and Wholesale Financial Solution and concluded that the failure to pay interest did not amount to an Event of Default and was within the terms of the facility agreement. Therefore there was no reason for the Bank to have concluded that the borrower was insolvent. The relevant part of the facility agreement is as follows:

> *Notwithstanding the provisions of Clause 7.2 and 7.3 and following specific request of the Borrowers, the failure of the Borrowers to pay the whole or any part of interest accrued in relation to the Loan whether pursuant to Clause 6.1 or Clause 6.5 or otherwise provided in this Agreement on an Interest Payment date up to twenty four (24) months from the Drawdown Date will not be deemed as an Event of Default and Clause 7.3 will not apply and any such unpaid interest will be deemed as part of the principal amount of the Loan (as the case may be) and capitalised on such Interest Payment Date.*

The court observed further that a company is not insolvent merely because it was operating at a loss and was saddled with debts. Further, any extension of credit offers some proof of a lender's belief in the prospects of the borrower's ability to ride out cashflow difficulties.

The control argument was, briefly, that the Bank effectively controlled the borrower's finances at the material time and was therefore fully aware of the borrower's insolvency. The Interveners argued that the Bank had *de facto* control and management of the borrower's finances for the operational needs of the Vessels. Therefore, it alleged that the Bank was "disguising its involvement by ordering necessaries, such as bunker supplies for the [Vessel], through the [borrower] so as to circumvent any responsibility for these trade debts".

The court once again examined the facts and the evidence of the Bank's Director of Shipping Finance and Wholesale Financial Solution and rejected the Interveners' control argument. One key document was an email dated 20 August 2014 in which the borrower provided the Bank with information regarding its short-term liabilities (including overdue payments for bunker supplies) as well as its financial situation. The Interveners relied on this email to show that the Bank was in control of the borrower. The court disagreed because the email was meant simply to inform the Bank of the borrower's financial situation and to seek assistance in tiding over the cashflow issues it was encountering. Nowhere in the email was the Bank's approval being sought. Additionally, the Bank did not reply to this email and this further suggested to the court that it was meant for information purposes only.

Further, the Bank's Director of Shipping Finance and Wholesale Financial Solution was consistent in his oral testimony that the Bank had not interfered with the borrower's operation or management decisions. The court added the observation that "as a matter of commercial prudence, the bank would not wish to be involved in the borrowers' business for it might compromise its own interests by stepping into the shoes of the borrowers as ship operator and exposing itself to the attendant risk and liabilities."

Other arguments were raised by the Interveners but rejected by the court.

Knowledge of the bunker supplies

The Interveners argued that general knowledge that bunkers were being supplied would suffice. Therefore, a mortgagee would always know that its mortgaged ship would be buying and using bunkers. In response, the court highlighted again that exceptional or special circumstances are required to warrant an alteration of the established order of priorities. It is worth setting out the conclusion of the court on this argument:

> *Hence, I take the view that it will not suffice to say that since all ships require bunker fuel to have motive power, the mortgagee must be taken to have knowledge of the fuel supplies being procured. I stress that the authorities clearly state that the order of priorities should only be recalibrated if the mortgagee was "fully aware, in advance" of the arrangements made by the necessaries supplier (see The Orion Expeditor).*

The Interveners also argued that there were sufficient facts showing the Bank's knowledge and that they would suffer injustice if the order of priorities was not altered. The court disagreed with the Interveners' view of the facts and pointed out that:

> *Injustice warranting an alteration to the order of priorities is only present when the mortgagee stands by and allows such bunker arrangements to take place despite knowing that the mortgagors were insolvent and that the mortgagee would somehow be benefitting from the supplies at the expense of the bunker supplier.*

The court concluded:

> *the interveners have not shown the existence of special circumstances to justify a departure from the established order of priorities so as to enable the interveners' claims to rank ahead of the bank's mortgage claims.*

Conclusion

This case is a useful illustration of the way in which the established order of priorities is intended to work to distribute the proceeds of sale of a ship to competing creditors. It also clearly sets out the relevant legal principles which should reduce or eliminate the need to resort to costly litigation in order to settle the issue of priorities.

The established order of priorities will only be altered in exceptional cases. If a mortgagee is aware that the mortgagor is insolvent, it should not obtain bunkers (or supplies of other necessaries for that matter) or passively allow the insolvent mortgagor to obtain such supplies in circumstances where it stands to benefit. If a mortgagee does so, it may have to accept that the supplier of such necessaries would rank ahead of it in the distribution of the proceeds of sale. In such circumstances, it cannot be said to be unfair to the mortgagee for the order of priorities to be recalibrated.

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