HANJIN IS A CAUTIONARY TALE FOR DISTRESSED INVESTORS

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It has become increasingly common for foreign companies subject to pending insolvency proceedings abroad to utilize Chapter 15 of the U.S. Bankruptcy Code to achieve their global restructuring goals. However, despite the growing number of Chapter 15 cases, uncertainty remains as to the role of Chapter 15 when the rights of creditors vary in different jurisdictions.

A series of recent rulings by Judge John K. Sherwood of the U.S. Bankruptcy Court for the District of New Jersey in the Chapter 15 case of *Hanjin Shipping Co.* (Case No. 16-27041) is indicative of the challenges faced by U.S. Bankruptcy Courts in ensuring the fair administration of cross-border insolvency proceedings when the substantive laws of the United States and applicable foreign jurisdiction collide.[1]

In *Hanjin*, the Bankruptcy Court addressed what constitutes "sufficient protection" of a maritime lienholder's interests under Section 1522 in a case in which the lienholder alleged that the substantive law of the foreign jurisdiction did not recognize, and would not enforce, the priority of its lien under U.S. law. Sherwood's decision, which held that the maritime lienholders were "sufficiently protected" merely by having the right to file a proof of claim in the debtor's foreign insolvency proceeding, has the potential to give Chapter 15 debtors significant leverage over their secured creditors.

Chapter 15 is based on the Model Law on Cross-Border Insolvency, a legal framework enacted by the United Nations Commission on International Trade Law in 1997 to govern cross-border insolvency proceedings. Legislation based on the Model Law has now been adopted by 43 nations or territories.

Consistent with the Model Law, the main objectives of Chapter 15 are (1) to encourage cooperation between the United States and foreign courts, (2) to provide greater legal certainty for trade and investment, (3) to promote the fair and efficient administration of cross-border insolvencies so as to protect the interests of all stakeholders, (4) to protect and maximize the value of the debtor's assets, and (5) to facilitate the rescue of financially distraught businesses, thereby protecting investment and preserving jobs.[2]

At its core, Chapter 15 is premised on the doctrine of international comity, which the U.S. Supreme Court has described as "the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens or of other persons who are under the protection of its laws."[3] Significantly, Chapter 15 does not attempt to reconcile differences between the substantive insolvency laws of the United States and foreign jurisdictions. Rather, it is designed to encourage cooperation between U.S. and foreign courts to facilitate the successful restructuring of international companies.

Seeking 'Sufficient Protection'

Hanjin is the largest shipping company in Korea and one of the top 10 container shipping companies in the world. Hanjin operates approximately 60 regular lines worldwide, transporting more than 100 million tons of cargo annually with its 140-vessel fleet. Hanjin's bankruptcy was precipitated by the financial issues facing the global shipping industry and, in particular, the imbalance between excess supply of shipping capacity and slowing global demand.

Facing a liquidity crisis and unable to reach agreement with its creditors on the terms of an out-of-court restructuring, Hanjin commenced insolvency proceedings in the Seoul Central District Court in Seoul, Korea, on August 31, 2016. Upon commencement of the proceeding, the Korean court entered an order staying all of Hanjin's creditors from taking any enforcement actions against its assets located around the world.

Shortly thereafter, Hanjin commenced a Chapter 15 case in U.S. Bankruptcy Court, seeking recognition of its pending insolvency proceeding in Korea as a foreign main proceeding. Hanjin immediately moved the Bankruptcy Court for the entry of a provisional order imposing Section 362 of the Bankruptcy Code, which operates to create an automatic stay upon the filing of a debtor for bankruptcy, in its Chapter 15 case. The automatic stay, among other things, suspends creditor collection efforts against a debtor and the property of its estate. Upon recognition of a foreign insolvency proceeding as a foreign main proceeding, the stay automatically goes into effect.

However, at least 21 days' notice and a hearing are required prior to the entry of a foreign recognition order. Hanjin argued that recognition of the automatic stay on a provisional basis was necessary to protect it against the risk of creditor enforcement actions in the United States during the notice period. Hanjin feared that absent the stay creditors would seek to seize its ships, resulting in the disruption of its regular lines and the rapid deterioration of its business. Hanjin's concerns were well-founded. At the time of the hearing, one of Hanjin's ships had already been arrested, while 13 others were hesitant to enter U.S. waters for fear of being seized.

Several U.S. maritime lienholders objected to Hanjin's motion for provisional relief. The maritime lienholders asserted that they held federal "maritime liens" against several Hanjin-chartered ships that would soon be in the United States, and that under Section 1522, the Bankruptcy Court could not grant Hanjin's requested relief without ensuring that their liens were "sufficiently protected."

In the United States, a federal maritime lien arises out of a creditor's provision of "necessaries" (*e.g.*, goods or services) to a debtor's ship. The lien is a property right in the ship that arises by operation of law to secure the creditor's claim and allows the maritime lienholder the right to seize the ship in the event of nonpayment of the underlying debt. Maritime liens are often referred to as "secret liens" because they need not be filed or recorded to be

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valid, perfected, and enforceable as against third parties. Rather, maritime liens arise automatically upon the provision of necessaries to the ship.

Generally, maritime liens have a higher payment priority than non-maritime liens. Amongst themselves, maritime liens rank in the order of last in time, first in right. Accordingly, a maritime lien that arises later in time primes prior liens. Maritime liens follow a ship wherever it goes and can be enforced by means of an action *in rem*, whereby the maritime lienholder secures the arrest of the ship to satisfy its claim. Given the transient nature of ships, a U.S. maritime lienholder must act quickly when a ship ventures into the territorial jurisdiction of the United States, so as to prevent the priming of its lien by subsequent creditors of the vessel upon its departure.

The primary argument advanced by the maritime lienholders was that Section 1522 requires the Bankruptcy Court to "sufficiently protect" creditors' interests and that under the facts and circumstances of this case, "sufficient protection" required the Bankruptcy Court to order Hanjin to provide some form of security to the maritime lienholders or, alternatively, to allow the maritime lienholders to arrest Hanjin's ships to satisfy their claims.

Section 1522(a) provides that the "court may grant relief under section 1519 or 1521, or may modify or terminate relief … only if the interests of creditors and other interested entities, including the debtor, are sufficiently protected."[4] Section 1519 empowers the Bankruptcy Court to grant certain provisional relief, including, among other things, staying execution against the debtor's assets from the time of the filing of a petition for recognition until the court rules on such petition. Section 1522(a) requires the Bankruptcy Court to balance the competing interests of the debtor and its creditors to ensure the sufficient protection of their respective interests, while Section 1522(b) allows the Bankruptcy Court to subject any relief granted under Section 1519 to conditions it considers appropriate, including the "giving of a security or the filing of a bond."[5]

The maritime lienholders argued that their interests could not be "sufficiently protected" without some form of security or the arrest of Hanjin's ships, because upon departure from the United States, the ships could be foreclosed on by a foreign mortgage holder (whose claims would have priority over the claims of the maritime lienholders outside of the United States), sold, and their maritime liens extinguished. The maritime lienholders also argued that due to the last in time, first in right priority rule, if Hanjin's ships were allowed to depart U.S. waters, more senior maritime liens could accrue, further diminishing the value of their own liens. Most importantly, the maritime lienholders asserted that in Korea, maritime liens for suppliers of necessaries to chartered vessels do not exist, so the lienholders would effectively be demoted to general unsecured creditors in the Korean proceeding.

Ruling for *Hanjin*

On September 6, 2016, the Bankruptcy Court entered an interim order, and on September 9, 2016, a final order, granting Hanjin's motion for provisional relief and denying the maritime lienholders' requests for sufficient protection. The Bankruptcy Court's decision was guided by five main considerations: (1) the debtor's ships were not entering U.S. ports because of the threat of arrest; (2) the stay imposed by the Korean court was intended to apply to all of the debtor's creditors; (3) the maritime liens were unenforceable under U.S. law until the ships entered U.S. territorial waters; (4) the negative impact that the status quo would have on other U.S. constituents; and (5) the debtor's lack of liquidity.

Under the terms of the final order, all entities were enjoined from, among other things, (i) executing against any of Hanjin's assets, (ii) enforcing a lien against any of Hanjin's assets and (iii) arresting any vessel that is owned by, operated by, or chartered to Hanjin, in each case, within the territorial jurisdiction of the United States. Neither of the Bankruptcy Court's orders provided the maritime lienholders with any form of security. Rather, the Bankruptcy Court found that the maritime lienholders' interests were "sufficiently protected" by virtue of them having the right to file a proof of claim and pursue their lien rights in the Korean court.

The maritime lienholders immediately filed a motion for reconsideration and a hearing on the motion was held

on September 15, 2016. In denying the motion for reconsideration, Sherwood noted that "the fundamental question is whether the maritime lien rights available under United States law should be enforceable despite the issuance of the stay Order in Korea."[6] The Bankruptcy Court focused on the fact that Hanjin had filed for insolvency protection in Korea, and under Korean law, the commencement of that proceeding stayed all creditor actions, including those of the maritime lienholders, against property of the debtor's estate.

The Bankruptcy Court reasoned that the status quo at the time of the Korean filing was that all but one or two of Hanjin's ships were outside of U.S. territorial waters and thus not subject to arrest by the maritime lienholders. The Bankruptcy Court found that allowing the maritime lienholders to enforce their rights under U.S. maritime law after the issuance of the Korean stay order would be contrary to the universalist approach under Chapter 15. Rather, the Bankruptcy Court held that "[t]o protect the interests of the Debtor's global rehabilitation and creditors as a whole, the Debtor's vessels had to be allowed to enter United States ports under the protection of the stay."[7]

The Bankruptcy Court acknowledged that the rights of the maritime lienholders would be superior in the United States, as opposed to Korea, and that Section 1522(b) provides the Bankruptcy Court with the ability to impose conditions on Hanjin's request for provisional relief. Nonetheless, based on the practicalities of the case, including the debtor's inability to provide security to the maritime lienholders and the fact that the debtor's foreign main proceeding would be facilitated if the ships could offload their cargo, the Bankruptcy Court determined that the maritime lienholders were sufficiently protected by having the right to pursue their claims in the Korean court.

Following the Bankruptcy Court's denial of the motion for reconsideration, the maritime lienholders filed a notice of appeal with the U.S. District Court for the District of New Jersey and requested an emergency stay on appeal. District Judge Kevin McNulty denied the motion for an emergency stay, finding the Bankruptcy Court's decision to be "a reasoned and well-considered one." The maritime lienholders appealed the District Court's denial of the stay to the 3rd U.S. Circuit Court of Appeals. On October 3, 2016, the 3rd Circuit issued an order dismissing the maritime lienholders' appeal of the District Court order for lack of jurisdiction. The maritime lienholders filed a petition for rehearing *en banc* of the dismissal of the 3rd Circuit appeal, which was denied on November 9, 2016. On December 13, 2016, Sherwood formally recognized Hanjin's Korean insolvency proceeding as a foreign main proceeding.

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Lessons Learned

Above and beyond the practical ramifications for maritime lienholders, *Hanjin* serves as a cautionary tale for distressed investors involved in complex cross-border bankruptcies. The interpretation of "sufficient protection" adopted in the *Hanjin* decision provides Chapter 15 debtors with significant leverage over the international restructuring process. Following *Hanjin*, other financially distressed companies may seek to file for bankruptcy protection outside of the United States to take advantage of alternate priority schemes that are more aligned with the debtor's strategic restructuring objectives.

For distressed investors, the decision highlights that the value of their liens and claims will be subject to, and in some cases may be materially impaired by, variability in the substantive restructuring laws of different jurisdictions. What is clear is that the jurisprudence of Chapter 15 will continue to evolve as debtors push the boundaries of the relief available to them and, in turn, Bankruptcy Courts must determine how to balance the oftentimes competing goals of international comity and the legal rights of U.S. constituents. ■

[1] *In re Hanjin Shipping Co., Ltd.*, Case No. 16-27041 (JKS), Interim Provisional Order Granting Recognition of Foreign Main Proceeding and Certain Related Relief Pursuant to Sections 362, 365, 1517, 1519, 1520, 1521 and 105(a) of Bankruptcy Code (Bankr. D.N.J. Sept. 6, 2016) [Dkt. No. 22]; *In re Hanjin Shipping Co., Ltd.*, Case No. 16-27041 (JKS), Order Granting Provisional Relief Pursuant to Sections 362, 365(e), 1519, 1520, and 105(a) of the Bankruptcy Code Pending Hearing on Petition for Recognition as a Foreign Main Proceeding (Bankr. D.N.J. Sept. 9, 2016) [Dkt. No. 102].

[2] 11 U.S.C. § 1501.

[3] *Hilton v. Guyot*, 159 U.S. 113, 164 (1895).

[4] 11 U.S.C. § 1522(a).

[5] 11 U.S.C. § 1522(a), (b).

[6] *In re Hanjin Shipping Co., Ltd.*, 2016 Bankr. LEXIS 3986, *19 (Bankr. D.N.J. Sept. 20, 2016).

[7] *Id.* at *22.