

# Alert

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## A Cautionary Tale for Vessel Mortgagees

Due to the financial problems caused by COVID-19 and economic conditions generally, more and more vessels are being arrested and sold at judicial auctions. While many articles have been written about the legal steps a mortgagee must take to enforce its mortgage, the need for active involvement and realistic expectations by the mortgagee cannot be over emphasized. This is best exemplified by a recent case where a foreclosed vessel was sold at a judicial auction for just 2 percent of the amount of the secured debt. A perfect storm of mortgagee mistakes led to this result.

### The mortgagee did not have the vessel appraised

After arrest, the mortgagee did not commission a ship valuation and survey to pass on to potential bidders. Instead, the mortgagee relied on a condition valuation survey undertaken years ago for insurance purposes only. The lack of an appraisal hindered the mortgagee's effort to market the vessel and to later show that the sales price was grossly inadequate.

### The mortgagee had unrealistic expectations as to what the vessel would bring

The mortgagee turned down a settlement offer from the shipowner that greatly exceeded the ultimate sale price. The mortgagee also ignored a potential buyer who expressed interest in acquiring the vessel from the mortgagee if the mortgagee would credit bid for the vessel and, if successful, sell it to the potential buyer with financing.

### The mortgagee did not pay attention to what the substitute custodian was doing

Only expenses related to services advanced to preserve and maintain the vessel under seizure for the benefit of all or most lien claimants are allowed as *custodia legis* expenses. Although the substitute custodian billed several man hours a day for taking care of the vessel, the vessel was not maintained. The electrical system of the vessel was damaged while in the custody of the substitute custodian. As result, there was no working air conditioning system leading to condensation on and in the generators and electrical equipment, which were saturated. The main engine was started and ran for an unknown period of time without any lubrication, and subsequently suffered serious heat damage to internal bearings and other components. There was also condensation on the steel that became corroded. There was even pilferage from the vessel.

### The mortgagee delayed the sale of the vessel

The mortgagee opposed the shipowner's efforts for a quick sale, which resulted in the continuing deterioration of the vessel as well as the accrual of *custodia legis* expenses alleged to be more than \$1 million. The lack of preventative maintenance and substantial damage to the engines, steel, air conditioning, and electrical system resulted in the court rejecting these expenses. The delay also had a dramatic negative impact on the value of vessel.

### The mortgagee did not market the vessel



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Other than the required publication in a newspaper of general circulation, the mortgagee did not advertise the sale of the vessel. Nor did it hire brokers to market the vessel, although it told the court it would do so. Potential bidders may also have been discouraged by the mortgagee's continuing and ultimately unsuccessful efforts to set a floor bid that was unrealistic.

### **The mortgagee did not have a bidder lined up**

The mortgagee did not make an effort to have at least one bidder at the auction to protect the mortgagee's interests by bidding an acceptable price. Nor did the mortgagee take steps to insure that there would be multiple bidders.

### **The mortgagee did not credit bid**

Although the court denied the mortgagee's request to set a floor bid, the mortgagee did not credit bid. There was no impediment to a credit bid by the mortgagee, as there were no liens against the vessel apart from the mortgagee's mortgage. This left the mortgagee at the mercy of the one bidder who attended the judicial auction.

### **The mortgagee did not timely object to the sale price or submit an upset bid**

In an order submitted by the mortgagee prior to the sale, objections challenging the sale of the vessel were due within three days, otherwise the sale would stand as automatically confirmed. Some courts have withheld confirmation in the case of a timely objection based on a substantially higher upset bid. Here, not only was the mortgagee's objection untimely, no upset bid was filed with the court. The lack of an upset bid undercut the mortgagee's effort to show that the sale price was grossly inadequate, requiring the withholding of confirmation.

### **The mortgagee alleged fraud and collusion without proof**

A judicial sale will generally not be set aside without fraud, unfairness, surprise, or mistake. While the mortgagee alleged fraud and collusion in suppressing the bidding, its claim was based on supposition and unsworn hearsay. Prior to the mortgagee's filings concerning these allegations, its so-called supporting witnesses refused to provide affidavits and denied that any collusion had taken place. The mortgagee's efforts to take depositions were unsuccessful and the court found that the mortgagee's evidence did not support fraud and collusion. This also soured the court on the mortgagee's other efforts going forward.

### **The Takeaway**

The takeaway from this case is that the mortgagee must have realistic expectations and be an active participant in the foreclosure in order to maximize its recovery. The mortgagee must have an appraisal prepared for potential bidders, pay strict attention to what the substitute custodian is doing, move quickly to auction the vessel, avoid promoting unrealistic floor bids, encourage potential bidders with an offer to finance, if need be, aggressively market the vessel through advertisements, brokers or otherwise, make sure there is at least one bidder at the auction to protect its interests, seek to have multiple bidders, and be prepared to credit bid. If disappointed, the mortgagee must pay attention to deadlines to object to the sale and be prepared to produce an upset bid. The mortgagee cannot rely on unfounded allegations of fraud and collusion to change the results and obtain a redo.

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