

# DON'T LET YOUR PREFERRED MORTGAGE GET EQUITABLY SUBORDINATED

By Ben Schupp, McGlinchey Stafford PLLC

**D**equitable subordination originated as a doctrine in the bankruptcy courts that allows for subordination of claims when the claimant has engaged in some type of “inequitable conduct” which has conferred an unfair advantage on the claimant or resulted in injury to creditors.<sup>1</sup> The good news is that getting your preferred ship mortgage equitably subordinated is rare and preventable. The bad news is that getting subordinated can be quite expensive. Adopted relatively infrequently by admiralty courts, equitable subordination is a favored play of outranked maritime lien creditors with few options — sort of a Hail Mary pass. However, as heartbroken football fans are well aware, sometimes those passes hit pay dirt.

How can such subordination be prevented? Let us count the ways:

## EXERCISE DUE DILIGENCE TO DISCOVER POTENTIAL FRAUDULENT ACTIVITIES OF YOUR BORROWER

We will assume that Marine Money's diligent readers are not

---

*Adopted relatively infrequently by admiralty courts, equitable subordination is a favored play of outranked maritime lien creditors with few options — sort of a Hail Mary pass.*

---

inclined to commit fraud themselves. However, what if a lender's substandard lending practices unintentionally allow a borrower to defraud others — including the bank itself? A Southern District of Florida decision indicates that the bank's mortgage can be subordinated.<sup>2</sup> The borrower created two different hull identification numbers (“HIN”s) to enable him to use the same vessel both as collateral for a bank loan and

to sell the vessel to an innocent third party for cash.<sup>3</sup> The bank had knowledge from a survey that the original HIN was not permanently affixed to the vessel at construction as required by Coast Guard regulations.<sup>4</sup> Further, despite the borrower's financial free-fall,

the bank extended its loan to borrower without appraising the collateral, requiring proof of insurance or investigating whether the vessel remained under the borrower's control.<sup>5</sup> The Court found that the bank's “... gross deviation from acceptable banking practices in 2008 and its failure to insist that [borrower] permanently affix the HIN on the vessel before initial documentation in 2003 — justify the subordina-

tion of the Bank's mortgage in this case.”<sup>6</sup>

## DON'T USE THE DEBTOR AS CREDITOR'S ALTER EGO OR INSTRUMENTALITY

While making a loan to a subsidiary is not uncommon in the maritime world and is not, by itself fraudulent, it does come with some added risks. The Fifth Circuit's seminal decision in *Custom Fuel v. Lombas*<sup>7</sup>, illustrates how such a loan should not be done. The bank foreclosed on a vessel that was owned by a company controlled by Lombas. The bank then formed a wholly owned subsidiary and capitalized the subsidiary with \$1,000 and extended it a \$2,500,000 line of credit. The bank then “sold” the vessel to the subsidiary which borrowed the full amount of the purchase price and took a first mortgage

Q  
2  
2  
0  
2  
2

on the vessel.<sup>8</sup> The bank subsidiary then bareboat chartered the vessel back to another Lombas controlled company.<sup>9</sup> The Fifth Circuit described the bank subsidiary as “...not a true debtor but an instrument of the controlling creditor—used...to shield its property from the claims of other legitimate creditors.”<sup>10</sup> The Court concluded that the mortgage was a sham and must be subordinated to the claims of legitimate creditors — a fuel supplier and repair yard that had maritime lien claims against the vessel.<sup>11</sup>

Conversely, a mortgagee with a legitimate mortgage can use equitable subordination to subordinate superior maritime lien claims. In *Florida Bahamas Line, Ltd v. Steel Barge STAR 800* a foreign ship mortgage holder was able to subordinate a superior maritime lien claim for wharfage by demonstrating that the vessel owner and the wharf owner (and its assignee) were alter egos of their principal, Joe Brown. Mr. Brown and his alter egos had engaged in inequitable conduct by failing to notify the mortgagee of such wharfage lien and failing to attempt to enforce such lien for 46 months.<sup>12</sup>

**ENSURE THAT YOUR BORROWER IS NOT UNDER-CAPITALIZED**  
Undercapitalization, like the “instrumentality” theory discussed above, requires the

court to look to the true nature of the transaction.<sup>13</sup> In undercapitalized companies, a purported debt is often, in substance, an equity interest in the debtor.<sup>14</sup> Undercapitalization is also a hallmark of another bankruptcy doctrine — recharacterization — which is used to recharacterize debt as a capital contribution.<sup>15</sup> In *Custom Fuel*, the subsidiary, having borrowed the entire purchase price, began with no equity in the vessel. The note owed to by the subsidiary to its parent had no fixed payment schedule, and the subsidiary did not make regular payments on the note.<sup>16</sup> The fact that the

amount owed on the note after three years was greater than the amount owed at the date the note was signed indicates that it was not intended to be repaid in the ordinary course, but instead was meant to become a permanent part of the entity’s financial structure.<sup>17</sup>

Courts often describe two different types of undercapitalization: (1) insufficient initial capitalization to make a viable business and (2) inadequate capitalization to obtain an advance from an informed outside lender.<sup>18</sup> While *Custom Fuel* involved the former, the maritime lien claimants in *THE PRIDE OF TEXAS* relied on

the latter type of undercapitalization. They argued that MARAD (the mortgagee) propped up the vessel owning debtor to the detriment of maritime lien creditors when no other lender would have made advances to the debtor. Such arguments have generally not fared well because the mortgagee’s priority over the maritime lien claimants typically remains unchanged despite allegations the mortgagee should have foreclosed earlier.<sup>19</sup> Generally, for a first mortgagee to lose on equitable subordination, the maritime lien claimants must show how they were harmed by the

inequitable conduct. No such harm was present in *THE PRIDE OF TEXAS*.<sup>20</sup> Such harm was apparent in *Custom Fuel* because the lien claimants would have had priority over the bank if the bank had chartered the vessel directly to the operator instead of first going through the convoluted “sale” of the vessel to a wholly owned undercapitalized subsidiary and the taking of a ship mortgage.<sup>21</sup>

**DON’T TAKE A GRATUITOUS SECURITY INTEREST**  
Marine finance attorneys should be careful to show what consideration is being given for

a lender’s security interest or a modification thereof. In *Wardley International Bank, Inc. v. Nasipit Bay Vessel*<sup>22</sup> the Ninth Circuit considered whether a ship mortgage should be equitably subordinated to the claims of fuel suppliers and maritime lien claimants. MCP purchased a vessel from its affiliate Overseas for \$2,450,000. MCP agreed to sign a note and ship mortgage in favor of Overseas.<sup>23</sup> In connection with Overseas’ refinancing of its pre-existing debts with its bank, i.e. Wardley, Overseas had MCP sign a note which was almost three million dollars more than the purchase price of the vessel.<sup>24</sup> Overseas then assigned the mortgage to Wardley and had MCP guarantee Overseas debt. Wardley did not advance any money to Overseas or MCP for the mortgage.<sup>25</sup> The parties also effectively extended Wardley’s security in the vessel for five years beyond the original final payment date.<sup>26</sup> Noting the lack of consideration to MCP for these terms, the control Overseas had over its affiliate MCP, and the control Wardley had over both MCP and Overseas, the court subordinated the bank’s mortgage to the maritime lien claims.<sup>27</sup>

**SAFE HARBORS FOR LENDERS**  
Now that we have discussed where a lender can go astray, what can a lender do and still have a reasonable degree of

*While making a loan to a subsidiary is not uncommon in the maritime world and is not, by itself fraudulent, it does come with some added risks.*

Q  
2  
2  
0  
2  
2

comfort that its ship mortgage will not be subordinated? Here's what the cases have taught us:

- Normal delays in foreclosing on ship mortgage are not likely sufficient to warrant equitable subordination.<sup>28</sup>
- Securing repayment with multiple security instruments such as a mortgage, assignments, security agreements, and personal guarantees does not warrant subordination.<sup>29</sup>

- Reasonable limitations on capital expenditures will not lead to a finding of control sufficient to trigger a successful alter ego argument.<sup>30</sup>

- Freezing of vessel owner's bank account by holder of ship mortgage does not constitute "control" by lender.<sup>31</sup>

## CONCLUSION

The lesson learned is that, if there is a close relationship between one of the creditors

and the debtor, you can expect equitable subordination to be raised by the outranked creditors. Nonetheless, the successful implementation of this doctrine will require more: namely (1) some harm to the outranked creditors and (2) some inequitable conduct such as fraud (or an unreasonable failure to detect it), undercapitalization, the use of an alter ego or the use of a gratuitous security interest. Traditional security mechanisms and enforcement will rarely, if ever,

get a lender in trouble. So don't get paranoid. Lenders should, however, take special care before leveraging their close relationship with a borrower not to harm other creditors through inequitable conduct as described in this article.



*Ben Schupp is a maritime attorney at McGlinchey Stafford PLLC in New Orleans who has for over 30 years been engaged in marine finance and the litigation of maritime lien claims.*

<sup>1</sup> *In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977).

<sup>2</sup> *Branch Banking & Trust Co of Virginia v. M/Y BEOWULF*, 883 F.Supp.2d 1199 (S.D. Fl. 2012).

<sup>3</sup> *Id.* at 1203-1212.

<sup>4</sup> *Id.* at 1204.

<sup>5</sup> *Id.* at 1218-1219.

<sup>6</sup> *Id.* at 1219.

<sup>7</sup> 805 F.2d 561 (5th Cir. 1987).

<sup>8</sup> *Id.* at 563.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 567

<sup>11</sup> *Id.* at 568-569.

<sup>12</sup> *Florida Bahamas Line, Ltd v. Steel Barge STAR 800*, 433 F.2d 1243 (5th Cir 1970).

<sup>13</sup> *Custom Fuel*, 805 F.2d at 567.

<sup>14</sup> *Id.*

<sup>15</sup> *Yasi v. M/V Horizon's Edge*, 2015 WL 3454718 \*4-5 (D. Mass. 2015)(considering undercapitalization under both equitable subordination and recharacterization doctrines, but rejecting arguments to subordinate ship mortgage on such grounds).

<sup>16</sup> *Custom Fuel*, 805 F.2d at 567.

<sup>17</sup> *Id.*

<sup>18</sup> *U.S. v. THE PRIDE OF TEXAS*, 1994 WL 913279 \*5 (E.D. Va. 10/5/1994).

<sup>19</sup> *Id.* at 6.

<sup>20</sup> *Id.*

<sup>21</sup> *Custom Fuel*, 805 F.2d at 567-568.

<sup>22</sup> 841 F.2d 259 (9th Cir. 1988).

<sup>23</sup> *Id.* at 260.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 262.

<sup>27</sup> *Id.* at 264.

<sup>28</sup> *Dresdner Bank AG v. M/V OLYMPIA VOYAGER*, 463 F.3d 1233, 1238 (11th Cir. 2006) (postponement of a declaration of default on a loan for a reasonable period of time, by itself, is insufficient to warrant equitable subordination of banks' preferred ship mortgage); *U.S. v. THE PRIDE OF TEXAS*, 1994 WL 913279 \*6 (E.D. Va. 10/5/1994)(no equitable subordination despite foreclosure on ship mortgage approximately seven months after default); *West of England Ship Owners Mutual Protection Association v. Patriarch Steamship Company*, 491 F.Supp. 539, 545 (D.Mass. 1980)(no equitable subordination despite fact that creditor did not foreclose on ship mortgage for several years after default); *But see Cantieri Navali Riuniti v. M/V SKYPTRON*, 621 F.Supp 171, 187 (W.D. La. 1984)(where ship mortgage holder shared same office with vessel operator and was intimately familiar with debtor's operations and shaky finances, mortgagee's long delayed foreclosure resulted in court subordinating mortgage to maritime lien claimants).

<sup>29</sup> *Transmontaigne Product Services, Inc. v. M/V WILBUR CLARK*, 2010 WL 1267302 \*6 (S.D. Al. 2010).

<sup>30</sup> *Id.*

<sup>31</sup> *Atlas Uluslararası Kumanyacılık Tic A.S v. M/V Arica*, 2022 WL 742487 \*3 (D. Del. 3/11/2022).