

# Ocean Law Memo

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## BOAT FORECLOSURES: SECURING THE SUPPLIER'S INTEREST IN DURABLE GOODS

### Introduction

Wilma Wiley sells marine hardware and equipment and has learned that the F/V Listless is being sold at auction pursuant to a foreclosure. Wiley is understandably concerned about this because she has recently extended credit to the Listless's owner, Paul Poor. The Listless is the only thing Poor owns and it is his only source of income. Since Wiley knows this, she also knows that once the Listless is gone she will be unable to collect from Poor.

The F/V Listless is a 35-ton fishing boat. Poor had been using the boat to eke out a living for some time, and he recently decided to try to do better. A new Moron fishfinder in Wiley's showroom looked like just the thing to improve Poor's catch. The Moron fishfinder was not well received in the fishing community and had been gathering dust in Wiley's showroom. Happy to see the thing go, Wiley extended credit to Poor for the purchase price. Poor installed the Moron in his boat. Poor's enthusiasm and the new Moron fishfinder notwithstanding, Poor's catch did not improve, and foreclosure proceedings against the Listless are now pending.

Foreclosure is a legal mechanism to satisfy a debt that is in default. A debtor's property is sold under court supervision, and the proceeds of the sale are used to satisfy the debt. Once the property is sold, all other claims against the property that are derived through the debtor are extinguished, and the buyer takes the property with a clean title. Creditors like Wiley will therefore wish to claim their interest in the property before it is sold, and they are generally permitted to join in foreclosures. In a foreclosure involving more than one creditor, rights to the sale proceeds are determined by

rules of priority, as we shall see below. Since priority depends upon the type of debt asserted, it does not matter which of Poor's other creditors initiated the foreclosure.

Wiley is not sure if she can recover anything from the foreclosure or, if she can recover, what she may be entitled to. She would prefer to obtain full payment for the fishfinder. She had difficulty selling it once and would prefer to use the money for other inventory. Nevertheless, if faced with a choice between repossessing the fishfinder or recovering nothing at all, Wiley would choose to have the fishfinder back.

A valid lien is necessary for Wiley to obtain a stake in the Listless's foreclosure. Liens of interest to Wiley include the federal maritime lien for necessities, the federal preferred ship mortgage and, as a group, liens under state law. State law liens and preferred ship mortgages require formal, affirmative action at the time they arise in order to take effect. Fortunately for Wiley, the maritime lien for necessities does not require such action. It can be claimed after-the-fact and regardless of whether it was contemplated at the time of the sale.

This article offers practical advice to suppliers, like Wiley, who sell durable goods to vessels. It begins with a review of priority rules for liens on vessels. Next is a summary of the nature of general maritime liens, followed by the requirements for a maritime lien for necessities. The lien for necessities is the usual result of sales of goods for use aboard vessels. For a large debt, a preferred ship mortgage may be feasible, and so this type of lien is also described. Details of state law liens are beyond the scope of



this article and are therefore not discussed independently. Tying together the three types of liens, an analysis of their comparative strengths and weaknesses is presented. Using the descriptions and requirements set out below, the conclusion will assess Wiley's position in a foreclosure.

### Lien Priorities

Generally, competing lien claims are first ranked according to class. The classes are, from highest to lowest, the following:

1. Expenses taxed by the court during legal seizure - expenses arising from the care and operation of the vessel while in the custody of the court (not regarded as a true lien, but given top priority);
2. Seamen's liens for wages, maintenance and cure, and wages of long-shoremen employed directly by the vessel;
3. Salvage and general average liens;
4. Tort liens (collision and personal injury, etc.);
5. Maritime liens for necessities arising prior to perfection of a preferred ship mortgage;
6. Preferred ship mortgages;
7. Maritime liens for necessities arising after the perfection of a preferred ship mortgage;
8. State created liens of a maritime nature;
9. Maritime liens for penalties and forfeiture for violation of federal laws;
10. Perfected non-maritime liens, including tax liens;
11. Foreign liens and mortgages;
12. Maritime liens asserted by trustees in bankruptcy.

Once the competing liens have been ranked according to class, they are paid by the court in order of their priority. This method of distribution will usually leave lower priority classes with no recovery and will leave one class with a remainder insufficient to pay all claims in that class.

Where a maritime lien for necessities class (numbers 5 and 7) obtains a

remainder distribution, a subset of classes is created. Each subclass is paid until there is not enough to pay the next lower subclass in full. The remainder is then distributed pro-rata among the claimants in that next lower subclass.

Subclasses of maritime liens for necessities are divided according to the time of their creation by a method known as the voyage rule. Liens arising on one voyage are in a subclass superior to those arising on the preceding voyage and inferior to those arising on the subsequent voyage. This is an extension of the doctrine of laches (discussed below) and inherently assumes that maritime liens cover short-term debts. The theory behind the rule is that a lien should be foreclosed against a vessel when the vessel first returns to the port where the lien arose.

The length of time that constitutes a voyage varies considerably and will generally be set by the court to suit the particular vessel being sold. The rule was originally applied strictly and maritime liens were arranged in accordance with a vessel's actual voyages. Today, however, such a strict application is likely by the courts only where the vessel operates on a regular oceanic service. Coastal shipping, harbor craft, Great Lakes shipping, and other locally owned and operated craft are now treated more sensibly by the courts. Such vessels may visit a lienor's port so frequently or irregularly that the lienor has no opportunity to act within the space of a single "voyage." Although there is no single solution to this problem, the prevalent view of the courts is that liens are ranked by season under the voyage rule, and a season is generally regarded as a calendar year.

### Nature and Effect of a Maritime Lien

The federal maritime lien is a device designed to facilitate maritime commerce. It is harsh to other lienors because it is informal, but it acts against vessels large and small, U.S. and foreign. It is justified by the threat posed to creditors by a vessel's mobility and by the assumed desire of the vessel to sail the seas.

The maritime lien is based upon a personification of the vessel. The persons responsible for a vessel's actions are often beyond the reach of potential creditors, and so the vessel itself is responsible in the event of a default on a debt. As a result, the lien alone does not act against a ves-

sel's owners, operators, or sister ships even if they are within reach of the creditors.

The vessel that is personified is the whole vessel, and the whole vessel only. Maritime liens are not secured by a part or element of the vessel, or by equipment that is not necessary and appurtenant to the vessel. Equipment that is not "essential" to the vessel's activity and which can be removed without damaging the vessel might be beyond the reach of a maritime lien.

The maritime lien is best suited for short-term debts. It cannot be foreclosed unless there is a default on the debt, and numerous superior liens might arise before a default occurs under an extended credit term. A creditor with long-term debt is thereby powerless to prevent his relative priority position from falling.

A maritime lien is "secret" in that it need not be publicized by filing in a public office or by possession of the boat to have effect against third parties. However, where there is a filed preferred mortgage on a U.S. vessel, the Coast Guard office in the vessel's home port will accept maritime liens for filing. Filing can be done when the lien is created; this assures notice to the lienor of a foreclosure sale. Filing does not affect the validity of a lien. A lien may be valid even if not filed and may be invalid even if filed. Maritime liens cannot be filed for foreign vessels or for U.S. vessels with no preferred mortgages.

A maritime lien arises when the transaction occurs and, subject to the doctrine of laches, it is not time-limited. The lien for necessities generally arises when goods are delivered to the ship or its agent, but it has been found by courts to occur earlier (at the time of contracting, when contracting precedes delivery). "Laches" is the only true defense to a valid maritime lien. This defense generally requires that a lien become so stale, because of the passage of an unreasonable amount of time, that the vessel owner is justified in relying upon its lapse. Otherwise, the lien will remain valid over time.

A maritime lien can be extinguished only by payment of the underlying claim or by a judicial execution or foreclosure. It can be executed only by a federal admiralty court acting in rem (Latin for "against the thing") owing to the personification of the vessel. Because the action is in rem, only the U.S. District Court (an admiralty court) having the vessel within its jurisdiction may act.

A judicial execution begins with seizure of a vessel by U.S. Marshals pursuant to a claim of lien foreclosure with the appropriate court. A seizure requires only the creditor's good faith claim of lien upon the vessel; the claim need not necessarily succeed. Only where a vessel is seized in malice or in bad faith will a claimant become liable for a retaliatory action for wrongful seizure.

Seizure can be avoided or escaped if the vessel's owners or operators post a bond or surety with the court in the whole amount of the claim. The surety substitutes for the vessel, enabling the vessel to remain in use. If the claimant prevails, there is no need to sell the vessel because the debt is fully covered by the surety. There is therefore no need to involve all of the vessel's creditors under this alternative.

Once a vessel is seized, unless the owner promptly pays off the debt, the court will supervise an auction sale of the vessel to satisfy the lien claim. Notice of the sale to other creditors is provided when the lienor, as required by the governing rules, advertises the filing of a foreclosure. Thus, most of the vessel's creditors will generally join in the execution. The rules of priority then control the distribution of proceeds from the vessel's sale.

#### Maritime Liens for Necessaries

A sale of goods will create a maritime lien for necessities if it meets the following requirements:

1. The sale must be a "maritime transaction";
2. The sale must be for the benefit of a "vessel";
3. The goods sold must be "necessaries";
4. Persons acting on the vessel's behalf must have the authority, either actual or apparent, to do so;
5. The sale price must be reasonable under the circumstances; and
6. The goods must be delivered to the vessel against which the lien applies.

The maritime lien for necessities is a creature of maritime law. It is therefore necessary that the transaction giving rise to the lien be maritime in nature--a "maritime transaction." The transaction must be undertaken in reli-

ance upon the vessel as collateral, at least in part. Reliance solely upon the credit of the vessel's owners or operators, to the exclusion of reliance upon the vessel as collateral, does not constitute a maritime transaction.

A maritime transaction must be in furtherance of a maritime venture in which the vessel is engaged. A laid-up vessel or a vessel under court seizure is not engaged in a maritime venture and cannot incur a maritime lien. Yachting and sportfishing, on the other hand, are maritime ventures. Construction and outfitting of a vessel are not maritime because the vessel is not yet engaged in a maritime venture. Alternatively, repair of a vessel is a maritime transaction unless the repair is so major as to be termed a reconstruction. A reconstruction usually involves a significant modification to the hull of the vessel.

It is conceivable that a court might decide that goods do not have a maritime nature themselves. This does not appear to have occurred yet, but it is possible that certain goods, such as television sets, might be viewed as non-maritime. Certainly, under such circumstances, the goods will not be necessary appurtenances to the vessel and may be secured independently of the vessel by means other than a maritime lien.

"Vessels" to which maritime liens may attach comprise a broad class. Federal law provides the following:

"The word 'vessel' includes every description of watercraft or other artificial contrivance used or capable of being used as a means of transportation on water."

1 United States Code (U.S.C.) § 3.

Sailing yachts, skiffs, and fishing boats have been found by the courts to be "vessels." Rubber rafts are not "vessels," and floating objects that cannot be used for transportation are not "vessels."

"Necessaries" is a term from the federal statute allowing maritime liens that has often been considered by the courts. It has been construed broadly. To be "necessaries," the goods need only be reasonably necessary for the venture in which the vessel is engaged. It has been held that a dynamic positioning system, a radar unit, and a fathometer are all necessaries. Only where goods do not contribute to the venture or are extravagant will they fail to be "necessaries."

Persons with authority to act for the vessel include anyone with actual authority and some persons regardless of their actual authority. Persons unlawfully in possession of a vessel never have authority to incur liens. Persons with apparent authority include the vessel's master, managing owner and ship's husband (one who arranges for the vessel's provisions). Apparent authority acts as actual authority unless the supplier seeking the lien has actual knowledge of the absence of actual authority. This consideration is most significant in cases where the operator is not the owner of a vessel, but is using it under a charter. Charter contracts often prohibit the operator from incurring liens against the vessel, and so the operator does not have actual authority. A supplier may nonetheless rely on apparent authority unless he has actual knowledge of the prohibition. Even if the supplier knows of the charter, there is no duty to inquire about a prohibition on liens in the charter contract. A supplier need inquire only when the circumstances warrant strong suspicion that the person cloaked in apparent authority has no actual authority.

The requirement for a reasonable sale price affords some protection to the vessel from the otherwise harsh consequences of a maritime lien. It behooves the supplier to impose a provably reasonable charge for the goods, because a failure to do so may invalidate the lien.

Goods must be delivered to the vessel against which a lien is sought, or to a person with authority to act for that vessel. Both ownership and possession must be delivered. This requirement is seldom of concern to the supplier, since ordinarily there is no distinction between the two. Possession of the goods by the vessel is clearly imperative for a maritime lien for necessities because, if possession is not present, the goods cannot be "necessaries." We will therefore be concerned only with a lack of ownership. Ownership of goods is purportedly withheld, despite delivery of possession, in lease and conditional sale transactions which are really security devices. In a conditional sale, ownership is supposedly retained by the seller until the full purchase obligation is satisfied by the buyer. Since ownership is ultimately intended for the buyer, this transaction will yield a maritime lien. In a true lease, however, transfer of ownership is never intended and a maritime lien cannot arise for the price of the goods. Leases with irresistible purchase options are sometimes found by the courts

to be, in fact, conditional sales. Leases allow the supplier to recover the goods themselves out of a foreclosure on a vessel. However, the equipment must be clearly marked or tagged so that other potential lienors will not expect it to go with the boat. Absent such identification, the equipment may be lost as necessary appurtenances of the whole vessel in a foreclosure. In these cases, the lessor is generally granted a maritime lien on the whole vessel.

#### Preferred Ship Mortgages

Preferred ship mortgages are markedly distinguishable from maritime liens. They are not historical as are the liens but are a creation of federal legislation. They are non-maritime. A preferred mortgage differs from a maritime lien in that it takes priority over subsequent maritime liens and is subordinate to preceding maritime liens. There are rigorous requirements for perfection of a preferred mortgage, and failure to follow those requirements fully will void the preferred status of the mortgage. An attorney competent in such matters should be consulted to create or challenge such a lien. Therefore, the detailed requirements of preferred mortgages will not be addressed here.

The preferred mortgage is not "secret," as is the maritime lien. Notice of a valid preferred mortgage is both on file with the Coast Guard office of the vessel's home port and endorsed by the Coast Guard on the vessel's documents. The master of the mortgaged vessel has a legal duty to make the documents available for inspection to anyone legitimately interested, including potential lienors. A supplier should always check for endorsements or, if necessary, filings with the Coast Guard before extending credit.

A preferred mortgage cannot be taken on all vessels that may be subject to maritime liens. Preferred mortgages can only be taken on most, but not all, "documented" vessels. Documented vessels may include any U.S. vessel admeasured at five net tons (approximately 35 feet long) or more. The only documented vessels that cannot incur preferred mortgages are those less than twenty-five gross tons that serve as towboat, barge, scow, lighter, car float, canal boat, or tank vessel.

It may be desirable for a supplier of durable goods to obtain a preferred mortgage on a qualified vessel. It would be possible only if the owner is amenable. It would be desirable only

where the goods sold represent a substantial portion of the vessel's value, where payment contemplated for the goods is an extended installment obligation, and where there are few, if any, maritime liens already in existence. The mortgage must be filed by the supplier at the Coast Guard office in the vessel's home port, and endorsed on the vessel's documents. The supplier may thus enjoy an assured priority credit position regardless of any future maritime liens.

#### Analysis of a Vendor's Lien Options

Lien options are best considered at the time of a sale and creation of a debt, rather than waiting for a foreclosure. A maritime lien for necessities will often arise automatically to provide security, but not always, and such a lien might not be the best form of security available. For these reasons, a supplier should consider other security devices that require affirmative steps to create at the time of the sale. Such devices that may be of interest to the supplier of durable goods considered in this paper include the preferred ship mortgage and, as a group, other liens under state law (usually under a state's version of the Uniform Commercial Code). The use of one or both such devices in addition to reliance upon a maritime lien for necessities will then give the supplier some latitude in the event of a foreclosure.

A supplier must consider several factors when deciding how best to secure a debt arising out of the sale of durable goods to a vessel. These are: the credit status of the vessel at the time of the sale; whether the debt created is long term or short term; the nature and value of the goods being sold; and the availability of security aside from the vessel.

Both a maritime lien and a preferred mortgage are subject to challenge in a judicial confrontation. If they are successfully defeated, the supplier is left without any lien unless he has something to fall back on. A supplier should therefore perfect a lien under state law in addition to relying upon the federal lien. The state lien does not prejudice a valid federal lien but may be extremely beneficial absent the federal liens. The priority of a state lien is low, but it is better than no lien at all.

State liens offer remedies not available under the federal lien scheme. These include self-help (the ability to repossess the goods) and

reliance in part on the personal credit of the debtor-owner. Personal credit permits attachment of property other than the vessel to which the goods are sold and pursuit of deficiency judgments if the vessel sale does not satisfy the debt.

A lien created by state law is recommended when it is known that the goods sold to a vessel are not "necessaries" that give rise to maritime liens. Such a lien will enable the supplier to attach the goods themselves rather than the whole vessel. It will enable the supplier to exercise the state remedies if the lien is in default: the supplier may simply take back the equipment or may sell it separately from the whole vessel. Because other maritime liens attach only the vessel, they will not be considered superior to the state lien in the equipment itself.

A state lien is also desirable when there is doubt as to whether goods are necessaries. In addition to being a fall-back position if a maritime lien fails, it will offer the supplier a choice in the event of a lien sale of the vessel. If his priority as a maritime lienor is high, the supplier can assert the lien as a maritime lien for necessaries. If his priority is low, the supplier can seek to characterize the goods as non-essential and remove them from the vessel.

There is a remote risk when using a state lien to back up a maritime lien or a preferred mortgage. The state lien may suggest that a supplier's intent was to rely upon state law to the exclusion of federal law. Filing of a preferred mortgage or of a maritime lien, if possible, should effectively remove any such doubt. The risk is greatest when a maritime lien is not filed. In such a case, the maritime lien may be seen as a mere after-thought, something that was not contemplated at the time of the original transaction. It is submitted that such a result is extremely unlikely in view of the purposes of maritime liens and of the informal way in which they are often created. It should also be noted that state lien laws liberally allow fall-back filing, providing specifically that such filing will not act to the prejudice of other interests.

A preferred ship's mortgage, if it can be obtained, will be advantageous when used to secure long-term obligations arising from major equipment purchases. Expenses associated with the extensive formal requirements for creating a preferred mortgage will not be warranted if the equipment price is

small. The benefit of the preferred mortgage, priority over subsequent liens, will go unused with a short-term debt. The disadvantage of the preferred mortgage is that pre-existing liens for necessaries are superior to the mortgage, whereas a maritime lien for the same transaction would have priority over the same pre-existing liens. The mortgage should therefore be used only when it is known that there are few, or no, outstanding liens upon the vessel when the mortgage is created.

A risk of using a preferred mortgage is that upon foreclosure the mortgage might be found to be invalid for failure to follow the strict statutory procedures for perfection. In that event, the supplier may still have a valid maritime lien for necessaries, but it is possible that there will be no lien at all. By coloring the debt as a mortgage, the supplier may have created a non-maritime lien. An unperfected non-maritime lien does not present a valid claim against the vessel.

The maritime lien for necessaries can be relied upon in a foreclosure, either as a fall-back or as a principal security device, because it is not subject to formal filing requirements. It is a creature only of the appropriate circumstances described above in the section on Maritime Liens for Necessaries. It can be used without regard to whether formal steps were taken to obtain security at the time of a sale, or despite the fact that formal steps were taken to create alternative forms of security.

Although not strictly necessary, a lien-for-necessaries should be filed whenever possible at the time of the sale of goods to a vessel. Such a filing does not necessitate assertion of the lien in the event of a foreclosure but will be valuable proof of the lien if it is asserted.

Upon the foreclosure of a vessel, a lien for necessaries should be asserted in all circumstances, with three narrow exceptions.

The first exception is where the supplier has obtained a preferred mortgage. If a preferred mortgage is invalid, a maritime lien should be claimed as a fall-back.

The second exception is where the personal credit of the owner or operator is adequate to eliminate any desire to rely upon the vessel as collateral. This occurrence will be rare because a maritime lien is valid even if both the credit of the vessel and personal credit are relied upon.

The third exception is where security in the goods themselves under state law is preferred to the security in the whole vessel obtained by the maritime lien. This should occur only when it is certain that equipment is not necessary to the vessel. Goods that are "essential" will be attached as a part of the whole vessel by other maritime liens and preferred mortgages, which will take priority over any state lien.

The disadvantage of the maritime lien is that it is subordinate to future maritime liens. If the lien secures a long-term debt, this may pose a significant drawback. Nonetheless, if a preferred mortgage cannot be obtained, the maritime lien is the best security available.

### Conclusion

Wiley probably has a valid maritime lien for necessities even if she made no effort to create a lien at the time of the sale.

1. The sale of the fishfinder to the Listless was a "maritime transaction"--it involved a sale to further a maritime venture.

2. The Listless is a "vessel" in that it is used as a means of transportation on the water.

3. The fishfinder sold to the Listless is probably a "necessary" item. There is some doubt because the item was not in fact helpful, but its purpose was to further the venture in which the Listless was engaged, fishing.

4. Poor had authority to incur a lien on the Listless at the time of the sale. He had actual authority because he was the owner and apparent authority because he was the master of the Listless.

5. The sale price for the fishfinder was not unreasonable.

6. Delivery of both ownership and possession of the fishfinder was made to the Listless. Since recovery of the money is preferable to Wiley, this type of lien will serve her well if it is in a beneficial priority position relative to other liens against the Listless.

Even if Wiley had possessed the foresight to do so, she would not have desired to obtain a preferred mortgage. She probably could have arranged one. The Listless is a "documented" vessel, for which such mortgages are allowed, and Paul Poor would have agreed

to anything to get the fishfinder. However, the price for the fishfinder did not warrant the expense of Wiley's attorney for the necessary work to arrange a valid preferred mortgage.

Wiley should have filed a lien under state law for two reasons. First, the lien might have been asserted as a fall-back lien if the fishfinder is not a "necessary," because then no maritime lien would exist. Second, the lien should allow Wiley to remove the equipment itself from the vessel if the maritime lien in the whole vessel, although valid, is of such a low priority that it is valueless. The fishfinder is not a "necessary appurtenance" to the vessel and can be removed without damage to the vessel. Wiley can therefore remove the unit or sell it separately but still leave a "whole" vessel to satisfy other liens against it.

Whether Wiley had the foresight to obtain further security, or must rely solely on a claim of a lien-for-necessaries, she must assert her liens in the foreclosure proceeding. If such claims are not brought before the proceeds from the vessel sale are distributed to lienors that did assert claims, they will be lost. A judicial execution in a federal admiralty court extinguishes all unclaimed liens. Since Wiley does have at least one viable lien to claim, it is fortunate that she watched for the Listless' foreclosure.

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