

## Why are Ship Suppliers Treated Differently in Canada and the U.S.?

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When mortgagees of ships with multiple encumbrances against a ship seek to have the ship sold by judicial sale, it is not unusual to have creditors from all over the world claiming against the proceeds of sale. Such proceedings usually involve the ranking of competing claims between necessaries suppliers and mortgagees from various jurisdictions around the world. Priorities between creditors become relevant when, as is often the case, the proceeds from the sale of the ship are insufficient to satisfy all valid claims.

In the November 2001 issue of Harbour and Shipping, the writer outlined how the claims of competing creditors are ranked in Canada during judicial sale proceedings, where there is a pool of funds generated by the sale of the said ship. This article will look specifically at the different treatment received by Canadian ship suppliers, bunker suppliers and ship repairers (referred to as “necessaries suppliers”) under Canadian and U.S. law.

### **Priorities under Canadian and U.S. law**

Under Canadian law, creditors (ignoring claims associated with the cost of arrest and sale of the ship) are ranked as follows, with Canadian necessaries suppliers who do not have possession of the ship having the lowest priority:

1. disbursements incurred by the Admiralty marshal or sheriff in protecting the vessel prior to sale.
2. costs of sale, including the costs of arrest and appraisal of the ship.
3. possessory liens, such as repairers’ liens, held by a creditor who has possession of the ship and whose possession pre-dates other liens;
4. traditional maritime liens for salvage, master and crew wages, master’s disbursements and pilotage;
5. possessory liens arising after a maritime lien;

6. the claim of a mortgagee or a mortgage holder;
7. statutory rights *in rem* including claims of necessary suppliers, claims arising out of contracts for the construction, repair or equipping of a ship and claims for necessities supplied to sister ships of the ship that has been seized and sold. *In rem* means proceedings or actions instituted against a thing.

U.S. law gives necessities suppliers a *maritime lien*, a special creature of maritime law which is discussed in more detail below. The priority afforded to U.S. necessities liens is somewhat complicated but generally depends upon whether it pre-dates a ship's mortgage registered against the ship and whether the mortgage is a U.S. ship's mortgage or a foreign one. The U.S. priorities between maritime liens for necessities and mortgages can be summarized as follows:

1. a maritime lien for necessities arising before the recording of a ship's mortgage;
2. a U.S. ship's mortgage or a foreign ship's mortgage that is guaranteed by the U.S. government;
3. a maritime lien for U.S. necessities arising after the recording of a U.S. ship's mortgage or a foreign ship's mortgage guaranteed by the U.S. government;
4. foreign mortgages that are not guaranteed by the U.S. government; and
5. foreign statutory rights *in rem*.

As can be seen from the above rankings, the claim of a necessities supplier is treated differently in Canada than in the U.S. Not surprisingly, Canadian ship suppliers disapprove of this differential treatment and feel that the distinction between U.S. and Canadian law creates an inequity because their claims are defeated by the elevated status of U.S. necessities suppliers, whether participating in ship foreclosure proceedings in Canada or the U.S.

### **Conflicts of Law Principles**

This unequal treatment of Canadian necessities suppliers arises because of the application of traditional conflicts of law principles. When considering the ranking of competing creditors' claims, these principles require the Court to determine the specific creditors' claim (or "right") based on the law of the jurisdiction in which the right arises. This is called the *lex loci* (or the "law of the place"). For example, the right of a U.S. necessities supplier is determined

by the treatment of his rights under U.S. law (which, as outlined above, gives him a maritime lien).

Once the rights are determined, the Court must then rank the various rights in accordance with the law of the jurisdiction of the Court. For example, in Canadian proceedings, the various rights will be ranked according to Canadian priorities law. Consequently, a U.S. maritime supplier, by virtue of his right to a maritime lien under U.S. law, will defeat the claim of a Canadian necessities supplier who has only a statutory right *in rem* and will rank ahead of a mortgagee. This is analogous to a U.S. necessities supplier receiving the benefits of a secured creditor while a Canadian necessities supplier is treated as an unsecured creditor in a traditional commercial insolvency situation.

The Supreme Court of Canada applied these conflicts of law principles in *The "Strandhill"*<sup>i</sup> decision in 1926 which stated that "a right acquired under the law of a foreign state will be recognized, and may be in force, under the law of England, unless opposed to some rule of domestic policy or procedure which prevents the recognition of the right." The Supreme Court of Canada applied these principles in the context of a priorities hearing in *The "Ioannis Daskalelis"*<sup>ii</sup>. The creditor was an American shipyard claiming payment for ship repairs performed at the request of the ship's manager. The owners of the ship fell into serious financial difficulties and it was arrested and sold in Canada. The proceeds of sale were insufficient to cover all of the creditors and the ship repairer claimed it had a maritime lien and therefore was entitled to rank ahead of the claim of the mortgage held by a Greek bank.

The Court applied the decision in *The "Strandhill"* as authority for holding that the necessary repairs furnished by the shipyard gave rise to a maritime lien under U.S. law, which was enforceable in Canada. Applying Canadian law to the question of priorities between the competing claims, the Court held that the maritime lien of the ship repairer ranked ahead of the claim of the mortgagee.

### **The Debate**

The Canadian ShipSupply & Services Association (CSSA) has prepared a brief supporting the view that the differential treatment of Canadian necessities suppliers as compared to their U.S. counterparts under Canadian law is "unjust, inequitable and discriminatory".<sup>iii</sup> In addition to how Canadian law treats Canadian necessities suppliers, the CSSA points out that

Canadian necessities suppliers suffer a similar inequity in U.S. ship foreclosure proceedings. Under the conflicts of law principles discussed above, the rights of Canadian necessities suppliers are determined by Canadian law which gives them only a statutory right *in rem*. A statutory right in rem, under U.S. law, ranks after maritime liens for U.S. necessities suppliers, U.S. ships mortgage and foreign ship's mortgages. Consequently, they experience the same low priority under U.S. law.

In order to remedy this disparity, the CSSA proposes an amendment to the *Federal Court Act* which would grant maritime lien status to Canadian necessities suppliers so that they have equal ranking in the U.S. and Canada with U.S. necessities suppliers. While the idea of equalizing the treatment of Canadian necessities suppliers is attractive and worthy, this solution is not as simple as it may appear at first glance. In fact, this proposal has stirred considerable debate in the shipping industry. This issue is presently being considered by the Canadian Maritime Law Association and was recently discussed by the B.C. Maritime Law Subsection of the Canadian Bar Association. The Canadian Bankers Association has also been invited to consider the CSSA's proposal, although it has not taken a formal position at the time of writing, and the Shipping Federation of Canada would likely have its own views on the CSSA's proposal.

Why the debate? Firstly, some maritime lawyers would say that such an approach is too radical a departure from the traditional treatment of maritime liens and priorities under international law. To understand this position, one must consider the historical development of the maritime lien.

Traditionally, maritime liens have been viewed as an extraordinary remedy, granted in limited circumstances where there is a sense of necessity in the provision of services to a ship in distress and claims for personal or property injury caused by the ship. For example, maritime liens are recognized in respect of claims for bottomry<sup>iv</sup>, damages done by a ship or collision claims and salvage claims. Maritime liens are also granted for crew and master's wages, which have always been treated with priority by the Courts. A maritime lien is a right or privilege which arises from a particular type of claim and which attaches to a ship and remains attached to the ship after the ship is sold to a third party. It is a secret claim (in that it is not registered at the ship's port of registry) and is not extinguished until either the claim is satisfied or the ship in question is sold by way of judicial sale<sup>v</sup>. Other *bona fide* purchasers are not protected.

The U.S. position is unique in that it departs from the traditional treatment of necessities suppliers under the 1926 Brussels Convention, which codifies the classes of maritime liens as follows:

1. law costs due to the State and expenses incurred in the common interest of the creditors to preserve the vessel or procure its sale; tonnage dues, light or harbour dues and other public taxes; pilotage dues;
2. claims arising out of the employment contracts of the master, crew or other persons hired on board;
3. remuneration for assistance and salvage and the contribution of the vessel in general average;
4. indemnities for collision or other accidents of navigation, for personal injury to passengers or crew or for loss of or damage to cargo and baggage;
5. claims resulting from contracts entered into or acts done by the master, acting within the scope of his authority, away from the vessel's home port, where such contracts or acts are necessary for the preservation of the vessel or the continuation of its voyage.<sup>vi</sup>

The 1926 Brussels Convention grants a maritime lien for necessities suppliers but only in the limited circumstances set out above (i.e., where the contract is entered into by the master and is necessary for the preservation of the vessel or the continuation of its voyage). The 1926 Convention is in force, but it has not been ratified by Canada, the U.K. or the U.S. Interestingly, the granting of a maritime lien for limited necessities contracts has been removed in the 1967 and 1993 amendments to the Brussels Conventions, although neither amendment was ratified by the minimum number of countries required for ratification.

In addition to departing from traditional principles of maritime law, elevating Canadian necessities suppliers to the status of maritime lien claimants would create uncertainty for the commercial world. It must be remembered that maritime liens are “secret” in the sense that it is impossible to discover them by searching the title of a ship, as one would discover the presence of a mortgage. Similarly, it is important to keep in mind that necessities suppliers are really no

more than trade creditors or “unsecured” creditors. Granting trade creditors the special rights afforded by a maritime lien elevates them to the position of a secured creditor, contrary to traditional rankings of priorities in commercial insolvency or bankruptcy situations.

Maritime legal scholar William Tetley discusses the importance of the fact that judicial sale proceedings are a remedy invoked against the ship itself, not against its owners. The power to arrest a ship and sell it under judicial sale is a procedural remedy which allows the Court to sell the ship in order to satisfy claims against the ship. He states:

*“Because the claimant chooses to proceed in rem [against the property] rather than in personam [against the person] against the shipowner, does not mean that the claimant should be granted the special status of secured creditor and thus be preferred to the ordinary creditors of the bankrupt.”<sup>vii</sup>*

Finally, the fact that maritime liens would remain attached to a ship even in the event of a sale to a third party would create significant uncertainty for purchasers who have no ability to search out the existence of such liens. In today’s business environment, it would be reasonable for a potential purchaser to expect that a ship might be encumbered by a mortgage, but he would have no way of investigating the number of trade creditors with claims against the ship. It also poses a dilemma to parties who extend credit secured by mortgages to shipowners as they must consider the potential claims of a number of unknown trade creditors.

There are other options for dealing with the plight of Canadian necessities suppliers. However, a full discussion of these options is beyond the ambit of this article. Addressed briefly, one option is to demote the status of U.S. maritime lien claimants under Canadian law. Under the English approach (which is contrary to traditional principles of conflicts of law), a claimant is entitled to a maritime lien if such a right accrues under the law of England.<sup>viii</sup>

## **Conclusion**

While it is understandable that we would look to our U.S. neighbour, as one of our largest trading partners, for a solution to the inequitable treatment of Canadian necessities suppliers, it is submitted that such a resolution must be considered in light of the concerns discussed above.

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<sup>i</sup> *The Strandhill v. Walter W. Hodder Co.*, [1926] S.C.R. 680

<sup>ii</sup> *Todd Shipyards Corp. v. Ioannis Daskalelis (The)*, [1974] S.C.R. 1248

<sup>iii</sup> “Brief for Remedial and Harmonizing Legislation to Secure Claims for Necessaries Supplied to Ships”, Canadian Shipyards & Services Association (June 2001).

<sup>iv</sup> Bottomry was an early form of marine insurance whereby money was lent to a shipowner to essentially insure the risk of the voyage and security was taken against the ship. The loan was repaid only if the ship survived the voyage. Consequently, high rates of interest were charged to compensate the lender for the risk of the ship not surviving the voyage. Such loans were replaced by marine insurance and rarely, if ever, exist today.

<sup>v</sup> Under the terms of judicial sale, all claims against the ship in question are extinguished on the date of the sale and the only remedy those claimants have is to participate in the judicial sale proceedings and have their claim paid from the sale proceeds.

<sup>vi</sup> *International Convention for the Unification of Certain Rules of Law Relating to Maritime Liens and Mortgages*, Brussels, April 10, 1926.

<sup>vii</sup> William Tetley, *Maritime Liens and Claims* (London: Business Law Communications Ltd, 1985) at p. 238.

<sup>viii</sup> *The Halcyon Isle*, [1980] 2 Lloyd’s Rep. 325 (P.C.)