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**BONDING SHIPYARD CONSTRUCTION
Or, How to tell the Home Office that
the Project has been towed to Mexico**

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While we think of suretyship as a landlocked security device, it has in fact had a long-standing presence in the realm of water-borne commerce, covering a wide ambit of statutory and commercial applications. Given this history, one would expect the doctrines defining a maritime surety's rights and obligations to have been well established in the context of the marine environment. However, this is not always true. When conflicts evolve to the point of seizure, arrest, attachments, or forced movements of marine property, the consequences can be significant, and there is often precious little authority to use as a guide.¹

A QUICK PRIMER ON ADMIRALTY LAW

The general maritime law has established a clear distinction between original construction and post-construction activities. Vessel construction is most definitely *not* a maritime activity. As a result, admiralty jurisdiction does not attach to vessel construction claims or disputes, and laborers, suppliers or material providers involved in any aspect of original construction lack maritime lienholder status.

A shipbuilding contract is regarded as “a contract made on land, to be performed on land.”² It is also held as being merely preliminary to a vessel's primary function as an instrument of maritime commerce and navigation.³

[A] maritime contract is defined to be one having reference to commerce or navigation. The particular element necessary to give it a maritime character is direct connection with commercial transactions of navigation; and such connection is lacking in a contract to create a new ship, or, if not lacking entirely, it is remote and contingent, so that it is not perceptible at the time that the contract goes into effect. . . .⁴

Therefore, a shipbuilding contract is non-maritime, and an action for its breach is not within the scope of federal admiralty jurisdiction.⁵ Likewise, a contract for the supplying of materials

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1. In that regard, it should be borne in mind that much of what follows is purely the author's opinion.
 2. *The People's Ferry Co. of Boston v. Beers*, 61 U.S. (20 How.) 393, 401 (1858).
 3. *B&B Salvage & Rigging, Inc. v. M/V NORTH BEND*, 548 F. Supp. 123, 124 (E.D. Mo. 1982), *aff'd*, 716 F.2d 908 (8th Cir. 1983); *Empacadora Del Norte, S.A. v. Steiner Shipyard, Inc.*, 469 F. Supp. 954 (S.D. Ala. 1979).
 4. *The MANHATTAN*, 46 F. 797, 799-800 (D. Wash. 1891).
 5. *North Pac. S.S. Co. v. Hall Bros. Marine Ry. & Shipbuilding Co.*, 249 U.S. 119, 126-27 (1919).

for the construction of a vessel is non-maritime.⁶ In this vein, a contract that provides for the payment by the United States Maritime Administration (“MARAD”) of a construction differential subsidy related to ship construction has been found to be outside of admiralty jurisdiction.⁷

Vessel status does not attach until the construction has been fully completed. Full completion requires that the vessel be launched, fully fitted out and made ready in all respects to function in maritime commerce. If there is anything yet to be performed that is necessary to consummate construction – even if it is to be carried out after the hull has been floated – full completion will not have been achieved.⁸ The fact that goods or services might have been contracted after primary construction began, or even after the hull has been launched, is immaterial.⁹ For example, a towboat rigging purchased and delivered during original construction, but not installed until after the tug’s launching and publicity voyage, was held to be part of the vessel’s original construction so as to deprive the seller of maritime lienholder status.

However, once construction is truly complete and the vessel has been exposed to the vicissitudes of the sea, it becomes an instrument of maritime commerce and is subject to the full breadth of admiralty jurisdiction and doctrine. It is upon this basis that the admiralty draws the distinction between vessel construction and vessel repair. The Supreme Court long ago recognized that “[i]t is not always easy to determine what constitutes repairs as opposed to original construction.”¹⁰ Fortunately, the line is obscure only in rare instances.¹¹ Clearly, vessel repair most definitely *is* a maritime activity. “Repair” can and does include anything from routine equipment repair to total refitting and conversion of the vessel itself.¹²

6. *Owens-Illinois, Inc. v. United States Dist. Court*, 698 F.2d 967, 970 (9th Cir. 1983).

7. *See, e.g., In re American Export Lines, Inc.*, 568 F. Supp. 956 (S.D.N.Y. 1983).

8. *Thames Towboat Co. v. The FRANCIS McDONALD*, 254 U.S. 242, 244-45 (1920); *Hatteras of Lauderdale, Inc. v. GEMINI LADY*, 853 F.2d 848, 850-51 (11th Cir. 1988); *Hyundai Heavy Indus. Co., Ltd. v. M/V SAIBOS FDS*, 163 F. Supp. 2d 1307, 1311-12 (N.D. Ala. 2001).

9. *B&B Salvage & Rigging, Inc.*, 548 F. Supp. at 124.

10. *The JACK-O-LATERN*, 258 U.S. 96, 99 (1922).

11. *See, e.g., Bill Fowler, Inc. v. Stadler*, 558 F. Supp 1115 (S.D. Fla.1983) (an existing vessel sold as a pleasure vessel was being remade at the instance of the buyer for a commercial fishing service; the court characterized such work as constituting original construction rather than repair work, so that admiralty jurisdiction was lacking). *See also The MANHATTAN*, 46 F. at 800. In *The MANHATTAN*, despite the fact that the vessel had not been completed post-launching, the District Court of Washington held that completion contracts were maritime because the vessel had been towed and “embraced by the element upon which she was intended to float. . . .” *Id.* This result, however, is questionable under *The FRANCIS McDONALD*, 254 U.S. at 244-45, which was a later decided case.

12. *The JACK-O-LATERN*, 258 U.S. at 99-100. *See also Pleason v. Gulfport Shipbuilding Corp.*, 221 F.2d 621, 623 (5th Cir. 1955) (holding that a Navy salvage and repair vessel that no longer had motive power of its own or a steering mechanism, but was capable of being used as a means of transportation under tow, was in maritime); *Campbell v. Lognicka*, 181 F.2d 356 (5th Cir. 1950) (holding that the conversion of a Navy bomb target boat into a pleasure yacht was maritime).

Understandably, therefore, it is not uncommon to come across relatively large shipyard projects that fall within the realm of the admiralty.

There is a caveat, however. If work on an existing vessel occurs during or causes its removal from maritime commerce for a prolonged period of time and/or changes its character to such an extent that it can be said that it has been taken out of navigation, then it will be regarded as a “dead ship” with no vessel status and the contract for the work will be classed non-maritime. In *Evansville & Bowling Green Packet Co. v. Chero Cola Bottling Co.*, a wharfboat, attached to shore by cables and used as an office, warehouse, and wharf, was held not to be a vessel.¹³ Furthermore, in *Russell v. City Ice & Fuel Co. of Point Pleasant*, a fuel flat that was used as a stationary dock not was found not to be in navigation.¹⁴ And in *Robert E. Blake, Inc. v. Excel Environmental*, which concerned a personal injury indemnification action, the contract between a contractor and subcontractor relating to work on a deactivated vessel was held to be non-maritime.¹⁵

The consequence of the distinction is that vessel construction contracts and disputes will be governed by the appropriate state law, while post-construction vessel contracts and activities fall primarily within the jurisdiction of admiralty courts.¹⁶ There is, however, one major exception to this rule. Projects for the federal government, whether original or post construction, will be controlled by the Miller Act, 40 U.S.C. §§ 270a *et seq.*, and/or other federal substantive laws.

The obligations of a marine surety rest directly upon this analysis. The nature of the suretyship obligation is defined by the underlying contract. If the underlying contract is one of marine construction, then the suretyship will not represent a maritime contract and will not fall within admiralty jurisdiction. If, on the other hand, the suretyship attaches to the performance of ongoing work upon an existing private vessel (i.e., repairs), then generally it will be regarded as a maritime contract.¹⁷ Finally, if the underlying contract, be it construction

13. 271 U.S. 19, 21 (1926).

14. 539 F.2d 1318 (4th Cir. 1976).

15. 104 F.3d 1158 (9th Cir. 1997). *But see The JACK-O-LANTERN*, 258 U.S. at 98-99 (holding that the conversion of a hull from an unpowered car float to a navigable amusement steamer was not a new construction even though the essential character of the vessel was completely changed); *M/V MARIFAX v. McCrory*, 391 F.2d 909, 910 (5th Cir. 1968) (holding that work performed after the vessel had been laid up for fifteen years to be in the nature of repairs).

16. *Stephens Boat Co., Inc. v. Barge ORR I*, 791 F. Supp. 145, 147 (E.D. La. 1992) (holding that a contract for the installation of equipment necessary to outfit the vessel for its intended purpose only created a state law lien under LA. CIV. CODE ANN. art. 3237, and, although the vessel’s construction was complete, it had been launched, and the price paid for, the state law right could not itself support admiralty jurisdiction).

17. In *Aqua-Marine Constructors, Inc. v. Banks*, 110 F.3d 663, 671 (9th Cir.), *cert denied sub nom. Polaris Ins. Co. v. Aqua-Marine Constructors, Inc.*, 522 U.S. 933 (1997), the appellate court quite ably explained the fine parameters of admiralty jurisdiction *vis-a-vis* a surety’s involvement with maritime contracts. A pure guaranty to pay money to the obligee to compensate for loss in the event of nonperformance by the obligor is not a maritime contract because no maritime performance is involved. *Pacific Surety Co. v. Leatham & Smith Towing & Wrecking Co.*, 151 F. 440, 443-44 (7th Cir. 1907). On the other hand, the

or repair, pertains to a federal project, the Miller Act and other federal substantive laws control the surety's rights and obligations.

The application of state law to private shipbuilding projects obviously localizes the body of law applicable to any given situation. Industry-related special mortgages, liens and privileges against vessel construction projects are common under state law, and the practitioner must be cognizant of the controlling laws of the governing jurisdiction. Of course, the difficulty with marine construction arises from the breadth and mobility of the projects themselves. It is not uncommon for construction of various portions of a vessel to take place contemporaneously across state, national and even international jurisdictional boundaries. Likewise, custom manufactured component parts, whether small or significant, might originate in any number of jurisdictions. Once a hull has been launched, its ability to navigate across jurisdictional bounds, sometimes covertly, can greatly complicate or even frustrate entirely the best efforts of not only creditors, but also sureties at risk in the venture.

PAYMENT BOND CONSIDERATIONS

As was noted above, the law governing payment bond claims will turn on whether the vessel is being constructed or repaired. In the event of new construction, State law applies; in the event of a vessel repair, admiralty law will apply. Finally, if the vessel is being constructed for the federal government, then the Miller Act applies. However, it should be noted that section 270e of the Miller Act allows contracting bodies to opt out of that statutory scheme in the case of shipbuilding contracts.

New Construction. Laborers and suppliers to a shipbuilding project are typically granted lien rights against the work by virtue of state law, based upon the same public policy considerations that favor their landbound colleagues. Additionally, various creditor interests may hold mortgage or security rights in the work. All of these interests must be considered by a marine construction surety in the event of a defaulted project. Again, this is principally a state law analysis that turns upon the peculiarities and nuances of the governing law. This point is clearly illustrated through consideration of the laws of two states with major shipbuilding industries – Louisiana and Mississippi.

In Louisiana, for example, vessel construction raises a hybrid situation under the law. In general, the Louisiana Private Works Act, LA. REV. STAT. ANN. § 9:4201 *et. seq.*, is applicable to a work for “the improvement, construction, erection, reconstruction, modification, repair, demolition, or other physical change of an immovable or its component parts.”¹⁸ The Louisiana Private Works Act does not apply by its terms to vessels, which are regarded in

obligation of a surety to perform any part of the underlying maritime contract is itself maritime, so as to render the suretyship a maritime contract. *Aqua-Marine Constructors, Inc.*, 110 F.3d at 670-72. “In sum, actions against sureties on bonds securing performance are cognizable in admiralty if the surety’s obligation under the bond is the same as that of the original promisor, but not if the surety is obligated only to pay a sum of money and the duties of the original promisor were otherwise.” *Id.* at 672 (citing 7A JAMES W. MOORE, MOORE’S FEDERAL PRACTICE ¶ 260.2, at 3060 (2d ed. 1995)).

18. LA. REV. STAT. ANN. § 9:4808 (emphasis added).

Louisiana law as *movable* property.¹⁹ While Louisiana certainly provides for the protection of creditor mortgage and security rights pertaining to incomplete vessels and bestows state law lien and privilege rights upon the claims of laborers, suppliers and material persons involved in the construction, there is no express or particular provision delineating the function of suretyship in the shipbuilding context. Accordingly, such matters fall into the realm of conventional suretyship under Louisiana law, and the particular terms of the suretyship contract carry great significance. Unless the surety has expressly undertaken payment bond obligations contracted in the bond instrument to pay the claims of laborers, suppliers, and materialmen, there is no legally enforceable obligation that it do so.

In contrast, it can be argued that shipbuilding operations are included in the private works suretyship requirements of Mississippi law. Section 85-7-181 of the Mississippi Code extends the benefits of Mississippi's private construction "stop payment" provisions to "any person who may have furnished materials used in the erection, construction, alteration, or repair of any house, building, structure, fixture, boat, water craft, railroad, railroad embankment, . . . or the wages of any journeyman or laborer employed. . . ."²⁰ A sister statute, Miss. CODE ANN. § 85-7-185, provides:

When any contractor or subcontractor entering in to a formal contract with any person, firm or corporation, for the construction of any building or work or the doing of any repairs, shall enter into a bond with such person, firm or corporation guaranteeing the faithful performance of such contract and containing such

19. *P.B.C. Systems, Inc. v. L.A.D. Construction Co., Inc.*, 428 So. 2d 984, 987 (La. Ct. App. 1st Cir. 1983). Actually, *P.B.C. Systems, Inc.* provides valuable insights into Louisiana law on these issues. A materialman sued the general contractor and the project owner for funds allegedly due for materials furnished in the construction of a barge. *Id.* at 985. The plaintiff claimed to have duly filed a notice of claim pursuant to Louisiana law, thereby preserving his state-law lien and privilege rights against the barge. *Id.* Upon appeal, the appellate court reversed the entry of default judgment in favor of the plaintiff, holding that, in the absence of privity, the barge owner could not be held personally liable on the claim. *Id.* at 987.

The court noted that the existence of a lien or privilege against a vessel does not in and of itself create personal liability on the part of the owner. *Id.* at 986. The court recognized that a "contrary situation" exists in the case of "immovables" (real property) under the Louisiana Private Works Act, LA. REV. STAT. ANN. § 9:4802, because personal liability against the owner of an immovable is founded upon statutory grounds and not upon the existence of a privilege against the owner's property. *Id.* at 986-87. The court noted that "[t]he fact that the Private Works Act provides for personal liability against the owner of an immovable does not avail materialmen who furnish labor or materials for vessels or other materials." *Id.* at 987 (citing *Graeme Spring & Brake Serv., Inc. v. DeFelice*, 98 So. 2d 314 (La. App. Orl. Cir. 1957)). Thus, the court held, "without privity of contract or some other grounds for incurring personal liability, Western [the owner] cannot be cast with a money judgment in the instant case." *Id.* None of the invoices at issue were addressed to the owner; rather, they were charged to the contractor. More importantly, the plaintiff's petition stated that the materials were ordered by the contractor in accordance with the contractor's purchase order from the owner, and the allegation could not be construed to allege any express or implied promise to pay by the owner. *Id.* Therefore, the court held that no basis existed for holding the owner personally liable for the amounts owed to the plaintiff, so that reversal of the default judgment against the owner on that particular count was required. *Id.*

20. Miss. CODE ANN. § 85-7-181.

provisions and penalties as the parties thereto may insert therein, such bond shall also be subject to the additional obligations that such contractor or subcontractor, shall promptly make payments to all persons furnishing labor or material under said contract; and in the event such bond does not contain any such provisions for the payment of the claims of persons furnishing labor or material under said contract, such bond shall nevertheless inure to the benefit of such person furnishing labor or material under said contract, the same as if such stipulation had been incorporated in said bond, and any such person who has furnished labor or materials used therein; for which payment has not been made, shall have the right to intervene and be made a party to any action instituted on such bond, and to have his rights adjudicated in such action and judgment rendered thereon, subject, however, to the priority of the rights or claim for damages or otherwise, of the obligee. The bond herein provided for may be made by any surety company authorized to do business in the State of Mississippi.²¹

Obviously, this is a very specialized, and localized, area of the law.²²

Vessel Repair Contracts. No bonding requirement for private vessel repair contracts exists under the general maritime law or under generally applicable federal statutory or regulatory law. Therefore, any bonds pertaining to such projects are generally treated as conventional (or “common law”) bonds. However, as failed or troubled ship repair projects involve maritime lien claims and the potential for the assertion of these claims *in rem* against the vessel, the surety can find itself liable for maritime liens.²³

This is all the more troubling since, in situations such as these, the owner typically has an interest in appearing and defending against the claims in order to protect its ownership interests. Additionally, if the owner is in privity with the claimants on the various contracts, then the owner itself may stand responsible *in personam* on the basis of the maritime contracts. The end result either way is that the owner faces the potential of sustaining monetary loss – loss for which it is likely to seek redress from any available source.

Maritime contracts are subject to admiralty jurisdiction. Actions upon such contracts can expose the breaching party to liability in admiralty *in personam*. In appropriate cases,

21. MISS. CODE ANN. § 85-7-185.

22. Illustrative of this point, the author presents this statutory comparison without expressing any conclusion or opinion as to whether a “work” under MISS. CODE ANN. § 85-7-185 includes “water craft” or “boat” projects covered under MISS. CODE ANN. § 85-7-181.

23. Being “secret” under the general maritime laws, true maritime liens require no recordation or formality, although the filing of a notice is optional under the Commercial Instruments and Maritime Lien Act. See 46 U.S.C. § 31343. Additionally, maritime lien rights enjoy higher rank and priority against the *res* than rights arising through state law (a bottom priority in the maritime hierarchy). 1 THOMAS J. SCHOENBAUM, ADMIRALTY AND MARITIME LAW § 9-6 (4th ed. 2004).

where the breach supports the assertion of a maritime lien, liability can exist against the vessel, *in rem*. As is explained in the well regarded treatise, THE LAW OF ADMIRALTY, authored by Grant Gilmore and Charles L. Black:

In American jurisprudence the existence of a maritime lien is synonymous with the availability of a libel [suit] *in rem*. As Justice Field wrote in *The Rock Island Bridge* [73 U.S. (6 Wall.) 213, 215 (1867)]: ‘The lien and the proceeding *in rem* are, therefore, correlative – where one exists, the other can be taken, and not otherwise.’ A ship may be libeled *in rem* only in aid of a lien claim; non-lien claimants are limited to an action *in personam*, although once a lien claimant has instituted an *in rem* action certain claimants who do not have maritime liens may share in the distribution of the fund. While a vessel may be levied upon and sold in satisfaction of an *in personam* judgment, that sale does not divest existing liens. Only in an *in rem* proceeding can the ship be sold free of liens, with a consequently greater fund for distribution among claimants. Furthermore, in distribution of the fund lien claims (with the exception of some claims arising while the ship is *in custodia legis*) are paid in full before non-lien claims are entitled to anything. What is essentially important to a claimant in having his claim ranked as a lien is in the first place the priority he receives over non-lien claimants, and secondly the availability to him of the *in rem* process by which alone liens can be executed.²⁴

As has been mentioned, maritime liens arise only with regard to non-public vessels in navigation.²⁵ Modification, refurbishment and repair work carried out upon existing vessels constitutes the furnishing of “necessaries” under the Federal Commercial Instruments and Maritime Liens Act, 46 U.S.C. §§ 31301 *et seq.* As such, assuming the owner’s consent to or ratification of the work, the provider of vessel repairs is generally entitled to maritime lien protection for the work performed on the behalf of the vessel, with the ranking and priority of the lien attaching from the time of the first repair work.²⁶

24. GRANT GILMORE & CHARLES L. BLACK, THE LAW OF ADMIRALTY § 9-19, at 622 (2d ed. 1975).

25. Again, based upon the premise that a vessel under construction is not in navigation, construction debts do not support maritime lien security.

26. There is serious discord in the law as to whether maritime lien rights can be asserted constructively against a sovereign entity, *in personam*, for work performed for a “public” vessel. A “public vessel” is defined by the Federal Commercial Instruments and Maritime Liens Act to include “a vessel that is owned, demise chartered, or operated by the United States Government or a government of a foreign country.” 46 U.S.C. § 30101(3). Clearly, vessel property of the United States is not subject to *in rem* proceedings in admiralty. *The SIREN*, 74 U.S. (7 Wall.) 152, 155 (1868); 46 U.S.C. § 31342(b). However, the question of whether the government can be sued *in personam* for work performed upon a public vessel by a contractor lacking direct privity with the government is far from settled. *Compare Bonanni Ship Supply, Inc. v. United States*, 959 F.2d 1558, 1562-64 (11th Cir. 1992) (holding the Federal Commercial Instruments and Maritime Liens Act does not preclude the imposition of maritime liens on public vessels where an admiralty plaintiff sues the United States *in personam* on principles of *in rem* liability), *and*

Juxtaposed against maritime lien rights, which harken back to the ancient roots of maritime law, is the preferred ship mortgage – a relatively recent security right established statutorily in favor of maritime financing creditors. Under 46 U.S.C. § 31301(6)(A), a "preferred mortgage" with regard to a "vessel of the United States" designates a preferred mortgage instrument under 46 U.S.C. § 31322 (i.e., one that satisfies the formal and procedural statutory requirements). Section 31326 (b)(1) of Title 46 provides that, upon foreclosure, the *preferred mortgage lien* has priority over all claims against the vessel *except* claims for expenses and fees allowed by the court (*in custodia legis* expenses), costs imposed by the court, and *preferred maritime liens*.²⁷ A "*preferred maritime lien*" is statutorily defined as any maritime lien on a vessel that arises prior to the filing of the preferred ship mortgage lien, or that otherwise is for damage arising out of maritime tort, for wages of a stevedore employed by one presumed to have authority to incur maritime liens for necessities on the behalf of the vessel, for wages of the crew, and for general average or salvage.²⁸ Thus, valid maritime liens, including liens for repairs, that arise prior to the filing of the domestic preferred ship mortgage are "preferred maritime liens" and rank the security of the mortgagee.²⁹ Subject to certain exceptions, such as equitable subordination or a mortgagee's laches in enforcement or waiver, the only maritime liens that rank the domestic preferred ship mortgage security are those specified in the statute.

Marine Coatings of Alabama v. United States, 71 F.3d 1558, 1561-63 (11th Cir. 1996) (holding a maritime repair lien asserted *in personam* against the Government is not a claim authorized by the Public Vessels Act, 46 U.S.C. App. § 781, but is covered only by the Suits in Admiralty Act, 46 U.S.C. App. §§ 741-52), *with Sipco Serv. & Marine, Inc. v. Bethlehem Steel Corp.*, 892 F. Supp. 129, 130 (D. Md. 1995) (concluding that the Federal Commercial Instruments and Maritime Liens Act precludes the imposition of maritime liens on public vessels, and circumvention of the rule through assertion of *in rem* rights through *in personam* actions is unsound), *and E.J. Bartells Co. v. Northwest Marine, Inc.*, No. C92-1424D, 1994 WL 476189, at *2, 1994 A.M.C. 1057 (W.D. Wash. Jan. 21, 1994) (finding subcontractor had no cause of action under Suits in Admiralty Act, and Government did not waive sovereign immunity as against such actions, as confirmed by 46 U.S.C. § 31342(b), so that suit was dismissed), *and Hopeman Bros., Inc. v. USNS CONCORD*, 898 F. Supp. 338, 340 (E.D. Va. 1995) (same). None of these decisions address the coverage of the Miller Act, 40 U.S.C. §§ 270a *et seq.*

27. 46 U.S.C. § 31326(b)(1).

28. 46 U.S.C. § 31301(5).

29. Under 46 U.S.C. § 31301(6)(B), a mortgage on a *foreign* vessel is a "preferred mortgage" as long as it is validly "executed under the laws of the foreign country under whose laws the ownership of the vessel is documented and has been registered under those laws in a public register at the port of registry of the vessel or at a central office." Due execution and registration under the laws of the "home" country are key. *Oil Shipping (Bunkering) B.V. v. Sonmez Denizcilik ve Ticaret, A.S.*, 10 F.3d 1015, 1018 n.4 (3d Cir. 1993); *Mobile Marine Sales, Ltd. v. M/V PRODRAMOS*, 776 F.2d 85, 89 (3d Cir. 1985). The ranking and priority of a foreign preferred ship mortgage is not as strong as that accorded to a domestic preferred ship mortgage; American lienholders are given preferential rights. Specifically, 46 U.S.C. § 31326(b)(2) provides that the lien of a foreign ship mortgage that has not been guaranteed by the Maritime Administration "is subordinate to a maritime lien for necessities provided in the United States." Thus, the lien rights of those who provided "necessaries" (i.e., repairs) to the vessel are superior to the foreign preferred mortgage lien, no matter when the necessities were provided or furnished.

One significant and basic defense to maritime lien claims concerns the issue of whether or not lien status can attach on the basis of authorization, or the lack thereof, from the owner or from the appropriate vessel interests. This defense is particularly poignant and relevant in the instance of shipyard repair projects. One of the fundamental elements of a maritime lien for “necessaries” is proof by the claimant of the provision of “necessaries to a vessel on the order of the owner or a person authorized by the owner.”³⁰ In the shipyard setting, this burden of proof is very demanding.

From a statutory standpoint, there is no legal presumption of authority on the part of a general shipyard contractor to authorize the imposition of maritime liens against a vessel.³¹ Moreover, maritime jurisprudence leans strongly towards a general denial of maritime lien status to shipyard subcontractors unless it can be affirmatively shown that the vessel owner was aware of and in fact contemporaneously ratified the work being carried out upon the vessel by the claimant or that the owner authorized the work in question on the credit of the vessel.³² Contracts entered into by vessel owners that contemplate services and materials being provided by third parties support owner scienter and militate against the authorization defense, but are not independently determinative. Additionally, the invalidity of lien claims against the vessel *in rem* would not necessarily apply to the contract claims of the various claimants *in personam* against the contractor and potentially, against the owner.

All of these principles play out in *Integral Control Systems Corp. v. Consolidated Edison Company of New York, Inc.*³³ Consolidated Edison, a public utility, contracted with a shipyard to perform all work necessary to convert and upgrade a tank barge for use by the utility.³⁴ The conversion contract was for a lump sum, to be paid through progress payments, with retainage.³⁵ Interestingly, the shipyard itself was in the midst of Chapter 11 bankruptcy reorganization when the contract was confected.³⁶ The shipyard entered into a number of subcontracts for the performance of portions of the work.³⁷ As matters evolved, the shipyard fell behind in its payments to the subcontractors, which initiated actions *in rem* against the barge and *in personam* against Consolidated Edison and, presumably with a lifting of the

30. 46 U.S.C. § 31342.

31. 46 U.S.C. § 31341. Note, the statute does not include a contractor in the listing of parties presumed to have authority to procure necessaries for a vessel. See, e.g., *The JUNIATA*, 277 F. 438, 440-41 (D. Md. 1922) (citing Act of June 23, 1910, § 5, 36 Stat. 605, re-enacted by Merchant Marine Act June 5, 1920, § 30, 46 Stat. 1006, 46 U.S.C. § 971 (predecessor statute)).

32. See, e.g., *Crescent City Marine, Inc. v. M/V NUNKI*, 20 F.3d 665 (5th Cir. 1994); *AAB Electrical Industries, Inc. v. Control Masters, Inc.*, 1980 A.M.C. 1795 (E.D. La. 1980).

33. 990 F. Supp. 295 (S.D.N.Y. 1998).

34. *Id.* at 296.

35. *Id.* at 296-97.

36. *Id.* at 297.

37. *Id.*

bankruptcy stay, against the shipyard to collect the balances.³⁸ For its part, after having obtained a lifting of the automatic stay in bankruptcy, Consolidated Edison pressed a third party claim against the shipyard.³⁹

The United States District Court for the Southern District of New York, one of the pre-eminent admiralty courts in the country, was called upon to address the issue of whether the subcontractors held valid maritime lien rights as against the barge. The District Court's analysis was framed by 46 U.S.C. §§ 31341 and 31342.⁴⁰ There was no dispute in the case that the barge constituted a "vessel" and that the services rendered to the vessel by the subcontractors constituted "necessaries" as defined by the lien statutes, but the key issue was whether the shipyard had been authorized by Consolidated Edison to procure the services of the subcontractors, as required by 46 U.S.C. § 31342.⁴¹ Invoking what it found to be the general rule of admiralty law, the district court held that authorization was lacking.⁴²

In reaching this conclusion, and in ruling against the subcontractors' rights to proceed *in rem* against the Consolidated Edison barge, the court distinguished the decision of the Eleventh Circuit Court of Appeals in *Marine Coatings of Alabama, Inc. v. United States*.⁴³ In *Marine Coatings of Alabama*, the appellate court reversed the grant of summary judgment in favor of the government/vessel owner and remanded the case for trial on the basis that a triable issue of material fact existed as to whether the government was aware of the subcontractor's retention and performance based upon the facts of the case.⁴⁴ The *Consolidated Edison* court noted that factors pertinent to the Eleventh Circuit's decision in *Marine Coatings* included the shipyard's reference to the subcontractor in its reporting to the government, the large portion of the general contract that was actually performed by the subcontractor, knowledge by government officials of the subcontractor's presence and inspection of the subcontractor's work, and the fact that government representatives maintained a presence at the work site and approved work that had been done.⁴⁵ There was no indication in the record presented to the *Consolidated Edison* court that any of those factors were present in its case.

38. *Id.*

39. *Id.* n.1.

40. *Id.* at 298.

41. *Id.* at 299.

42. Citing a "considerable body of law," the court noted the general proposition in admiralty is that a subcontractor, without the expressed consent of the owner having been established, cannot assert a maritime lien for necessaries against a vessel. This position is based upon the fact that a contractor carries out its functions not as an agent of the owner, but as contractor - so that those with whom the contractor deals generally must be found to have been extending credit to the contractor rather than relying upon the credit of the vessel in carrying out their services or providing their materials. *Id.* at 299-300. See *Port of Portland v. M/V PARALLA*, 892 F.2d 825 (9th Cir. 1989).

43. 932 F.2d 1370 (11th Cir. 1991).

44. *Consolidated Edison Co.* 990 F. Supp. at 300-01.

45. *Id.*

Furthermore, the district court characterized the *Marine Coatings* approach as being a very restricted exception to the general rule, and preferred to phrase the exception “more accurately” along the lines of an explanation provided by the Ninth Circuit in which it reasoned that “an owner can still become responsible for the services of a subcontractor, if the owner has ordered the general contractor to retain that subcontractor.”⁴⁶ In practicality, an owner’s affirmative act in retaining the subcontractor would arise comparatively rarely.

COMPLETION OF BONDED VESSELS

Are You a Competent Person? The first principle that must be acknowledged in handling a default on a vessel construction contract is that virtually everyone in the surety industry is profoundly ignorant of the technical side of vessel construction. The same claim attorney who can discourse intelligently about the relative merits of post-tensioned concrete will have no clue as to the location, identity or function of starboard stern bilge knuckles.

Even worse, the regulatory landscape is far more complex and dangerous than it is in traditional construction. For example, one of the first steps in investigating a defaulted project is a site inspection. However, the simple act of going into the hold of a vessel under construction can be a violation of the law unless a “competent person” has certified that it can be done safely.⁴⁷ Some of these regulations are self-enforcing. For instance, the atmosphere in a ship’s hold can be lethal in a startling number of ways.

In short, the very first thing to do upon receipt of notice of a vessel construction default is to retain an experienced naval surveyor. While that means that you will be working with a consultant who has no notion of suretyship or the information that a surety requires to make its decisions, you will at least have someone to lead you through the morass of regulations, the byzantine customs of the shipping world and the unexpected steps needed to actually reach completion of the vessel. On the bright side is the fact that since most naval surveyors work as independent contractors for maritime insurers, they are very experienced in estimating construction costs and in inspecting the work.

Forget About A Relet. Once you have retained a naval surveyor and have been led through a hopefully non-lethal site inspection, you will be considering the surety’s traditional options: throw money at the obligee, finance the principal, or relet the work to another contractor at a ridiculous premium. Like most people in the surety business, you will lean towards the latter as being the least of three evils. It is at this point that you will recognize one of the fundamental problems in bonding vessel construction: the obligee does not always own the project.

In a traditional surety default scenario, a building is being constructed on property owned by the obligee. It is being built with equipment which, by its nature, is movable because it is transported from job site to job site. When the shoreside contractor defaults, the surety can bring another contractor in to complete. As the obligee controls the property, the issue of access does not arise.

46. *Id.* at 301 (quoting *Port of Portland v. M/V PARALLA*, 892 F.2d 825, 826 (9th Cir. 1989)).

47. *See, e.g.*, 29 C.F.R. § 1915.12.

In vessel construction, however, shipyards do not go to the obligee, the obligee goes to the shipyard. As shipyards, by and large, are immobile, it is not possible to relet the work unless the vessel has reached a stage of completion that it can be moved to another shipyard, which is rarely the case. Further, moving the vessel brings the surety into a whole new universe of expense and risk. Hull insurance and P&I insurance are absolutely necessary to undertake such a move. Coast Guard approval is required, which can take a while to arrange. Finally, a single large tug can cost over \$250 an hour (no deduction for standby time or travel time), and it can take two or three tugs to safely handle a hull. If the decision is made to do this, one option is to contract with the completing shipyard to arrange for the move and to take responsibility for same.

As a general rule, though, the only options are to try to buy back the bond or else to finance the principal. Neither of these options is attractive.

Buy Back Equals Bond Penalty. If the job is in the very beginning stages, the obligee might agree to release the surety in return for reimbursement of its invested costs. If completion has proceeded to the point that the vessel can be moved, the obligee might be willing to release the bond in return for payment of the excess completion costs. Absent these two somewhat unusual scenarios, it is unlikely that the obligee will agree to a buy back of the bond, as it will not want to take on the financial responsibility for completion of the project for the very same reasons that the surety should not want to shoulder these. The entire process, as we shall see below, is fraught with risk. The owner, furthermore, does not want the money. Rather, the owner wants a vessel. Your options, then, are litigation to determine the amount due, or financing your principal.

Financing the Shipyard: The Only Option Is the Worst. Before making the decision to finance the shipyard, consider that you will be called upon to pay costs which are normally considered general overhead, because that will be your only option once you embark on this course. For example, it is likely that the shipyard is on leased property. If you do not pay the rent, the landlord not only will shut down construction, it also probably will have a lessor's lien on the vessel. This lien may prime the obligee's rights, rendering your equitable subrogation rights useless. Do not be surprised if drydocks and other major equipment are also on a lease-purchase basis with hefty monthly payments. All of this overhead will remain fixed while the stream of other jobs (and income) dry up.

Also be aware that there is a design element present in most shipbuilding contracts. Engineers are required to provide stability certifications and a host of other documents in order to meet the requirements of Coast Guard certification. They have to be paid. Construction is inspected on a regular basis by the American Bureau of Shipping ("ABS") or some other approved inspection authority. They also have to be paid. If you fail to pay ABS because they are not a proper claimant under the payment bond, you will never deliver the vessel under the performance bond.

At the same time, you will have to deal with the disintegration of the shipyard's workforce. The most important workers are extremely skilled and economically mobile. They know that the shipyard will be out of business as soon as you complete your vessel, so every last one of them is looking for a new job, which they will accept the moment that it is offered,

regardless of the stage of completion of your vessel. They are much more difficult to replace than land-side construction workers. Furthermore, the process of documentation, as mentioned above, is unbelievably laborious, and is a continuing work in progress. There generally will be one or two highly paid employees taking care of this. Your choice is to continue to pay their salary, or to start from scratch.

Moreover, the universe of maritime liens that might arise during the course of any bonded vessel repair project is far more expansive than what might be expected in a traditional land-based setting.⁴⁸ Certainly, claims related to goods and services provided in the context of the bonded project hold the potential for maritime lien status. However, liens that have absolutely no relation to the project can also become very real obstacles. For example, all of the following could very conceivably arise and/or be asserted as maritime lien claims during the course of a given repair project: unpaid crew wage and penalty claims; personal injury claims of any member of the crew based on unseaworthiness and/or maintenance and cure; marine pollution claims; unrelated charter-party claims or disputes; claims for vessel stores, provisions or bunkers; claims for unrelated repairs, equipment purchases or rentals, towage, dockage, wharfage, pilotage or stevedoring services; or even maritime lien claims that predated the project altogether. As if that were not enough, foreclosure actions against the vessel and/or its owners might be instituted during the course of the project by unrelated preferred ship mortgages. A vessel repair surety must be cognizant of this possibility and must maintain a continuous level of vigilance over the course of the bonded project so that it can quickly and effectively protect its interests.

In the construction setting, the single most disturbing aspect of financing completion is that the obligee does not always own the project – the principal often does. Ownership passes when the vessel is documented and the transfer of title is recorded by the National Vessel Documentation Center.⁴⁹ Until then, the project is simply no more than structural steel owned by the shipyard. The consequences of this can be dreadful.

Traditionally, sureties are careful not to pay unbonded obligations. These unsecured claimants have no call on the bond, the contract balances are tied up for the surety by the principles of equitable subrogation, and the project (in whatever stage of completion) is safely in the hands of the owner. The surety is well armored against the principal's general creditors. However, this is not the case with a shipyard.

When the principal's general creditors reduce their claims to judgment, they come looking for unencumbered assets, and the plum is the bonded vessel under construction. There is simply nothing to prevent the seizure and sale of your project. Filing the indemnity agreement as a UCC financing statement will help, but that often only secures you to the extent of the loss reserve that has been set. If the original contract is for \$5,000,000.00, and completion is estimated to cost another \$1,000,000.00, then the reserve will not be sufficient

48. This discussion presumes existing "vessel in navigation" status and "authorization" adequate to support lien status.

49. Documenting the vessel actually creates only a rebuttable presumption of ownership. See 46 U.S.C. §12104. Some vessel construction contracts provide that ownership passes as construction progresses, which presents its own set of problems.

to protect the surety's exposure if the \$4,000,000.00 in incurred completion cost is lost to a seizing creditor.

The best advice is not to finance the shipyard unless you can secure the surety's interests in the vessel. First, the financing agreement should contain a prohibition against the sale of the vessel by the shipyard without the surety's consent, and a clause allowing injunctive relief in the event of a breach. Second, the surety should take a first mortgage on the vessel, which secures future advances, and should require a promissory note secured by the mortgage for each advance. Be aware, however, that this will secure only your investment into the vessel; it will not necessarily protect the equity which the shipyard has in the completed construction.

Preferred Ship Mortgage. For a vessel under construction, state law governs mortgage, privilege and lien rights. However, in the case of a completed vessel that satisfies the size, citizenship and documentation criteria of the Federal Commercial Instruments and Maritime Lien Act, 46 U.S.C. §§31301 *et seq.*, the preferred ship mortgage instrument serves as the principal form of commercial security. The preferred ship mortgage stands as a recognized and enforceable encumbrance against the vessel from the time of its filing with the National Vessel Documentation Office in Falling Waters, West Virginia; as mentioned earlier, its rank and priority attaches from the time of filing.⁵⁰ The formal prerequisites for filing are spelled out in the Act, and the law requires substantial compliance with these requirements.⁵¹ Supporting and interpretative regulations appear at 46 C.F.R. Part 67. Notably, the Act does not require the existence of a present debt. Contingent debts are recognized, and hence the utility to the mortgagee/surety in cases of vessels owned by the principal. The preferred ship mortgagee's rights are enforceable in admiralty actions *in rem*, and actions on the mortgage indebtedness can be brought *in personam* in admiralty, on the civil side of federal court, or in state court.⁵² Extra-judicial remedies are also sanctioned.⁵³

Non-vessel property, such as earnings of the vessel that fall outside of the coverage of the preferred ship mortgage, can be covered through traditional U.C.C. filings. As secondary security, and to ensure against loss of secured rights should there be any question concerning the validity of the preferred ship mortgage filing, many marine financing creditors also require U.C.C. security interests in the vessel collateral.

50. 46 U.S.C. § 31322.

51. 46 U.S.C. §§ 31321 and 31322.

52. 46 U.S.C. § 31325.

53. *Id.*

THE BANKRUPT SHIPYARD

A final nightmare scenario arises when the shipyard goes bankrupt and a trustee is appointed. No longer do you have to protect the vessel and construction materials from seizing creditors. Now you have to protect them from the trustee.

Whose Material Is It? As mentioned earlier, unlike traditional construction project where the obligee owns the work, many vessel construction contracts do not convey ownership of the vessel or stored materials to the obligee until the vessel is completed, even though the obligee makes periodic progress or milestone payments.⁵⁴ In a bankruptcy context, this raises the issue of whether the uncompleted hull and stored materials are property of the estate.

Property of the estate is broadly defined as “all legal or equitable interests of the debtor in property as of the commencement of the case.”⁵⁵ However, “the estate’s legal and equitable interests in property rise no higher than those of the debtor.”⁵⁶ Therefore, if the debtor does not have any ownership interest in the disputed property at the commencement of the case, it is not property of the estate.⁵⁷

If title to the materials has not passed to the owner under the contract, the surety is exposed to claims by the trustee for payment for stored materials necessary for the completion of the vessel, even where the obligee has paid the principal for the stored materials under milestone payments. In one case handled by Krebs, Farley & Pelleteri, L.L.C., the trustee argued the materials were property of the estate and generously offered to “sell” them to the surety. To make matters worse for the surety, the principal had not paid the suppliers, who had submitted payment bond claims. This placed the surety in the unenviable position of paying for the same materials several times – once through the obligee’s release of contract funds, again by paying the trustee, and yet again by paying the supplier.

The terms of the contract limit the surety’s grounds to challenge this type of blackmail by a trustee. The surety may assert an equitable lien on the stored materials under the same rationale for recognizing its priority right to contract funds. However, a similar theory has been

54. In Louisiana, if the contract provides that “the purchaser shall be the owner of the ship to be constructed pursuant to the contract and title to the work shall vest in the purchaser as and when performed” and that “title to materials shall vest in the purchaser as and when delivered to the shipyard”, the purchaser acquires title to the vessel as constructed and materials as delivered. Otherwise, title transfers at closing. LA. REV. STAT. ANN. § 9:5524.

55. 11 U.S.C. § 541(a)(1).

56. *In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987).

57. *Id.*; *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7th Cir.1984) (holding that whatever rights debtor has in property at commencement of case continue in bankruptcy, no more, no less). Note that Bankruptcy law does not create property interests. *In re Pinetree, Ltd.*, 876 F.2d 34, 36 (5th Cir. 1989). Rather, in the absence of any controlling federal law, the debtor’s property interest are determined by reference to state law. *Bernhill v. Johnson*, 503 U.S. 393, 389 (1992); *In re Oxford Management, Inc.*, 4 F.3d 1329, 1334 (5th Cir. 1993).

rejected by the Fifth Circuit in *State Bank & Trust Co v. Insurance Company of the West*.⁵⁸ In *State Bank*, the Court recognized the surety's equitable right to contract balances, but refused to extend that right to use the principal's equipment and inventory to complete the work, even where the surety had to pay the remaining balances owed on that inventory under the payment bond.⁵⁹ The Court noted that:

We agree that when tangible personal property – distinct from contract proceeds – is at issue, the rationale for elevating the surety over the secured creditor has no application. Unlike the contractor's inchoate or potential rights in the contract proceeds, the contractor comes into the construction contract with present and effective ownership and the right to possess and use its own tools, equipment, and inventory. If the contractor has previously given a creditor a security interest in these materials – even those subsequently acquired – the creditor's right to realize on its collateral is not contingent on the contractor's full performance of its obligations.⁶⁰

The surety, however, may enlist the aid of the suppliers of the materials in asserting their vendor's privilege under applicable state law, or may assert the right itself under its rights of legal subrogation upon payment of the supplier. Individual state law should be consulted to determine what rights the vendors have to rescind the sale or assert a security interest in the materials.⁶¹

This issue, of course, could be avoided in underwriting by requiring a contractual provision that title to the hull and stored materials passes to the owner as the vessel is constructed and upon delivery of the materials to the shipyard. The surety may also be able to avoid this result by perfecting a UCC security interest in the materials prior to the bankruptcy filing.

58. 132 F.3d 203 (5th Cir. 1997).

59. *Id.* at .

60. *Id.* at 207.

61. For example, under Louisiana law a vendor has a privilege on the movable for payment of the purchase price. LA. CIV.CODE arts. 3217(7), 3227. The privilege arises by operation of law, and need not be recorded. *In re Tape City U.S.A., Inc.*, 677 F.2d 401, 402 (5th Cir. 1982). This privilege is recognized in bankruptcy. *Id.* at 403-04. However, the vendor's privilege is inferior to perfected security interests. LA. REV. STAT. ANN. § 10:9-201; Bayou Pierre Farms v. Bat Farms Partners, III, 693 So.2d 1158, 1160, n. 2 (La. 1997). Additionally, LA. CIV. CODE art. 2561 provides that “[i]f the buyer fails to pay the price, the seller may sue for dissolution of the sale.” Further, “[i]f the thing is movable and the seller chooses to seek judicial dissolution of the sale because of the failure of the buyer to perform, the court may not grant to the buyer any extension of time to perform.” LA. CIV.CODE art. 2564.

CONCLUSION – SURETY BEWARE

As illustrated by the forgoing, a vessel construction project is more than a construction project that happens to float. The surety faces an array of risks that do not attend a land-based construction project; and should carefully weigh those risks in underwriting and in fashioning pre-bond agreements that limit those risks.