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The Legal Issue

COMMERCIAL RISK MANAGEMENT: IS YOUR CORPORATE STRUCTURE REALLY LIMITING YOUR LIABILITY?

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It has been a longstanding practice in international shipping for a vessel to have a registered owner, which is a company formed for the express, singular purpose of owning the ship. Of course, this practice is not unique to shipping. The use of special purpose entities ("SPE's" or "SPV's") is common and well accepted in many industries across the globe. By definition, an SPE is a company formed to separate profits, losses and risk from other entity(s) and/or the individual(s) forming it.

Many — and possibly most — merchant shipping fleets mechanically follow a structure that historically was viewed as 'the way forward' to limit liability. In a nutshell: each ship is owned by a separate company (usually formed in an offshore jurisdiction with favorable tax benefits). In turn, the day-to-day vessel operations are handled by a common management company. Many times, the management company has some degree of common ownership and/or controlling interests as the ship-owning company.

Traditionally, the thinking behind such a structure was simple: in the event of a catastrophic loss caused by the vessel, the ultimate exposure would be limited to the maximum available liability insurance coverage for the single ship, not the aggregate fleet. With separate owning companies, it was believed that, in a worst case scenario, the bottom-line hard stop for out-of-pocket exposure for the beneficial ownership interests would be capped at the value of the investment in the single ship asset. Regrettably, with the passage and the natural evolutionary forces of time, the architects of this once prevalent structure are long gone, and the players in today's market have largely failed to consider and evolve their practices with the changing times.

Unlike traditional land-based businesses, the maritime industry is subject to a regulation that is generally accepted globally: the International Safety Management Code ("ISM Code" of "Code"). In relative terms, the ISM Code is "new-ish." A credible argument can be made that shipping has been around since Biblical times, with Noah being the first known ship owner. In contrast, the implementation of the ISM Code began a mere twenty (20) years ago. Noble in design and ambition, the Code's stated purpose is to provide an international standard for the safe management and operation of ships, and for the prevention of pollution through the establishment of safety-management objectives.

A safety management system (SMS) is required to be established by "the Company," which is broadly defined as the ship owner or any person, such as the manager or bareboat charterer, who has assumed responsibility for operating the ship for the ship owner and who, on assuming such responsibility, has agreed to take over all duties and responsibilities imposed by the Code. (See, e.g. – ISM Code Section 1.1.2.) Of interest, the preamble of the Code makes clear that "no two (2) shipping companies or ship owners are the same, and that ships operate under a wide range of differing conditions" and that "the Code is based on general principles and objectives." So, why then would ship owners throughout the world implement a cookie-cutter structure that treats all ships, regardless of their size, design or sector, precisely the same?

Virtually all the beneficial ownership interest(s) have

invested substantial time, money and resource to put their proverbial eggs (i.e. their ships) in separate baskets (i.e. vesting ownership in different SPE companies). Separate banking relationships, accounts and corporate formalities are maintained to varying degrees with the goal of minimizing risk and exposure. But, then, ill-advised decisions are bizarrely taken – assumedly unknowingly and/or unintentionally – which undermine the liability limiting efforts.

The very same people who worked so hard to create a limited liability structure 'blow it' by inextricably intertwining those very same assets by lumping them together and trading them on a single Document of Compliance ("DOC"). A DOC is, ostensibly, a vessel's license to do business. Without it, trading will come to an abrupt halt. Parenthetically, in twenty years of practicing maritime law, the author has yet to find an accountant, solicitor, technical consultant and/or any other shipping professional in any jurisdiction who can explain how this system is good and/or makes any sense when the common goal is to limit liability.

Rational thinkers keen to limit risk and exposure will agree: the historical single-ship structure with a common manager trading the fleet on a single DOC makes no sense in today's litigious world of complex regulations. Many owners and ship managers have come to learn the hard way that the traditional historical structure no longer serves the intended purpose. Flag Administrations have the right and obligation to withdraw a DOC if there is evidence of major non-conformities. (See Code at Section 13.5.) If a Flag removes a company's DOC, it must also remove all associated safety management certificates. (See Code at Section 13.5.1.) Put another way, vessels trading under the DOC will be unable to trade. (See Flag's dirty secret, Flag states are being very secretive about their withdrawals of ISM licenses. T*radewinds, 13 Sept 2007*.) In practical terms, the fleet is out of business.

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The required safety management systems are often purchased from consultants who prepare the manuals on a copy-and-paste basis. The manuals routinely assign significant responsibility to the holder of the DOC or 'operator' of the vessels. For clever lawyers and solicitors representing a multitude of civil claimants, including but not necessary limited to cargo and personal injury claimants, the DOC holder provides a second "juicy" target for a recovery. For obvious reasons, this is likely of greater concern to vessel's insurers than to the beneficial owners, as most of these sort of liabilities are insurable risks.

That said, many risks are uninsured and uninsurable. For example, the US authorities are well known for detaining ships on the suspicion of Marpol violations. This is accomplished through a coordinated effort between US port state examiners and the Customs & Border Protection agency, which withholds a vessel's departure clearance from the US port. Once detained, both the vessel's Owner and DOC holder must post a huge surety bond (most times millions of dollars), as well as waive jurisdictional defenses and agree to be prosecuted in the US. These are just some of the many onerous conditions required for the return of the vessel back to service.

It has become standard practice for DOJ prosecutors to pursue a set of vicarious criminal charges against the ship owning company, and take a double-dip by pursuing the very same charges against the DOC holder. In other words, the seven-figure, uninsured stakes are ostensibly 'doubled' simply because of the poorly designed corporate structure. Worse yet, should a conviction be obtained either by way of a negotiated settlement or adverse verdict, the fleet of vessels operating under the same DOC will be subject an environmental compliance plan (ECP). An ECP is both time and resource intensive, as well as extremely costly to implement on a fleet-wide per-ship/per year basis. The customary duration of an ECP is three years. Again, none of these expenses is insured or insurable.

So what to do? There are simple and effective structures which properly limit risk and otherwise avoid unnecessary additional exposure while complying with the requirements of the ISM Code. Traditional principles of outsourcing can and should be used to ensure that each one-ship company holds its own DOC. In this manner, the ethos of the limited liability principle of having one-ship company ownership structures is preserved, while the commercial benefits of operating a fleet under the traditional ship management structure can be maintained.

We have educated and assisted many clients to adapt and evolve their ISM compliance structure to avoid needlessly increasing their risks and exposure. For more information on how best to minimize risk and exposure, please contact George M. Chalos, Esq. of Chalos & Co, PC- International Law Firm at: gmc@chaloslaw.com