

M/V TRIDENT CRUSADER:

Fifth Circuit Holds That a Preferred Ship Mortgage On a Vessel Under Construction Is Valid

By Stuart P. Sperling*

On April 28, 2004, the United States Court of Appeals for the Fifth Circuit decided *United States v. TRIDENT CRUSADER and Det Norske Veritas*, 366 F.3d 391 (5th Cir. 2004), in which it held that a preferred ship mortgage on a vessel under construction is valid. This article will provide insight on the background of that decision, the Court's holding and the impact, which it will potentially have on the ship-financing sector.

I. Background

In early 1997, Searex Inc. (hereinafter "Searex") decided to engage in the construction of a series of lift boats, which would be used primarily to service offshore oil rigs. In order to fund this project, Searex sought financing from the Maritime Association of the United States Department of Transportation ("MARAD") under a Title XI loan guarantee. Title XI of the Merchant Marine Act, 1936, as amended, 46 U.S.C. app. § 1271 *et seq.* is the statutory program enacted by Congress to encourage investment in the shipping industry and guarantees ship construction financing. MARAD's acceptance of Searex's promissory note and Security Agreement on April 21, 1997 bound the United States to guarantee Searex's ship construction financing. With the ship financing aspects of the project finalized, the construction of the first lift boat, the M/V TRIDENT CRUSADER (hereinafter "CRUSADER"), commenced at Ingalls Shipyard, Inc. (hereinafter "Ingalls") in April 1998.

By the summer of 1998, however, unanticipated costs of construction created financial hardship for Searex. In May 1999, Searex had defaulted on its second bond installment.

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Thereafter, the relationship between Ingalls and Searex dissolved, bringing construction to a halt. As a result, the CRUSADER was moved to another shipyard (Boconco) on July 27, 1999 so that construction could be completed. On that same date, MARAD recorded its First Preferred Ship Mortgage on the vessel. At that time, no sea trials, certificate of inspection or classification certificate had been issued for the CRUSADER.

After recording its First Preferred Ship Mortgage, the United States (MARAD) filed suit against the CRUSADER *in rem* on July 5, 2001 in the United States District Court for the Western District of Louisiana. On July 17, 2001, the United States Marshal arrested the Vessel and, subsequently, an auction was held in which the vessel was sold to MARAD for Ten Million Dollars as a credit bid against its mortgage debt. The sum was thereafter placed in an account for distribution to any competing lienholder who intervened and could prove that its liens were valid and took precedence over the United States' preferred ship mortgage lien.

Det Norske Veritas ("DNV") was one of two parties¹ to file interventions alleging liens against the CRUSADER. DNV filed its intervening complaint on August 30, 2001 for services totaling \$932,225.00. DNV, a classification society from Oslo, Norway, had been employed by Searex to review plans and specifications and to supervise the actual construction of the lift boats. The services it provided after vessel completion were necessities.

At trial, DNV argued that the United States' preferred ship mortgage was void, because it was recorded while the vessel was still under construction. The district court agreed that vessel construction was not indeed completed until August 18, 1999, when the CRUSADER had successfully completed sea trials, DNV had issued her a classification certification and the United States Coast Guard had issued her a Certificate of Inspection. Nevertheless, the court

found that the United States had properly recorded its preferred ship mortgage on July 27, 1999 and held that the United States had a valid first preferred ship mortgage, which took precedence over the claims of the other lienholders, including DNV. After deducting the *custodia legis* fees, the court awarded the \$9,979,633.00 sale proceeds to the United States. DNV appealed the district court's decision.

II. The Fifth Circuit's Holding

On appeal, Judge Duhé writing for a panel of the Fifth Circuit, framed the issue as “whether a preferred ship mortgage is void if recorded after a vessel was documented, but before the vessel construction was complete.” In affirming the district court's opinion, the Fifth Circuit held that the ship mortgage statute, 46 U.S.C. App. §§ 31321, *et seq.*, permits a preferred ship mortgage to be filed on a vessel, before her construction is complete.

As aforementioned, the case concerned a mortgage to the United States under the Title XI program. This led the Court to rely in part on the expansive definition of “vessel” in the Title XI statute, 46 U.S.C. §1271(b), that includes vessels under construction. The court stated:

Section 1271 of Title 46 defines “mortgage” to include both a “*preferred mortgage* as defined in section 31301 of Title 46” as well as “a mortgage on a vessel that will become a preferred mortgage when filed or recorded under chapter 313 of Title 46.” 46 U.S.C. § 1271 (a) ... Vessel is defined to include: all types, *whether in existence or under construction*, of passenger cargo and combination passenger-cargo carrying vessels, tankers, tugs, towboats, barges, dredges and ocean thermal energy conversion facilities or plantships which are or will be documented under the laws of the United States, [certain] fishing vessels ... [certain] floating drydocks ... and [certain other] vessels. *Id.* § 1271(b) (emphasis added). With that broad definition of the term “vessel,” a mortgage on a vessel may be made before the vessel's construction is completed.

¹ On September 6, 2001, JFP Drilling Co. of Houston, Texas also filed an intervening complaint, claiming a lien against the CRUSADER for necessities in the amount of \$82,728.91.

366 F.3d at 392-393. The Court also made note of Title XI definition of “preferred mortgage” at 46 U.S.C. §1271(a)(2) that includes a mortgage “that will become a preferred mortgage when filed and recorded” under the ship mortgage statute.

The Court went further, though, in a section of the opinion that may have relevance to non-Title XI situations. The party challenging the Title XI mortgage asserted that the vessel had been documented based on a false statement in the builder’s certification, which stated that the “entire construction” was completed. The Court declined to proceed down this path, because a discussion of the subject would entail looking beyond the definition of vessel in the Title XI statute. Noting the “substantial compliance” provision of the ship mortgage statute, 46 U.S.C. §31322(a)(2), the Court agreed with the district court that there was no reason to upset the preferred status of the mortgage or the mortgagee in the absence of a finding that MARAD bore any responsibility for any errors in the documentation process. Finding no fraud or misconduct on the part of MARAD, the Court declined to equitably subordinate the mortgage.

Whither Empire Shipping?

The *Trident Crusader* Court declined to enter the jurisprudential whirlpool that concerns “what is a vessel” and “when a vessel under construction becomes a vessel.” Since the case concerned a Title XI mortgage, and Title XI’s definition of vessel includes a vessel under construction, the Court eagerly grasped the lifeline offered by the definition. If adopted by the other circuits, the *TRIDENT CRUSADER* case stands for the proposition that the preferred status of a Title XI mortgage will not be challenged for the reasons that the vessel was documented and the Title XI mortgage was filed during the vessel’s construction.

Prior to *TRIDENT CRUSADER*, there was little law on this issue. In *In re Empire Shipbuilding Co.*, 221 F. 223 (2nd Cir. 1915), the Second Circuit held that:

Mortgages of personal property generally, or of items of personal property which it is intended shall be put together to make a vessel, which it is intended shall thereafter be enrolled as a vessel of the United States, are not within its enumeration. *The status of the thing mortgaged is to be determined by its condition when the mortgage is made ... If it be then a vessel of the United States, the section applies; if it be not then such a vessel, the section does not apply ...* That this mortgage, when it was made June 1, 1911 was not a mortgage of a vessel of the United States, is indisputable ... [T]he testimony show[s] that two months' work remained to be done in order to complete her sufficiently to obtain a certificate of enrollment ... The subsequent enrollment of the vessel on August 9, 1911, no doubt changes the status of the vessel itself but we cannot see how it changes the status of the mortgage which was made two months before when the vessel was incomplete.

(Emphasis added) 221 F. at 225. Under *Empire Shipbuilding*, therefore, completion of a vessel at the time a mortgage is executed represents the *sine qua non* of a ship mortgage's preferred status. In *Chase Manhattan Financial Services, Inc. v. McMillan*, 896 F.2d 452, 458 (10th Cir. 1990), the Court did not say when substantial completion was achieved, but agreed with the court below that ninety-nine percent completion was sufficient.

Surprisingly, the Fifth Circuit did not refer to, nor attempt to distinguish *Empire Shipping*. Despite this, is it possible to reconcile *TRIDENT CRUSADER* with *Empire Shipping*? First, it is important to note that *Empire Shipbuilding* predates the Ship Mortgage Act, 1920, and its recodification in 1988, which included the substantial compliance principle. Second, the mortgage in *Empire Shipping* stated on its face that the vessel was under construction, and the Court did not lay down a rule about how one can tell when a vessel is sufficiently complete to be documented; it simply assumed insufficient completion. Third, because the case did not concern a Title XI mortgage, it could not take advantage of the Title XI definition of vessel that was not enacted until years later.

What is a Vessel, and Does it Matter?

As the Fifth Circuit noted, “Congress and the Secretary have defined ‘vessel’ in distinct ways for distinct purposes.” 366 F.3d at 393. The Court distinguished the definition of a vessel for purposes of a mortgage on a vessel from the definition used for admiralty jurisdiction purposes in other contexts. *Id.* DNV argued that the ship mortgage statute encompasses the Title 1 definition of “vessel” (a vessel is “every description of watercraft or other artificial contrivance used, or capable of being used, as a means of transportation water.” 1 U.S.C. § 3). *Id.* The Court dismissed this definition, though. *Id.* The Court also rejected the “vessel” definition used for Jones Act purposes – that to be a vessel, the vessel must be “in navigation.” *Id.*

In the wake of the Fifth Circuit’s decision, the ship-financing sector must navigate between the buoys of *Empire Shipbuilding* and *TRIDENT CRUSADER*. Does the holding of *TRIDENT CRUSADER* apply outside of a Title XI mortgage situation? How early may one file a ship mortgage? Does the principle in the case extend this holding to non-Title XI mortgages? If the issue arises in the non-Title XI context, there will be much for all sides to argue about, primarily what definition of “vessel” to apply.

The Fifth Circuit correctly noted that the Ship Mortgage Statute does not define the term “vessel.” 366 F.3d at 393. The statute consists of Chapters 303 and 313 of Title 46, which are in Subtitle III of Title 46. The definition of vessel at 46 U.S.C. §2101(45), which adopts the definition of vessel at 1 U.S.C. §3 applies only in Subtitle II. As aforesaid, the definition at 1 U.S.C. §3 states that term “ ‘vessel’ includes every description of watercraft or other artificial contrivance used, or capable of being used, as a means of transportation on water.” This definition is essentially a codification of the maritime common law definition of a vessel. Since

46 U.S.C. §2101(45) does not apply to the ship mortgage statute, what definition should be applied? Does 1 U.S.C. §3 apply to all of Title 46 on its own force, meaning that 46 U.S.C. §2101(45) was adopted for no purpose? This is not lightly to be assumed. If we infer from this that 1 U.S.C. §3 does not apply on its own force, do we still loop back to the ordinary, case law definition for the lack of a statutory definition? Maybe. In this void, the Fifth Circuit had no difficulty applying the Title XI definition of the vessel to a Title XI mortgage.

There is a third possibility. Immediately before the 1988 recodification of the Ship Mortgage Act, the definition of “vessel” as used in it was the term as defined in 46 U.S.C. §801, which included “watercraft . . . at whatever stage of construction,” essentially the same as the Title XI definition. This is so because 46 U.S.C. §888 applied that definition to “this act,” namely, the Act of June 5, 1920, of which the sections of the act popularly known as the Ship Mortgage Act, 1920 were a part (*see*, Historical Note to 46 U.S.C. §888), as well as, the now repealed 46 U.S.C. §984. This means that whether the *TRIDENT CRUSADER* reasoning from the definition of “vessel” applies to non-Title XI mortgages turns on whether the 1988 recodification intended to leave the definition unchanged, making the failure to reflect the substance of 46 U.S.C. §888 in the definitions in Chapters 303 and 313 of Title 46 a recodification oversight. This is a plausible inference from the fact that before recodification vessels under construction were included in both the Title XI and Ship Mortgage Act definition of “vessel,” the recodification did not define the term, that the definitions in 46 U.S.C. §2101 do not apply to Subtitle III of Title 46, and that the legislative history to the current ship mortgage statutes expressly leaves open the possibility that it may be necessary on some occasions to make reference to prior law to interpret the intention of the recodified statutes despite the fact that the

desire was to recodify the Ship Mortgage Act as positive law, H. Rep. No. 100-918 (1988), *reprinted in* 1988 U.S. Code Cong. and Admin. News, 6104, at 6109.

If the general concept of when a vessel under construction becomes a vessel is to be derived from the case law, mortgagees are in an awkward position. Whereas *Empire Shipping and TRIDENT CRUSADER* seems to imply that a vessel is not a “vessel” until it is truly and utterly complete, and *Chase Manhattan Financial Services, supra*, said that in any even 99 percent completion is sufficient, the U.S. Supreme Court staked out an opposite benchmark in *Tucker v. Alexandroff*, 183 U.S. 424 (1902), when it held that a vessel “lying in the stream under construction” was a vessel for the purpose of construing an extradition statute, for when the vessel was launched, it “thereby became a ship in its legal sense . . . and a subject of admiralty jurisdiction,” *id.*, at 428 and 438. Some parties would undoubtedly try to make use of the cases holding that ship construction contracts are not maritime contracts, and that suppliers to original construction do not have maritime liens. *See*, Schoenbaum, Admiralty and Maritime Law (4th Ed.) §1-10, *text supra* FN. 13-15, and the cases collected there.

To add another dimension to this conundrum, the vessel documentation statute – Chapter 121 of Title 46 – relies on the 46 U.S.C. §2101(45)/1 U.S.C. §3 definition of vessel. This suggests that a vessel may not be documented before it is a vessel in fact (as opposed to a vessel in navigation) under traditional admiralty principles. The Coast Guard’s vessel documentation regulations do not define vessel, and, therefore, probably rely on the same definition. When documentation is sought for the fisheries or the coastwise trade, the “major components of the hull and superstructure are fabricated” and the “vessel is assembled entirely” in the United States, 46 C.F.R. §§67.95, 67.97. It is significant to note that a vessel’s engines, equipment and many other components, which do not contribute to the watertight or structural integrity of a

vessel are usually not considered relevant to build or rebuild status. Moreover, when newly built vessels are delivered to their owners and are documented, they routinely have a long and sometimes very costly “punch list” of construction work yet to be completed. Thus, when a vessel becomes a “vessel” eligible for the filing of an application for documentation, or eligible to have a mortgage filed against it is not a precise point. One could reasonably infer that under the vessel documentation regulations, the assembly into the vessel of the major components of the hull and superstructure and attainment of “vessel” status under maritime common law principles constitute the completion of the build. While case law and confusion over the definition of vessel suggest that there is great flexibility in certifying to the Coast Guard that a vessel is "built" for documentation purposes, and routinely Coast Guard acts on receipt of a Builder's Certification in apparent good order without making its own inquiry, it would appear that the Coast Guard’s position would be that by "built" they mean practical completion.

This brings into focus what the *TRIDENT CRUSADER* court seemed to be driving at when it held that it would not call into question the preferred status of the mortgage held by a mortgagee that was not responsible for the vessel’s documentation. The court is protecting the mortgagee from the consequences of a possibly premature documentation of the vessel. The court’s holding and reference to the substantial compliance provision of the ship mortgage statute brings to mind the courts’ historic reluctance to overturn the preferred status of mortgages on technical grounds under provisions of the Ship Mortgage Act that have since been repealed. See, e.g., *Merchants National Bank v. WARD RIG No. 7*, 634 F. 2d 952 (5th Cir. 1981)(upholding the preferred status of a mortgage despite a discrepancy in the statement of a mortgage’s maturity date), and *The NAN B*, 78 F.Supp. 748 (D.AK. 1948) (discrepancy in the form of an affidavit of good faith). The Court seems to be saying that the Title XI mortgagee

may rely in good faith on the fact that a vessel has been documented and that its mortgage has been recorded even if the vessel's construction is not complete and if it has not reached a stage of completion that would, on its own, justify documenting the vessel. It so concludes because it applies the broad definition of "vessel" in the Title XI statute to mortgages irrespective of the narrower that definition that is applicable in other contexts such as the vessel documentation statute. This avoids having the mortgagee depend on an awkward judgment call about exactly when a vessel is sufficiently complete. There is a good possibility that this holding would also apply to non-Title XI mortgagees, either because the relevant definition of "vessel" for non-Title XI mortgages is still in 46 U.S.C. §801, or possibly on the basis that the good faith mortgagee analysis in the opinion is an independent holding that is not integrally related to the portion of the opinion that turns on the applicable definition of "vessel."

Ultimately, only time will tell how the ripples of *TRIDENT CRUSDAER* will impact the shores of other circuits.