

# The resolution of ex-territorial financial distress: a study of the shipping industry

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*“There is only one law in shipping: there is no law in shipping”.*

Sami Ofer (shipping magnate).

## Abstract

The professed objective of most bankruptcy legislation is to facilitate an orderly, more efficient, resolution of financial distress. Yet, relatively little is known about the pre-legislation stage, where distress is resolved through the enforcement of the debt contract as negotiated, *ex ante*, between debtor and creditor. Since such *freedom-of-contracting* approach is rare nowadays, we study the resolution of financial distress in the shipping industry, which avoids most national bankruptcy legislation due to the ex-territorial nature of its assets. We focus on three alleged weaknesses of the freedom of contracting regime. First, that such a system tends to be too crude because market participants have only a weak incentive to innovate better instruments. Second, that it is rife with conflicts of interests and coordination failures. Third, that it leads to under-priced asset auctions. Hence, respectively, we provide a detailed description of the industry’s institutional structure with special focus on innovations that deal with its specific circumstances. We devise a measure of coordination failures: the amount of capacity that is immobilized due to vessel arrest. (In a perfect world, asset repossession can be achieved with only the threat of arrest, actual arrest remaining off the equilibrium path.) We also point out that existing estimates of fire-sale discounts have a potential bias, perhaps up to 50% according to the alternative, instrumental variable approach that we develop. It is noteworthy that the unregulated nature of the industry makes it a unique natural experiment with *spontaneous order*, the decentralized development of market-based institutions.