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.