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HANJIN AND THE 'TITANIC EFFECT'

How on earth could it fail? Time to think the unthinkable.

STEVE SIMMS

HANJIN'S INSOLVENCY IS the biggest container line insolvency in world maritime history, 10 times bigger than what had been the biggest, US Lines 30 years before in 1986. It may prove to be the largest maritime insolvency ever – that is, so far.

To some, at least before Hanjin's South Korea insolvency filing, Hanjin's insolvency was unthinkable.

How could Hanjin, the world's seventh largest container line with a world-wide fleet of 90 vessels moving hundreds of thousands of containers with billions of dollars of cargo, ever fail? How could the South Korean government and Korean Development Bank, ever allow Hanjin to fail and its thousands of employees to lose their jobs? Why would Hanjin ever liquidate when there had to be any number ofcontainer carriers ready to absorb some or all of its vessels and operations?

That was still the idea for many weeks after the Hanjin Paradip was arrested in Durban in May, 2016. The arrest was widely reported and described as a charter party dispute. That was true, and the dispute was over unpaid charter hire. Not long afterwards, Hanjin stopped paying most if not all charter hire and stopped paying or allowed payables to increase to an increasing number of its creditors. By the time of Hanjin's Korea insolvency filing, Hanjin was several billions of dollars in debt and without loans, unable to pay even for the calls and discharge of its vessels.

Many ignored the M/V Hanjin Paradip arrest – along with the world economic downturn, Hanjin'sincreasingly deep debt to and dependence on Korea Development Bank and others, overcapacity in the container shipping markets, the ageing of Hanjin's fleet and the relatively high price it was paying for its chartered vessels. Hanjin simply had to be too big, or too present, or too much of the world maritime network to fail, and so that failure (and now what certainly will be either liquidation or a remaining, very limited and local operation of a handful of Hanjin's owned-and-over-mortgaged vessels) was unthinkable.

Hanjin's failure is an example of what some management writers have called the "Titanic Effect." The Titanic Effect is the observation that "the severity with which a system fails is directly proportional to the intensity of the designer's belief that it cannot."[1] The observation underlying the Titanic Effect, certainly played out in the Hanjin situation, is the basic human tendency to ignore warnings about possible enormous disasters as unthinkable.

The Titanic did go down, US Lines failed (also at the time unthinkably), and if there is not planning for the future with the possibility of disaster of Hanjin in mind one will go down as surely as the Titanic.

On the other hand, "to sum up the Titanic Effect would be to state the magnitude of disasters decreases to the extent that people believe that they are possible and that they plan to prevent them, or to minimize their potential impact. Ignoring the warnings regarding the red flags, can lead to the unthinkable and most certainly failure."[2]

So what happened with the Titanic? It was (much as some might have thought of Hanjin) an achievement of the modern world. Complex, apparently robust, massive and seemingly "state of the art." "According to some hypotheses," however:

Titanic was doomed from the start by the design so many lauded as state-of-the-art. The Olympic-class ships featured a double bottom and 15 watertight bulkheads equipped with electric watertight doors which could be operated individually or simultaneously by a switch on the bridge. It was these watertight bulkheads that inspired Shipbuilder magazine, in a special issue devoted to the Olympic liners, to deem them "practically unsinkable." But the watertight compartment design contained a flaw that may have been a critical factor in Titanic's sinking: While the individual bulkheads were indeed watertight, water could spill from one compartment into another. Several of Titanic's Cunard-owned contemporaries, by contrast, already boasted innovative safety features devised to avoid this very situation. Had White Star taken a cue from its competitor, it might have saved Titanic from disaster."[3]

Here's one of the roots of the Titanic Effect," and how it operated with Hanjin, just like it did with the Titanic: failure to "take a clue" from competitors and others in the maritime world.

Another element of Hanjin's Titanic Effect was shipper volume contracts. Despite the warning signs for Hanjin, shippers had contracted to continue to ship minimum volumes with Hanjin to obtain favorable rates. If they did not ship the contracted volumes, they owed money to Hanjin for breach of their volume shipping contracts. So, they were compelled to continue putting their cargo on Hanjin, almost as if they had been Titanic passengers compelled to board as the Titanic sunk. With so many shipper contracts and committed freights, how could Hanjin fail? The direct problem: a revenue stream of freights committed, less than operation cost.

Shippers, to name one group, should have "taken the clue" from Hanjin's increasing debt levels "Since 2013, Drewry Financial Research Services [had] warned that Hanjin was dangerously leveraged and living on borrowed time."[4] Thus the announcement of the Hanjin Korea insolvency court at the end of September was entirely predictable: any rehabilitation plan was "realistically impossible." The natural consequence of unpaid charters was accumulated charter hire of nearly $1 billion, leading further to the natural result that Hanjin had to terminate the charters. Without 80% approximately of its fleet which had been chartered, Hanjin had to fail, with unpaid charters literally spilling into others. "Mike Radak, chief operating officer of Hanjin Shipping America, told the LA Times that the carrier was giving back chartered vessels as soon as they were unloaded. 'Once it's empty, we hand

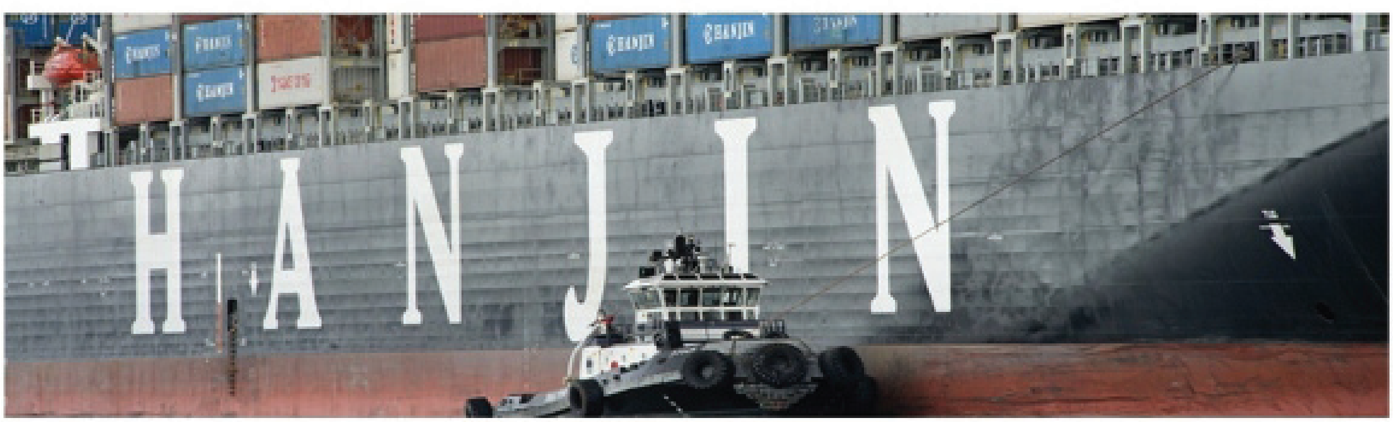
the keys over to the chartering company,' he said." [5]

So what should creditors of Hanjin do now that the unthinkable has happened? Particularly if you or your company provided bunkers or other maritime goods or services to Hanjin, if you have not already (and subject to the increasing numbers of cross-border insolvency injunctions issued by the date of this article and surely still to be issued):

- Accelerate accounts immediately (if restraining / insolvency order allows);
- Apply any funds received from Hanjin to non-arrestable amounts (depends on whether in rem arrest is available);
- Track to favorable arrest jurisdictions the vessels you are owed on, and arrest vessels you've provided fuel, goods or services to if possible and before entry of restraining orders;
- Don't give up on Korea as a place to arrest a vessel; it still may be possible to arrest even a Hanjin Group-owned vessel for a limited number of types of claims;
- Attach receivables otherwise due Hanjin (don't look only in your own jurisdiction for this. There are many where cross-border injunctions preventing attachment, will never be issued);
- Put owners of ex-Hanjin vessels and their P&I clubs on notice of your claims so if the vessels are sold, the new owners are either informed of your claims or, have a claim against the former owners who failed to disclose them at sale;
- If you are a bunker provider, make sure you have full documentation and fuel samples of your sales; this is a situation inviting quality claims by owners with unpaid charters, stuck with paying for fuel Hanjin ordered but didn't pay for;
- Determine the mortgage holders on the vessels you're owed on, and also put them on notice of claims. It may be that the mortgage holder has been unpaid for a while and you may have grounds, even if they arrest in a jurisdiction where the mortgage otherwise is prior, to have the ship mortgage subordinated to your claims;
- Collaborate with others owed on Hanjin and ex-Hanjin vessels – share costs of recovery and intelligence;
- Keep updated on developments;
- Assess possible insolvency voidable preference claims and defenses. Have you received payments from Hanjin within 90 days before its insolvency filings? If so without defenses (in the US, in rem maritime lien discharge, simultaneous exchange for value; new value, ordinary course of business payment) you may have to return the payment, years after you received it.
- Check with your credit insurer. Has it changed policies because of the Hanjin insolvency? Should you add more accounts to be credit insured?

All of the above, though, is "unthinkable management." That is, the Titanic has gone down and it is a matter of picking up survivors. A little over 30% of the Titanic passengers survived the sinking. That is far more than the percentage of Hanjin assets creditors (that is, after Hanjin's secured Korean creditors, including its affiliate Korean Air are paid) ever will pick up, even those effectively pursing the strategies recommended here.

The question comes up, should claims be filed in the Korean proceedings? Claims "deadlines" will be coming up soon and there were be a series of "deadlines" which may seem irresistible not to meet. But, there will be no recovery for unsecured Hanjin creditors, from their claims filed in the Korean proceedings. Instead, filing the claims submits the creditor not only to expense of preparing the claim and submitting it, but also to Korea court jurisdiction. The impossibility of recovery, but likelihood of restraint of the Korean court of a creditor pursuing Hanjin assets outside of Korea, are good reasons not to file claims in the Korean proceedings. One could try to dive to the Titanic for some



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kind of recovery there, but it is quite a long way down, and up, to have any recovery.

What is needed from a Titanic Effect event like Hanjin is not management of the unthinkable after it happens, but leadership which knows that the unthinkable is certain to happen. A strong contemporary example is Maersk. Maersk management sees the market trends and is making hard decisions now to anticipate the unthinkable (that its structure might not survive as the trends continue to their likely result) by transforming its organization. The lessons that all in the marine fuel, supplier, service and related maritime industries and vessel owners as well need to learn from the Hanjin Titanic Effect, is that their leaders need to do all possible to stop "unthinkable" failures before they occur, instead of waiting only to pick up the survivors after the failure. "The ability to deal with a crisis situation is largely dependent on the structures that have been developed before chaos arrives. The event can in some ways be considered as an abrupt and brutal audit: at a moment's notice, everything that was left unprepared becomes a complex problem, and every weakness comes rushing to the forefront."[6]

After a Titanic Effect loss like Hanjin, the tendency of any business is to focus on how to reduce being vulnerable again to that kind of loss. But, this approach is inadequate to prepare for the next "unthinkable loss" by seeking out and confronting Titanic Effect factors. The first step is to know that there is much that you do not know, and to seek the answers who may know instead of complacently (and probably insecurely) relying on your own. Losses and loss causes by "unthinkable" events are inherently difficult to anticipate because fundamentally, all had rather trust in their own (limited) knowledge than learn from the last 'unthinkable" event. What all in the marine industry, and particularly bunker and marine service providers and others, even those never associated with Hanjin (or having seen the signs and now fully paid by Hanjin or out with less of a loss) need to gain now from the Hanjin Titanic Effect experience, is resilience. Hanjin provides the opportunity to learn to expect the "unthinkable," to be resilient in the face of loss and recover from loss when it certainly will occur.

So, how could Hanjin's collapse been foreseen and its effects avoided? How can bunker suppliers and others better position themselves to recover from such a loss? Marine fuel traders and suppliers, marine service providers and others now should be asking:

- Which customers' credit lines are lines drawing out?
- Which customers have a profile like Hanjin's, of increasing debt, underpriced shippe contracts, older or smaller vessels, and healthier competitors?
- Where do the vessels of your customers call? Can you arrest the vessels there?
- What are your customers paying for charter hire? Is it above market rate?
- Have you as a marine fuel or other supplier, seen (or have a policy in place to look out for) "no lien" notices in on BDRS or other communications?
- Are you receiving payments from entities other than your actual customer?
- Do you regularly seek out information from the maritime press and sources other than your direct contacts, from sources throughout the maritime industry, even your competitors about how they do business? (remember how the Titanic owners ignored the very public statements by their competitor Cunard- often what you can learn is public); and overall:

How intensely do you believe that your business and the way that you do it cannot fail?

The more intense your belief, says the Titanic Effect, the less your business will be able not only to survive but revive after the certain-to-come "unthinkable event."

The press and industry analysts agree that there is perhaps to be an "unthinkable event" to follow Hanjin's collapse, another collapse of a significant container line. Hanjin's situation certainly gives reason to believe now, that some marine fuel traders, suppliers and marine services providers can fail as much as their managers want to believe otherwise. Hanjin provides the reason now not to ignore the industry warnings, to take clues from them, and for marine fuel traders, suppliers and marine services providers to be able to avoid the Titanic Effect from the marine industry's next "unthinkable" but certain-to-occur event.

[1] Kenneth E. F. Watt, The Titanic Effect: Planning for the Unthinkable (E.P. Dutton, 1974)
[2] Henry C. (Sandy) Waters , Sales - What A Concept!: A Guidebook for Sales Process Performance Improvement , p. 45 (2011)
[3] The History Channel, The Titanic, http://www.history.com/topics/titanic
[4] Peter Tirschwell, "Avoiding another Hanjin won't be easy", Journal of Commerce (Sep 21, 2016)
[5] "Hanjin Ordered to Sell Its Ships", The Maritime Executive, 21 September 2016
[6] Patrick Lagadec, Preventing Chaos in a Crisis, Preventing Chaos in a Crisis: Strategies for Prevention, Control and Damage Limitation, at 54 (1993).

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