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BRIEFING

BRAZIL – DOUBT OVER RECOGNITION OF SOME NON-BRAZILIAN MORTGAGES OF OFFSHORE MARINE ASSETS

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- A RECENT CASE HAS RAISED DOUBT OVER THE RECOGNITION OF NON-BRAZILIAN MORTGAGES OF OFFSHORE MARINE ASSETS OPERATING IN BRAZIL.
- THE CASE MIGHT MEAN THAT FINANCINGS OF CERTAIN UNITS WILL BE MORE DIFFICULT – AND AS A RESULT BRAZIL COULD ENCOUNTER DIFFICULTIES IN PROCURING KEY OFFSHORE EQUIPMENT.

In a surprising decision, a São Paulo state appellate court (the "Court") on 3 February 2016 upheld a lower court decision refusing to enforce a Liberian mortgage against FPSO *OSX 3*, which is operating on a long-term charter outside the Brazilian territorial waters in the Brazilian exclusive economic zone. A request for clarification and reconsideration of the decision was dismissed on 1 June 2016 so the decision has not been affected (see further below)[1].

FACTS

The Dutch company OSX 3 Leasing BV is the owner of the FPSO, which is registered in Liberia. As security for a US$500 million bond issued by OSX 3 Leasing in Norway, the owner granted a mortgage to Nordic Trustee ASA (as trustee for the bondholders). The mortgage is governed by Liberian law and registered in the Liberian ships' register. Nordic Trustee registered the mortgage with the Registry of Titles and Documents in Rio de Janeiro, but the mortgage could not be registered with the Port Authority (as the owner was not Brazilian) or the Maritime Tribunal (as the FPSO was not Brazilian flagged).

Brazilian creditor Banco BTG Pactual S/A (through its Cayman Islands branch) asserted an unsecured claim of almost US$27.4 million against OSX 3 Leasing and applied to the lower court for an attachment of the FPSO in order to enforce the debt. Nordic Trustee applied to that court for the dismissal of Banco BTG's

[1] No Brazilian-law advice is intended to be provided. The comments in this briefing are based on free translations of court documents and informal discussion with Brazilian law firms, including Basch & Rameh, Kincaid, Souza Cescon and Veirano. The case will be discussed at a meeting of the Norwegian Brazilian Chamber of Commerce in Saõ Paulo on 15 June 2016, at which David Osborne of WFW will be a guest speaker, alongside Brazilian lawyers.

attachment asserting the priority of its mortgage. In June 2015 the lower court made a declaration that Banco BTG's attachment had priority. Nordic Trustee appealed. The Court dismissed the appeal.

"THE COURT HELD THAT A SHIP MORTGAGE WILL BE RECOGNISED ONLY IF IT IS REGISTERED IN BRAZIL OR IN ANOTHER COUNTRY WITH WHICH BRAZIL HAS A TREATY SPECIFICALLY RECOGNISING ITS SECURITY INTERESTS."

HOLDING

Only ship mortgages from a treaty state are recognised in Brazil

The Court held that a ship mortgage will be recognised only if it is registered in Brazil or in another country with which Brazil has a treaty specifically recognising its security interests. The Court referred to two such treaties: (1) the International Convention for the Unification of Certain Rules of Law Relating to Maritime Liens and Mortgages (Brussels, 1926)[2] and (2) the Convention on Private International Law (the Bustamante Code) (Havana, 1928)[3]. Further, the Court stated that provisions in both the Brussels Convention 1926 (Article 1) and the Bustamante Code (Article 278), which specifically give effect to flag-state mortgages, only apply where the flag state is a contracting party to those treaties.

On the evidence presented the Court found that there was no principle of customary international law that flag-state mortgages are recognised and enforced. The decision did not refer to the International Convention on Maritime Liens and Mortgages (Geneva, 1993), which Brazil signed (but did not ratify). That more recent treaty specifically states that mortgages registered in a flag state will be recognised and enforced (Article 1), even if registered in a country which is not a contracting state (Article 13(1). However, it has been ratified by only 18 countries.

Although Banco BTG argued that the mortgage should not be enforced on the basis that Liberia is a flag of convenience, the Court excluded this point from its analysis.

The law of domicile of the vessel owner was not applicable

The Court rejected Nordic Trustee's argument that under Brazilian conflict-of-laws rules, interests in movable property are governed by the law of the owner's domicile, in this case the Netherlands. The Court found that, because the FPSO was to operate in Brazil for 20 years, it should not be treated as movable and the law of the site where the FPSO is located should apply. The Court recognised that the FPSO had entered Brazil under a temporary-importation customs status, but this did not affect its disposal of this argument.

"IF MORTGAGES OF FOREIGN FLAGGED VESSELS ARE NOT RECOGNISED, FINANCING MANY OF THESE UNITS FOR OPERATION IN BRAZIL MAY NOT BE FEASIBLE."

Consequences for creditors and the Brazilian market

If mortgages of foreign flagged vessels are not recognised, financing many of these units for operation in Brazil may not be feasible. The subsequent effects could be that Petrobras and other oil companies operating, or planning to operate, in Brazil may have difficulty procuring key offshore contractors.

On the other hand, with cargo vessels the Court's reasoning suggests that, for a case brought in Brazil, the law of the vessel owner's domicile might be applied leading to recognition of the law of the flag state.

[2] As of October 2015, the other state parties are Algeria, Argentina, Belgium, Cuba, France, Haiti, Hungary, Iran, Italy, Lebanon, Luxembourg, Madagascar, Monaco, Poland, Romania, Switzerland, Syria, Turkey, Uruguay and Democratic Republic of Congo.

[3] The other state parties are Bolivia, Chile, Costa Rica, Cuba, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, Panama, Peru, Dominican Republic and Venezuela.

Challenges to the Court's decision

In a motion filed with the Court on 22 February 2016, Nordic Trustee sought clarification or reconsideration of points which it maintains either were not addressed or incorrectly decided. In particular:

1. whether Nordic Trustee's registration of the mortgage in the Registry of Titles and Documents in Rio de Janeiro gives it validity under legislation (and decisions of the Court itself) giving it that effect;

2. reconsideration of whether customary international law recognises foreign flag-state mortgages (and whether the court should have ordered an investigation of that issue given the original 10-day time limit for preparation of Nordic Trustee's appeal);

3. reconsideration of the Court's decision that the FPSO is not movable property (changing the outcome under the applicable conflict-of-laws test) based on its operation under a long-term charter which is capable of termination; and

4. the FPSO was about 94 kilometres off the Brazilian coast, i.e. in the Brazilian exclusive economic zone but outside the 12 mile territorial sea limit, and the 50 mile contiguous zone limit, and therefore was outside Brazilian territory for the purpose of the UN Convention on the Law of the Sea. (Article 94 of that Convention gives the flag state sovereignty over the FPSO.)

"AN APPEAL TO THE FEDERAL SUPERIOR COURT OF JUSTICE IS LIKELY TO FOLLOW. THIS WILL BE AWAITED WITH GREAT ANTICIPATION BY DIRECT AND INDIRECT INTERNATIONAL STAKEHOLDERS IN THE BRAZILIAN OFFSHORE SECTOR."

That motion was dismissed on 1 June 2016, so did not result in any substantive clarification or reconsideration of the Court's decision. An appeal to the Federal Superior Court of Justice (the highest court in Brazil for subject-matter other than constitutional issues) is likely to follow. This will be awaited with great anticipation by direct and indirect international stakeholders in the Brazilian offshore sector. The timeline of any appeal is uncertain but could be protracted. In the meantime, interested parties may wish to consider how to manage the risk of non-recognition of a foreign flag mortgage in Brazil.

Solutions and mitigants?

The case is evidence-specific (especially as to international custom) and with other differently-presented evidence, or with different facts, it is not certain that the same result would be reached in any future case. Further, Brazilian law as regards a doctrine of precedent is in a process of development.

Reflagging to a flag jurisdiction more favourably treated in Brazil (by reason of being a party to the Brussels Convention 1926 or the Bustamante Code) is a possibility but might not always be easy or feasible in the circumstances.

Although the case related to a FPSO and the Brazilian law position in relation to internationally-trading cargo vessels appears to be somewhat more positive, the case reinforces that Brazil is not in any event a favourable jurisdiction for mortgage enforcement generally.

If there is no successful appeal to the Federal Superior Court of Justice or other change of Brazilian law, attention might focus on whether the 2001 Cape Town Convention on International Interests in Mobile Equipment should be extended to ships – and other maritime assets, so as to allow the creation of an "international

interest". Brazil is a party to the Cape Town Convention (and the Aircraft Protocol). The inclusion of ships was considered in the early stages of the development of Cape Town in the 1990s but was not then pursued, mainly due to perceived lack of appetite in the shipping industry and scepticism from shipping industry bodies. The issue has recently resurfaced[4] and this case in Brazil might give renewed impetus through industry pressure. Two caveats, however: the extension of Cape Town by a new shipping or maritime Protocol would almost certainly be a long process; and Cape Town relates to *mobile* equipment, so it would be necessary to address the issue – which has arisen in the Brazilian litigation – that some maritime assets in the offshore oil and gas industries might not invariably be regarded as "mobile".

[4] The Comité International Maritime (CMI) in 2015 established an International Working Group on Ship Finance Security Practices. Ships are on the agenda for the next Cape Town Convention Conference (Oxford, September 2016).

FOR MORE INFORMATION

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