THE SHIP FINANCE PUBLICATION OF RECORD

MARINE MONEY

INTERNATIONAL

HAMBURG ◆ SINGAPORE ◆ LONDON ◆ NEW YORK ◆ OSLO ◆ PIRAEUS

OCTOBER/NOVEMBER 2016 VOLUME 32, NUMBER 6

Leading the Way Out of Darkness

The Legal / Restructuring Issue

OFFSHORE RESTRUCTURING

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There is no point in pulling punches – the prolonged slump in global oil prices has taken a heavy toll on the offshore market that shows no sign of abating. Owners of offshore support vessels (OSVs) are having a particularly rough ride in a market hit by the toxic mix of significant overcapacity and slack demand. Prolonged low oil prices have caused many oil companies to apply the brakes to capital spending, especially on ultra-deep water (UDW) projects, where demand for FPSOs, drillships and other production floaters has been hardest hit. Owners of foreign flag vessels operating in Brazil have suffered the most, as 'flag blocking' has targeted their vessels. In all sectors, owners and operators are having to deal with the harsh realities of declining utilisation, depressed charter rates, delayed hire payments, depreciating asset value, and decreasing liquidity.

In the OSV market, the press has been awash with reports of companies undertaking major restructurings to stem losses and maintain their relationships with lenders in an effort to ensure that they are in a position to emerge from this downturn. Similarly, and whilst they are fewer players, a number of FPSO operators have been forced to restructure their loans.

But, unfortunately, not all offshore players have been successful in their negotiations, with a number of high profile operators having no choice but to file for bankruptcy. This article looks at the issues affecting both lenders and potential investors when faced with the aftermath of an operator's bankruptcy in the offshore sector.

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RECENT ENFORCEMENT

In the OSV sector, the insolvencies of the Harkand Group and World Wide Supply are recent examples of bondholders stepping in to take control of the owning companies (and their assets) following default under their respective high yield bonds. Another owner, Atlantic Offshore, also had to sell most of its business merely to continue operating as a going concern. However, and whilst undoubtedly some creditors have lost and will lose, the current market does present opportunities for investors willing to acquire assets in the expectation that, at some point, the market has to improve.

For FPSOs and other floaters, one only needs to look at Brazil and the Schahin bankruptcy for a case study in creditors enforcing their rights over offshore assets, and investors looking to make a turn in purchasing distressed assets at a price at which they believe they can operate the unit profitably in the future. There has been significant coverage of ICBC Leasing's repossession of the two semi-submersibles, the *Amazonia* and *Pantanal,* after ICBC claimed the termination of the finance leases following Brazilian operator Schahin filing for bankruptcy protection last April. More recently, Ocean Rig purchased the Schahin-owned, UDW drillship *Cerrado* at a judicial auction procedure in Aruba, where she had been arrested by her lenders. Ocean Rig reportedly paid US$65 million for the *Cerrado*, approximately 10% of her construction price paid to Samsung Heavy Industries in 2011. Her sister ship Sertao, which was also previously operated by Schahin, has been laid up under arrest in North East England since November 2015, but has yet to find a buyer. Another UDW drillship, the Deepsea Metro II, previously operated by Odfjell, was sold by the Curaçao court in March 2016 for US$210 million, a purchase believed to have been financed by its original bank lenders to 'warehouse' part of an eye-watering loan debt of over US$800 million.

For OSVs, a number of court sales have been reported, including the *Harkand Da Vinci* and *Harkand Atlantis,* two DSVs repositioned from Scotland to Gibraltar by their Norwegian bondholders for judicial sale earlier this year.

COURT SALES OF DISTRESSED ASSETS

What do banks and bondholders expect to achieve from a court sale process?

First, to sell the mortgaged asset to a purchaser free of maritime liens.

Such claims survive an ordinary, private sale and 'follow the ship' into her new ownership. That is not a major issue when buying a ship from a solvent ship owner who warrants the ship to be free of debts, liens and encumbrances (under, for example, Clause 9 of Norwegian Saleform 2012). But, when the owner is insolvent, and the lender driving the sale is understandably unwilling to give such a warranty on its defaulting borrower's behalf, investors usually expect clean title, which only a court bill of sale will deliver. Investor nervousness about hidden maritime liens is, nevertheless, often disproportionate. In many cases, the owner's only significant creditor will be the mortgagee, with OPEX paid on time until the ship's charter employment has ended, causing a rapid worsening of the owner's financial position after the ship has been in lay up for a period of time with no earnings stream. Even where there are unpaid trade debts, they will not usually be maritime liens. Under English law, leaving aside salvage, collision and pollution claims, which will ordinarily be insured and bonded at the time of a casualty, the only maritime liens are crew wages claims, which will invariably be paid on or before delivery when the owner's crew are repatriated.

In England and other common law jurisdictions, it is also possible for all maritime creditors to protect against a change of ownership by issuing a protective writ that permits the ship to be arrested if ever she trades to that jurisdiction, on the deemed basis of her ownership as at the date the writ was issued. But appropriate searches of court registries, such as in London and Singapore, can be carried out pre-sale to address this concern. If there is a concern about maritime liens being enforced post-sale in countries like the USA, where US supply or 'necessaries' claims are given lien status, then liens insurance can be purchased relatively inexpensively.

Second, to stimulate bidding interest in a dead market, as illustrated by the fact that Ocean Rig was the only bidder at the Cerrado auction, collecting that ship for its reserve price.

Third, to complete a sale where the borrower is insolvent and unwilling or unable to cooperate in a private sale, leaving the court as the only seller that can actually execute a bill of sale to deliver the ship. It is true that the mortgage will usually include a 'power of sale' and POA enabling the mortgagee to sell in the name of the owner. But such sales into the market are not the norm, again because investors will expect the lender to warrant the ship's freedom from debts, which the lender is likely to be unwilling to do.

Buyers of OSV's and other offshore vessels would be advised to consider also whether all of the on board equipment and machinery belongs to the vessel or is either third party hired equipment (normally expressly excluded from court sales) or equipment and machinery subject to retention of title provisions.

Whilst a court bill of sale gives clean title, the court sale process presents problems for many lenders. First, courts usually expect the purchaser to pay cash into court, where it will remain for several weeks or months until the court distributes the fund to creditors. That is fine when an investor such as Ocean Rig makes a cash bid for the asset. But, most such sales will be financed by the lender, either to an existing customer or sometimes to a warehousing entity controlled by the lender. In such cases, for the lender to have to 'double fund' its purchase — outlaying new capital before receiving any back to apply in reduction of the old loan debt — can be very painful. Some courts will accept a bank guarantee in lieu of cash — for example, those in the Netherlands Antilles. In the sale of the Harkand PSVs, the Gibraltar court was prepared to accept the ships themselves as security for payment of the price, by arranging for the court sales only to be completed when the court had ordered distribution of the price back to the bondholders. With offshore assets that are likely to remain unemployed and/or laid up or 'stacked' post-sale, it will typically not be an issue for the assets to remain under arrest for several weeks post-sale.

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Ultimately, whilst a court sale may make the asset more marketable, there is barely a market today for assets such as UDW drillships, save for the occasional bargain hunter like Mr Economou. Banks and bondholders, therefore, find themselves left with the invidious choice of cashing out for a small fraction of their debt to outside investors expecting a bargain, or warehousing the asset at significant cost. To 'warm stack' a drillship is likely to cost US$30,000 per day, and a further US$2-4 million to reactivate. Such costs can be reduced to under US$10,000 per day by cold stacking, with reactivation costs rocketing to tens of US$ millions, increasing exponentially over time. If and when the UDW market recovers, the cold stacked rigs will also be the last to get the business, as they will take up to a year to reactivate. Further, if that recovery is protracted, seventh generation drillships under construction will be coming on line to snatch the business. Bleak as this choice clearly is, most banks are not ready to decide to cash out.

And even if the lender were so minded, the lender may simply not be in a position to re-position the asset to a jurisdiction like Gibraltar or the Netherlands Antilles, either because the asset is arrested or the owner will not agree to move the asset. Many lenders now find their assets detained or under arrest in Brazil, where the court sale process is extremely slow and riddled with legal uncertainty. Earlier this year, for example, a Brazilian appellate court held in proceedings relating to the arrested FPSO *OSX3* that Brazil will not recognise foreign mortgages (in that case, Liberian) unless the country of mortgage registration has ratified a legal convention on recognition of security interests to which Brazil is party, such as the pan-Latin American 'Bustamante Code' under which, for example, the Brazilian court would have recognised the OSX3 mortgage had it been Panamanian. Although that decision remains under appeal to Brazil's Supreme Court, many of the foreign lender financed assets engaged offshore Brazil are Liberian or Marshall Islands flag, leaving their lenders vulnerable to having their security not recognised in any judicial sale process. Outside Brazil, no lender is likely to want to arrest offshore assets in places like Angola, Nigeria and Indonesia, given endemic delays and uncertainties with the legal process in such countries.

DEALING WITH INSOLVENCY RISK

The unattractiveness of the court enforcement process has confirmed the view of most lenders that the optimal solution is to work with defaulting borrowers to restructure their loans if possible. Many operators of offshore assets will still have some revenue from those ships in their fleet that remain employed, and receivables in the form of unpaid hire from slow payers or lump sum compensation due from oil companies on early termination of drilling contracts. If the borrower is able to meet its trade debts as they fall due, although unable to service its loan, then the choice of a lender wishing to get paid is stark: either cooperate with the borrower or crystallise an immediate loss.

If the lender wishes to take a hard line, it will also need to be concerned about the risk of driving its borrower into insolvency. Were the borrower's group to file for Chapter 11 protection in the US, for which the jurisdictional entry threshold is very low and open to almost all shipping companies with no US presence, not only would the 'automatic stay' that has worldwide effect prevent the lender from enforcing its security, but also cash balances and earnings payable to the borrower would be available to fund bankruptcy expenses across the group. Non-US lenders who violate the stay risk exposing officers of their US affiliates to fines or imprisonment for contempt of court. Even if they have no such US group presence, in today's world of ever increasing cross-border recognition of bankruptcy stays, the US stay is likely to be recognised in the lender's home country. So, for example, a US stay would be recognised in England under the Cross Border Insolvency Regulations 2006, both countries having adopted the UN Model Law on cross-border insolvency. A Chapter 11 filing will, therefore, stop any lender enforcement dead in its tracks.

Further, payments made within 90 days preceding the filing will be at risk of claw back in Chapter 11 as 'preferential transfers' which may even extend to lump sum compensation payments previously earmarked to mandatory loan prepayments. Accordingly, the temptation for lenders to insist on such lump sums being used for prepayment, leaving no cash for the borrower to continue to operate or even to stack its asset, will be held in check by the insolvency risk. Further, especially where earnings under the financing package have been paid to a group affiliate, in a financing backed by guarantees of different group entities, there is the risk of 'substantial consolidation' of the group's assets and liabilities in any US bankruptcy. Accordingly, borrowers in financial difficulty may hold the whip in any restructuring negotiation, even if the threat of a US bankruptcy – which is likely to drive the borrower into liquidation – will rarely be carried out. Indeed, the threat of a future US bankruptcy may also act as a deterrent to concluding a restructuring that is at risk of challenge in a later US bankruptcy. It may be possible to address that risk through the transfer of the secured asset into a 'bankruptcy remote' ownership structure, such as a Delaware corporation, administered under a trust arrangement that includes company constitutional restrictions on the borrower filing abusively for Chapter 11 protection in the future, which a US bankruptcy court should respect, if ever violated.