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Risks and Liabilities in Developing Offshore Resources

In

Transactional Shipping

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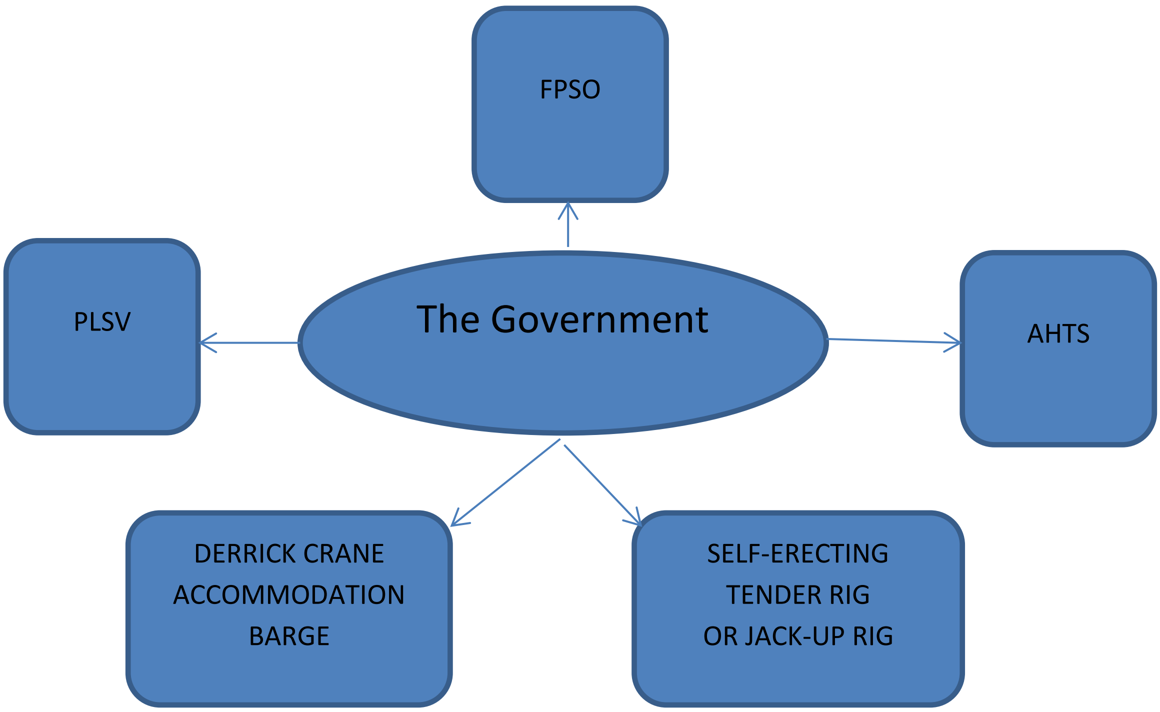
Developing the oil field with vessels

It is simple logic that the development of offshore resources requires the heavy use of vessels, because the resources are offshore. The location of the resources in a seabed makes it necessary to employ "floating vessels, usually capable of navigation" – hence, a "ship" – to (i) store, produce, offload, transport the resources by sea onshore where they are to be used, (ii) bring the manpower to the oilfields to work on them, and (iii) lay the infrastructure to extract the resources.

We are talking about petroleum here because more often than not, the resource that is developed offshore is petroleum. With the price of Brent Crude oil being in excess of USD100 a barrel [USD109.73 on 24 October 2011], which is stratospheric compared to how it was just 5 years ago, it has become more and more economically viable to extract petroleum from the further reaches of the seabed than ever before. It has also become more economically viable to *technically innovate* vessels to do so, of a *bigger size*, that are able to operate in oil fields far out at sea.

This ever increasing importance and economic viability of gathering offshore resources increases the stakes that are at play in offshore vessel transactions. However, despite the large stakes, the risks and liabilities in developing offshore resources are still too often overlooked. This paper explores these issues and aims to provide a basic yet comprehensive overview of the risks and liabilities that may arise in vessel transactions in the development of offshore resources, and specifically oilfields.



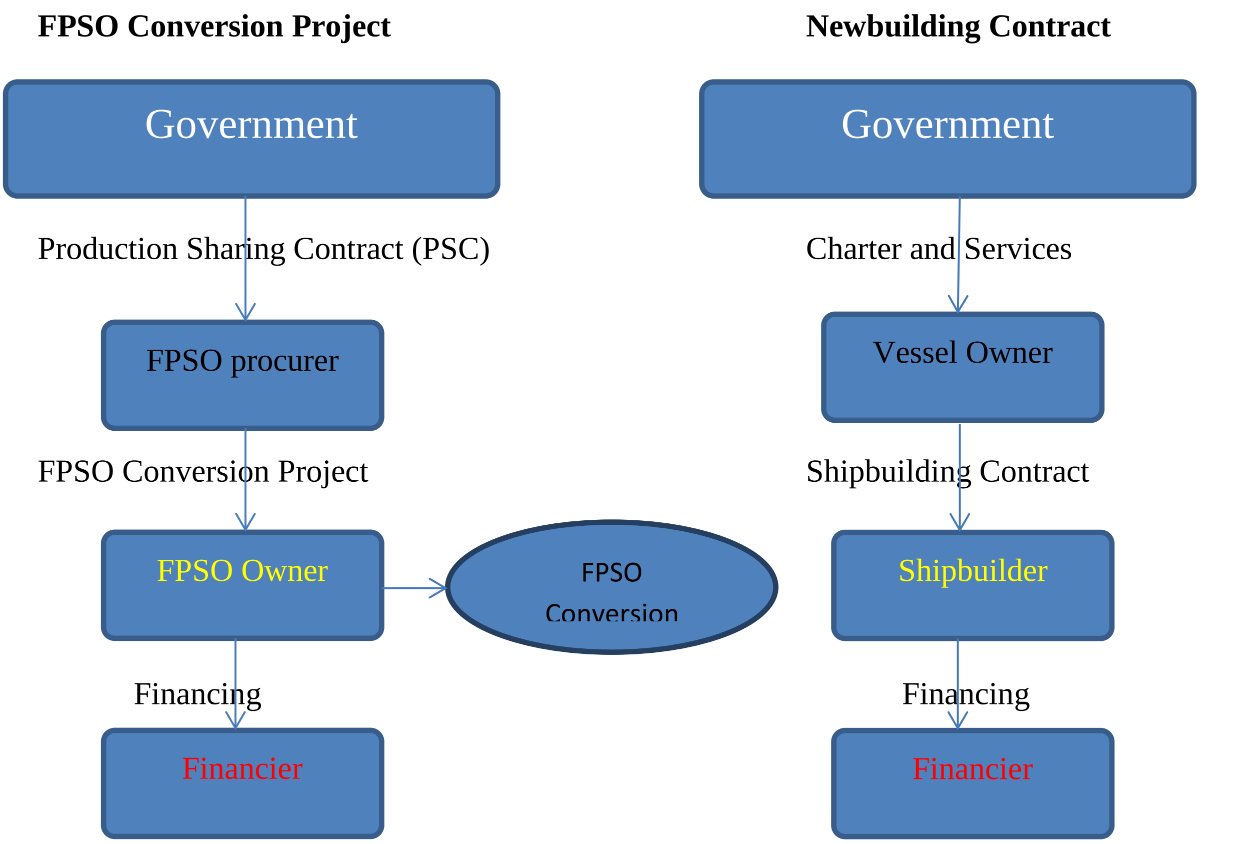
The vessel transactions

In offshore vessel transactions there is a long line of parties involved and a long list of contracts concluded to bring the vessels to the oil field and the oil out of it (See charts on page 2). At the top of the chain of vessel transactions in the development of offshore resources is the Government. This is because it is the Government of any particular country that owns the offshore resources and therefore ultimately carries out the development of the offshore resources. Normally for this purpose the Government has established a petroleum development company, incorporated by statute, in which is vested the ownership of all such resources and which is given the responsibility to develop it.

The range of vessels that the Government has to procure to develop the oil field is wide. It starts from the self-erecting tender rig or the jack-up rig, to the FPSO/FSO/MOPU/MOBU/MODU, to the flexible pipe lay support vessels that lay the flexible pipes, to the derrick crane accommodation barges, and to the humble but indispensable AHTS.

At the onset of the oil field development project the Government enters into a production sharing agreement (called a 'PSC' in the industry) with a developer of offshore resources. This developer tends to be a joint venture (or a tripartite joint venture) between a subsidiary of the Government and an oil major with a large oil company.

Contractual Graph



Throughout the chain of transactions, at any point in the chain, it is likely that multiple parties are involved, or multiple contracts, or both, in several jurisdictions. The developer for example could be a tripartite joint venture between a Singapore-based group of companies with Japanese-based companies (such as for the FPSO Stybarrow M.V. 16 off Australia); or a US-based oil company with a Kuwaiti national oil company and a Malaysian national oil company (such as the Belud FPSO project to be deployed off East Malaysia).

The shipbuilder could be equally international: for example a Brazilian-Norwegian joint venture, or a Dutch group of companies, whose subsidiary can then supply the pipe lay support vessel's topside to the Dutch shipbuilder, as well as to the Brazilian-Norwegian shipbuilder. Sometimes the owner of the vessel, the shipbuilder, the charterer and the holding companies are all related companies and all based in Singapore, but the financier is Norwegian. For the values of the vessels built and deployed offshore are now so high, that it often takes a lot of teamwork from all over the world to get the deal done: from the project requirement to the technical expertise and of course the financing needed to fund it all.

This narrative shows a simple picture of the vessel transaction chain in order to aid understanding of the structures involved and the international nature thereof. In such an international framework it is easy to see the potential for risks to arise, like inconsistency in the dispute resolution clauses or that the interconnectivity between the transactional documents is not robust enough to withstand the layers of transactions. And if a crack appears in one layer, this is magnified in the layers below, as we shall see later. Ultimately the bottomline questions to be answered are: is this an insurable deal? And is this a bankable deal?

The deal

Once the Government has procured the developer of its oil field, the developer then in turn procures the FPSO or the rig or whichever other vessels that are required to develop the oil field. An invitation to bid (or 'ITB') is made to the parties of choice. Sometimes the Government entity directly procures the vessel such as flexible pipe lay support vessels. The contract that is concluded between the Government or the developer, and the owner or provider of the vessel, is the Charter. The Charter is the 'deal' from which all other vessel transactions usually spring, as in the end the main goal of the production or conversion of a vessel is for it to be chartered out. The Charter emerges between the vessel procurer and the vessel provider, and anchors all the other transactions along the chain.

For the vessel then needs to be built – hence the shipbuilding contract is entered into between the vessel provider and the shipbuilder. Alternatively, it needs to be converted into the sort of vessel being procured or provided – hence the FPSO conversion project. The procurement of the vessel then needs to be financed – hence the financing transaction which includes the loan and the security agreements. And so we have it: the Government gives the PSC which gives rise to the Vessel Charter which gives rise to the Shipbuilding Contract which gives rise to the Financing. That is the chain of vessel transactions in developing offshore resources.

Risks and Liabilities.

The risks that can arise in the vessel transaction chain are just as varied and myriad as the transactions themselves. Because of the complexity of the vessel transaction chain and the interdependence of the contracts, it can be difficult to overview all the possible exposures. In practice even the most basic of measures and the most fundamental risk management steps can and are sometimes neglected. Some of the most salient issues I have experienced include:

- Not understanding the Charter fully
- Not choosing a suitable Vessel Owner SPV
- The connectivity of multiple related contracts
- The prohibition on financial assistance
- Taxation aspects of vessel transactions

Understand the Charter

It helps to understand the Charter. This might seem rather obvious, but in the hurly-burly of doing the deal, often the Charter 'exposures' that are so important to cover in the contracts down the chain are obscured from view. The lawyers must then chip away at the layers of annexures or the difficult language which have 'buried' the exposures. Sometimes the Charter or related contracts are in Malay or Portuguese. Whether they are a liquidated damages limitation of 40% of the contract value, or a loss of limitation of liability clause, it is of utmost importance to do whatever it takes to reveal the exposures for what they are, make sense of them to the extent possible under the circumstances, and obtain as many clarifications as necessary to determine their true meaning – but this can be difficult.

The soaring price of oil means the evolvement of technically innovating solutions and higher-value assets for digging for oil and gas further out into the sea and deeper into the seabed. Before the start of the global financial crisis in July/August 2007, the Norwegian Sale Forms for fairly new pipe lay barges might price them at USD30 million. Now the shipbuilding contracts value can be USD230 million for a newbuilding pipe lay support vessel. The Charter's day rate could be USD230,000 a day. The liquidated damages for delay limitation may be USD130 million.

So the Vessel Owner needs to transpose the Charter exposures into the Shipbuilding Contract. As a first step for the Vessel Owner it would help if the lawyers are involved from the very beginning. In an invitation to bid, for instance, the Vessel Owner could then immediately have a legal risk analysis of the documents released. A risk analysis should be divided into the technical requirements and the legal contracts. Only then can a commercially viable bid be proffered. Whilst a technical team reviews the technical specifications of the Vessel being procured, a legal review should be made of the contracts relating to the Charter and the services in providing the Vessel.

Sometimes, as lawyers, we are involved too late. We are only called in when the client is already committed to a raft of agreements. The negotiations had ended and the award was made. The deal is done and the die is cast. Then the only job left for the lawyers is to ferret out the exposures – and try to pass them on to the next party in line.

Another problem that may occur specifically in cross border transactions is that the contracts are in another language, in which case local lawyers need to be engaged – if they haven't already – to have an accurately and professionally translated document.

Choose a suitable SPV to own the vessel

Let us examine at this point the identity of the Vessel Owner. The Vessel Owner is normally a special purpose vehicle company ('SPV') to ring fence and off balance sheet the financing and to procure all other protections that a single-shipowning company may have under shipping law, financing or corporate law. Therefore it pays to choose the right SPV. It pays from a tax viewpoint, a leasing viewpoint, a registration viewpoint and a commercial viewpoint. The structure of the vessel transaction is very much influenced by the identity of the Vessel Owner – and vice versa.

The issues to consider for ownership and/or flagship of the vessels are:

- Where will the Vessel be built?
- How will the Vessel be financed?
- Where will the Vessel be deployed?
- Who will be the shareholder of the Vessel Owner?
- What is the window for operating the Vessel?

The jurisdiction of incorporation of the Vessel Owner and the flag of the Vessel will depend on the answers to these questions.

From a tax perspective and by way of example, the Netherlands is a popular onshore jurisdiction for the incorporation of SPVs in structured finance transactions. This is because the effective tax rate of a Dutch SPV is nil. After tax profits are paid to the Dutch corporate services provider as dividends in lieu of a management fee, which are tax exempt income for the corporate service provider. There is no withholding tax on interest paid on notes issued by Dutch SPVs – unless the notes qualify as "hybrid debt" such as subordinated notes with a term of over 50 years (very limited circumstances).

In addition, Dutch SPVs are exempt from VAT under certain circumstances, and can be structured so as to be exempt from Dutch banking or other regulations, as well as some licencing requirements.

The above example shows that properly considering the SPV structure can ensure great benefits overall. The decision is ultimately a balance between the tax benefits and the regulatory requirements. Initial and recurrent costs are also factors, but not as much. The Charter often determines who the Vessel Owner is, with licencing and local content requirements playing a big part.

The Shipbuilding Contract or the FPSO Conversion Project

We then move on to the next party in the chain of vessel transactions. In a new building project, this would be the shipbuilder. A shipbuilding contract is mainly based on one contract with a shipyard on turn-key or engineering, procurement and construction (EPC) terms.

In an FPSO conversion project however, the legal nature of the contract is different from that of a new building project. The owner in an FPSO conversion project will usually have a lot of separate contracts with the PSC or concession holder. Some contracts may be on a turn-key or EPC basis, and at least one FPSO owner I know of is seriously considering having all these separate contracts meshed into one, on the basis of an arbitration tribunal's view that this should be done, to preserve consistency and interconnectivity between the various stages of an FPSO conversion project, but more usually an FPSO conversion project has a tranche of several contracts that carry with them integration and coordination risks.

The contracts include:

- The contract for the provision of a floating production storage offloading services between the PSC or concession holder (the FPSO contract);
- The contract of engineering, procurement and construction or conversion for the FPSO vessel between the PSC or concession holder with the FPSO owner;
- The construction or conversion contracts with the shipyards;
- The procurement contracts for major parts like a derrick crane for an accommodation barge, or a pipe lay tower for a pipe lay support vessel;
- The charter and the operations & management contracts between the PSC or concession holder and the FPSO owner;

The FPSO owner would seek to ensure that it is able to perform the FPSO contract within its capital expenditures (capex) and operating expenditures (opex) budgets. The difficulty is that the capex and opex budgets are committed to at the onset of the project when the bid proposal is made to the PSC or concession holder under the invitation to bid for the provision of FPSO services.

Inconsistent dispute resolution clauses in related contracts

One challenge in managing the risks in related contracts is inconsistent dispute resolution clauses. The English Commercial Court recently in *PT Thiess Contractors Indonesia v PT Kaltim Prima Coal and another* [2011] EWHC 1842 (Comm) refused a stay of court proceedings in favour of arbitration.

The court held that where different but related agreements contained overlapping and inconsistent dispute resolution clauses, the court should consider the nature of the claim and the particular agreement out of which the claim arose. Where a claim arose out of, or was more closely connected with one agreement than another, the claim ought to be subject to the dispute resolution regime contained in the former agreement, even if the latter was, on a literal reading, wide enough to cover the claim. The fact that there might be a degree of overlap between dispute resolution clauses did not mean that a stay in favour of arbitration should be imposed. Hence, related issues did not necessarily get to be resolved under the same or similar dispute resolution proceedings – unless parties agree contractually to do so.

So, where difficulties arise because multiple related issues from different but related contracts are being resolved under overlapping dispute resolution clauses, parties risk having multiple legal proceedings in different forums. One solution is to provide for a contractual right or obligation in each related contract to stay litigation in favour of arbitration or vice versa, when the same or closely related issues become the subject of different proceedings.

Financial assistance

In the financing of the vessel transaction, because the amounts needed to be funded are so high, parties turn to more and more inventive methods. It is important in the structuring of these new unusual methods to ensure compliance with legislation. Once you have a structure outlined, check with your local lawyer that the structure does not contravene local laws before you put the structure in place.

One issue which frequently crops up in the structuring of financing these vessel transactions is whether a company can give financial assistance to the purchase of shares in itself, or in a subsidiary, or in a holding company. The issue arises because the mix of debt and equity in financing structures gets more and more blurred in current financing methods, where shares instead of debt are issued to financiers (usually for tax or accounting purposes), but the same financiers still require security. Therefore the issuance of these shares in a financing structure often gives rise to the question whether their purchase by the financier can be financially assisted by the borrower or its related companies by the giving of securities such as a mortgage over the vessel, assignments of the charter and insurances, and guarantees.

In the common law jurisdiction the traditional approach is to prohibit any such financial assistance. The concern is that the transaction would result in an unlawful reduction of the capital of the company. For instance, Malaysia prohibits it by statute. The more progressive common law jurisdictions still prohibit it unless the transaction goes through what is called a "white-wash" process, which effectively means that shareholder approval must be sought for the financial assistance (and all the necessary related paperwork is concluded). This is true for Singapore, and in fact, Labuan (an offshore jurisdiction of Malaysia) allows it although it still requires the white-wash process.

The White-wash process is the approval by a special resolution of the company (Cook and Another v Green and Others [2009] Lloyd's Rep. PN5)1. A special resolution in common law jurisdictions is a resolution passed by not less than 3/4ths of shareholders given not less than 21 days' notice of the proposed resolution. Of course, a resolution signed by all shareholders (or a unanimous circular resolution) is usually statutorily deemed duly passed at a meeting.

The statute would provide that a company may provide financial assistance, whether directly or indirectly, for the purpose of or in connection with the purchase of its own shares or the shares of any of its subsidiaries or of its holding company where the transaction has been approved by a special resolution of the company, and the directors have certified to the meeting, in writing, to the effect that there are no reasonable grounds for believing that-

(i) the company is, or would after giving the financial assistance be, insolvent; or

(ii) the realizable value of the company's assets, excluding the amount of any financial assistance in the form of a loan and in the form of assets pledged or encumbered to secure a guarantee, would, after giving the financial assistance or loan, be less than the aggregate of the company's liabilities and stated capital.

[1] Malaysian and Labuan law is based on English law (Sections 3 and 5 Civil Law Act 1956 of Malaysia).

The UK has done away with the “white-wash” process as well as the prohibition on financial assistance, however, it is still necessary to ensure that the company keeps within the parameters allowed by law, which the prohibition on financial assistance seeks to safeguard, namely:

(i) The first parameter within which the company must keep is Capacity – Whether the Memorandum and Articles of Association of the company allow for, and approval of the shareholders and directors are obtained in, the provision of the security to financially assist the acquisition of its shares or that of a related company;

(ii) The second is Directors’ duties – The directors need to consider whether the provision of the securities is consistent with their duty to act in good faith and is likely to promote the success of the company for the benefit of its members as a whole, recording their reasons for giving the assistance in sufficiently detailed board minutes (accompanied with a ratifying shareholder resolution approving the transaction - which would assist in confirming that a director is acting in the best interests of the company);

(iii) The third parameter is Solvency – The directors must consider the cash flow and net asset position of the company to ensure there are no pertinent insolvency worries; and

(iv) the fourth is the main worry of Capital maintenance – The directors must ensure that the transaction would not result in an unlawful reduction of capital of the company.

In conclusion, the rules on what is allowed in structuring the financing of a vessel can vary from country to country. Not understanding the local regulations may cause a financing structure to be unenforceable in a specific jurisdiction, or even illegal.

Offshore shipping related taxation issues

Another risk and liability which arises from the development of offshore resources is tax. This applies to various aspects of the shipping deal - from taxes related to financing to the taxation on the actual income under the Charter or derived from extraction the offshore resources.

An important tax related question is how the income arising from an oil rig is taxed. A different tax treatment may apply for different jurisdictions. It is worth noting that most common law jurisdictions impose tax on a territorial basis. This means that tax is imposed in respect of income accruing in and derived from the common law jurisdiction country. Income would generally be considered to be sourced where services are performed in that common law country.

For instance, the actual wording in the Malaysian Income Tax Act 1967 at Section 3 on the imposition of income tax is:

“Subject and in accordance with this Act, a tax to be known as income tax shall be charged for each year of assessment upon the income of any person <u>accruing in or derived from Malaysia or received in Malaysia from outside Malaysia</u>.”

So where a non-resident company such as a Norwegian company derives income from Malaysia, the income will be taxable in Malaysia under the following situations:

- Where the income is derived or deemed derived from Malaysia
- Where the Norwegian company has a Permanent Establishment in Malaysia

Where services are performed offshore but within Malaysian waters or oilfields, the scope of Malaysian taxes extend to such services. The income from the services performed offshore is considered derived from Malaysia and therefore subject to Malaysian income tax.

By way of explanation, Malaysian territorial waters extend 12 nautical miles (Emergency (Essential Powers) Ordinance, No. 7, 1969, as amended in 1969, in accordance with the Geneva Convention on the Territorial Sea and the Contiguous Zone 1958, being the Ordinance under which any reference to territorial waters must be construed).

'Territorial waters' under specific statutes like the Continental Shelf Act 1966, the Petroleum Mining Act 1966 and the National Land Code or any statute relating to land in Sabah and Sarawak, and also 'internal waters', extend to just 3 nautical miles.

However, Malaysian offshore oilfields tend to be in its exclusive economic zone under the United Nations Convention of the Law of the Sea 1982 (UNCLOS), which extends 200 nautical miles out to sea. Furthermore, oil rigs and other offshore installations in Malaysian oilfields must be licenced by Petronas under the Petroleum Development Act 1974. This Act provides for Petronas ownership of the exploration and exploitation of petroleum, whether onshore or offshore.

Therefore such services performed offshore would be considered as 'derived from Malaysia', and hence subject to Malaysian income tax. Actually, foreign sourced income is exempt from tax in Malaysia unless the recipient is in the business of banking, insurance, shipping or air transport.

A different example would be the tax regime in Singapore, a country which aims to position itself as a predominant shipping hub in South East Asia and therefore is very favourable to shipping. The slew of tax benefits the Singapore government has been allowing over the years, which already included schemes that exempt qualifying shipping income from tax, was more recently confirmed in its 2011 Budget - and even extended. For instance, there is now an automatic withholding tax exemption for interest payable on loans obtained from foreign lenders for financing the construction or purchase of Singapore-flagged ships. These tax incentives for the maritime sector which are administered by the Maritime and Port Authority of Singapore and are streamlined and consolidated under the new Maritime Sector Incentive scheme with effect from 1 June 2011.

Conclusion

Those are just some of the legal and practical challenges that can arise in a shipbuilding contract for an offshore development or an FPSO conversion project, and should be considered in risk assessments by owners and banks.

Needless to say, if you have any further questions and if I can assist any further just drop me a note and we can have a chat.