Schjødt

Energy, Shipping & Offshore update

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Newsletter Editorial

We are pleased to welcome all readers to the first edition of the Schjodt Energy, Shipping and Offshore newsletter.

These are exciting times. The imperatives of the transition to the production and use of clean energy, the reduction of emissions from existing technology and the achievement of energy security, pose huge challenges and offer huge opportunities to everybody operating in these industries. And this is in addition to everybody's "day job", participating in the running of an efficient and developing business, managing the challenges that this entails with world-wide supply chain and trading disruption.

In our newsletters, we aim to provide our readers with informative and helpful articles on these developments and other issues in these industries as they arise. The articles will contain a spread of perspectives and issues across our offices in Norway, Sweden, Denmark and the UK. We aim to keep our readers abreast of any significant developments in the law in these jurisdictions, but our articles are also intended to offer a commercial perspective on topical issues that these sectors face. In our view the purpose of the law is to facilitate commercial enterprise not the other way around.

In this, our first edition, we include articles on the availability of lease finance in the shipping and offshore industries.

Decarbonisation in Shipping, Sanctions in the wake of Russia's invasion of Ukraine, an assessment of the impact of the Energy Security Act in the United Kingdom and an assessment of the issues in "early life" agreements that often form the springboard for a commercial relationship.

We hope that you find these articles valuable and we look forward to receiving any feedback you may wish to offer and to your continued readership.

If you would like to discuss any aspect of the articles in this newsletter, please contact either your usual Schjodt contact or the writer direct:

Camilla Bråfelt
Partner, Oslo

Camilla Bråfelt is a partner in the shipping and offshore group in Schjodt Norway and one of the editors of this newsletter (editorial and decarbonisation)

D: +47 23 01 15 31

M: +47 915 35 616
camilla.brafelt@schjodt.com

David Gardner
Partner, London

David Gardner is a partner in the London office of Schjodt, the partner responsible for that office and one of the editors of this newsletter (editor and early life)

D: +44 208 078 9497

M: +44 777 166 5372
david.gardner@schjodt.com

Lease Financing in Shipping

It is evident that the shipping industry requires new sources of capital. During the past 12-13 years, the major international shipping banks have reduced their exposure by USD150 billion. This has been particularly the case with European banks. The demand for financing however continues to grow. In Europe, it is estimated that the annual funding gap is in the range of USD50-60 billion. As the level of conventional bank led ship financing has reduced over recent years thanks largely to compliance and regulatory requirements impacting negatively on banks' ability to lend, alternative sources of funding have stepped in, with companies turning to the US and Norwegian capital markets, private equity investment, new alternative financing companies and, probably most importantly, ship leasing companies. The global ship leasing market has grown significantly and is now a key source of finance for the shipping sector.

Lease Financing in Shipping

In response to this, BIMCO released the first standardised 'SHIPLEASE' term sheet for sale and leaseback financing to assist companies looking to source/finalise lease financing products. The term sheet sets out key terms and conditions for a sale and leaseback transaction and can serve as a very useful starting point for negotiations.

Sale and leaseback financing has been able to unlock balance sheet value and release cash and provide long term financing up to 12 years(tenor) and profiles up to 25 years (useful economic life of the asset). The structure allows the owner of a ship to sell and lease it back, freeing up capital. Other benefits include structuring transactions which can be 'covenant light' with a reduced interest rate and refinancing risk and a single bilateral relationship with the relevant leasing company. Leasing strategies typically target net returns in the 10% - 15% range driven by long term contractual cash flows and can benefit from asset collateral and inflation protection.

Put simply, these deals are structured with a lessor (leasing company) giving to a lessee (the shipping company) in consideration of specified lease payments, possession and economic control of a ship for an agreed time period. The most common types of structures are either operating leases or finance leases. Operating leases are often employed for short/mid-term charters at the end of which, the ship is returned to the lessor. Finance leases are usually used for long term financing for ships. Here, the lessor will act as financier only and the lessee will enjoy the benefits and also the risks of ownership having full operational control. A 'hell or high water' clause will be included in the lease which will provide that the lessee cannot terminate the lease or be excused from making any payments under lease, including under the wide range of indemnities it will usually be required to give. Any early termination will require the lessee to compensate the lessor.

Leasing companies have been very active in funding all sectors of the shipping industry (cruise ships, LNG carriers, drilling rigs, FSRUs, tankers, bulkers, container ships, offshore support vessels etc) and in relation to both new and second-hand tonnage. Chinese leasing companies are now thought to finance approximately 10% of the world's fleet and provide a range of financing solutions, including finance leases, operating leases and direct equity investment on a joint venture basis. They have been very successful in arranging single source financing solutions for high value assets. For example, in the cruise sector, we have seen Chinese leasing companies finance upwards of thirteen new buildings for a range of cruise operators with deal sizes ranging from USD200m to USD840m. In some cases where the transaction is significant, leasing companies will work together to co-arrange/co-invest and thereby share the funding costs/risk. These transactions need to be carefully structured however to ensure all parties involved have the protections they need and would expect to see in an equivalent syndicated debt financing.

Lease Financing in Shipping

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Similarly, in the offshore and oil and gas sectors, Chinese leasing companies have shown appetite to finance a range of high value assets with contract support from an acceptable counterparty. With the exception of drilling rigs, where there have been several enforcements and restructurings, numerous financings have been successfully arranged for LNG carriers, FSRUs and specialist offshore/wind farm support/maintenance vessels. One particular transaction of interest involved CSSC, a Chinese shipyard affiliated leasing company. In 2015, CSSC arranged a USD1.2bn pre and post conversion financing for a FLNG vessel contracted for operations offshore West Africa.

Additionally, in recent years we have seen the increasing growth in shipping of the Japanese Operating Lease with Call Option (JOLCO). For some time, the JOLCO has been a reliable source of funding, predominantly in the aviation sector. However, more recently this has changed. Japanese investors have widened their investment risk appetite to the benefit of the shipping sector. These deals are structured by the Japanese equity arranger establishing a SPC in Japan. The equity required for the ship being provided by Japanese investors. The SPC enters into a loan agreement with its bank(s) who provide the debt for the vessel acquisition. Simultaneous with the ship purchase, the SPC enters into a bareboat charter with purchase option with the shipping company. As security for its obligations under the bareboat charter, the shipping company provides the SPC with various security and the SPC in turn provides its lenders with the usual security package over the ship and its rights to the ship. The shipping company does not provide any security directly to the lenders. However, the Japanese equity arranger will provide limited support to both the banks and the shipping company by way of letters of undertaking. Further, the loan agreement will be limited recourse against the SPC.

JOLCO structures are increasingly being used to help fill the lending gap in the market and are popular as they typically provide 100% financing (approximately 30% equity/70% debt). As with other forms of tax-based leasing products, some of the tax benefit available to the equity investors is passed to the shipping company/charterer. Further, as equity is usually repaid at the end and lease payments are primarily applied to meet the debt component, the shipping company can also benefit from cheaper funding.

On the flip side, JOLCOs are not as widely available as other leasing deals. The Japanese equity will pay scrutiny to the strength of the shipping company/charterer and will want to be as sure as possible that the purchase option for the ship will be exercised.

To conclude, globally since the financial crisis in 2008, approximately 20 plus institutionally supported ship leasing businesses have been established, developing diverse asset portfolios by focusing on transactions across a variety of market segments. An increasing number of these leasing companies are now focusing on 'green shipping' opportunities created by the demand for greater environmental accountability and the latest EU and IMO environmental regulations. Regulatory pressure on shipping companies to operate 'green ships' has resulted in better lease terms for lessors (eg lower loan to value ratios, robust fixed purchase prices and more attractive profit-sharing mechanisms). Shipping's transition to low carbon fuels/compliance with new ESG requirements, is having a significant impact on the need for capital and the world's ship leasing businesses are moving quickly to help fix a huge funding gap. These leasing companies are adapting financing strategies with strong counterparties supported by long term contracts/cashflows to support the decarbonisation of the shipping industry and will only continue to grow their market share of the industry's financing needs.

Written by:

Gervais Green
Partner, London

Gervais Green is a partner in the London office of Schjodt and the head of the English law finance practice

D: +44 208 078 9505
M: +44 738 772 2459
gervais.green@schjodt.com

Decarbonisation in shipping

– an update

The end of 2022 brought with it significant developments in the race towards decarbonising the shipping industry.

As presented in previous newsletters[1] both the IMO and the EU are developing new requirements to force shipping to reduce emissions from ships.

In the below we will give a brief presentation of the status of the MARPOL emission reduction regime and the EU ETS regime for shipping.

[1]See in particular https://www.schjodt.no/en/news--events/newsletters/green-shipping--increased-emissions-control/

IMO

On 1 January 2023, the MARPOL Annex VI regulation regarding the energy efficiency existing ship index (EEXI) and the carbon intensity index (CII) entered into force. As a consequence of the new regulation, all vessels above 400 GT will have to calculate an EEXI at its first survey after the regulation enters into force. The calculated EEXI will show the particular vessel's energy efficiency compared to a baseline for the relevant ship type and will be relevant for assessing the vessel's future energy efficiency performance.

In addition, and perhaps more importantly, all vessels above 5,000 GT will have to determine their operational annual CII. The CII will provide for an annual reduction factor to be used for assessing the continuous improvement in reducing emissions under MARPOL Annex VI. A vessel's actual performance for a year will be verified against the annual CII (as reduced annually by the reduction factor). Based on the verification, the vessel will be given a rating from A to E and a statement of compliance will be issued to vessels complying with the annual carbon intensity rating for the vessel. Currently, the MARPOL Annex VI contains few sanctions if a vessel fails to comply with the CII. A vessel that is rated poorly (E in one year or D in three consecutive years) will not receive a statement of compliance and will be required to provide a corrective action plan.

As the EEXI and CII regimes entered into force on 1 January 2023, the first annual assessment of CII performance is expected in 2024, when the reported figures from 2023 are assessed. It is expected that the IMO will monitor the outcome of calculations closely in preparation for the assessment of the introduction of an enforcement mechanism, and corrective action is scheduled to take place within 2026.

Even though MARPOL Annex VI contains little "sting" in form of sanctions, it is expected that other players in the shipping industry will monitor the CII ratings of each ship; charterers, financiers, and other involved parties aspiring for zero emission policies may prefer to avoid vessels with low CII performance.

It is worth noting that the calculation of CII has met with significant criticism, mostly with regard to the incentives for which they provide and the methods by which the calculation will work for different sectors of shipping. A quite bizarre consequence of the CII calculations is that a vessel will receive better CII performance by having longer ballast legs than performing more laden legs. Under a charterparty, the CII may create different incentives for owners and charterers.

EU

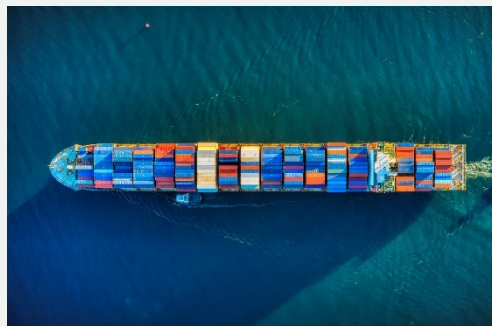
In late December 2022 EU legislators agreed to extend the EU emission trade system (ETS) to shipping with effect from 2024.

The shipping industry will be phased into the ETS over a three year period; 40 % of emissions reported in 2024 will have to be paid for in 2025, 70 % of emissions reported in 2025 will have to be paid for in 2026 and 100 % of emissions reported in 2026 will have to be paid for in 2027.

Once shipping is phased in, all emissions from intra-EU voyages will be included in the ETS, while 50 % of emissions from voyages to/from EU will also be included. At the outset, the ETS will extend to all cargo vessels and passenger vessels above 5,000 GT regardless of flag. It is being discussed whether to include smaller vessels (above 400 GT) from 2026. Offshore service vessels will be included at a later stage, from 2027.

When shipping is included in the ETS, shipping companies (owners, managers and bareboat charterers) will need to buy emission allowances from a pool of limited allowances for emitting CO_2. Other greenhouse gasses will be included at a later stage, with methane and nitrous oxide (N_2O) being first in line to be included from 2026. At the end of each year, an assessment will be made of the company's emissions from ships in the preceding year and a company may face fines if they do not have allowances to cover their emissions. If a company fails to have sufficient allowances for their emissions two consecutive years, the company's vessels may be refused entry into EU ports until the fine is paid.

It is the shipping company that is responsible for compliance with the ETS. How the cost may be distributed in a contractual relationship will largely depend on the nature and duration of the contract. The ETS and the effect of the trading of the vessel on the emissions should be taken into account when entering into new contracts.



Contractual consequences

Both the IMO emissions reduction regime and the inclusion of shipping into the EU ETS will affect the performance and trading of vessels. Furthermore, the consequences of the emission reduction requirements will work differently for different trades and different sectors within the shipping industry. In addition, the two regimes may potentially incentivise owners and charterers differently – e.g. an owner may be incentivised to reduce speed on the vessel to reduce emissions, while a charterer (under a short time charter) will want to receive his cargo as soon as possible or an owner may prefer retrofitting a vessel to cater for new technology for reduced emissions, while the charterer may prefer keeping the vessel as it is but going on slow speed. Parties involved in the shipping industry should be aware that the emission reduction regimes may not necessarily be aligned with the general distribution of risk and responsibilities in a charter party. Parties should therefore carefully consider how the two regimes will affect the performance of a vessel as well as the economics in a contract, when a new contract is to be entered into.

BIMCO has launched a suite of clauses to accommodate the new emission reduction regimes, with in particular the EEXI Transition Clause for Time Charter Parties 2021, the CII Operations Clause for Time Charter Parties 2022 and the ETS – Emission Trading Scheme Allowances Clause for Time Charter Parties 2022 issued in response to the IMO emissions reduction regime and the inclusion of shipping into the EU ETS.

The BIMCO clauses address the challenges faced by parties to time charters. We understand that clauses addressing voyage charter parties are being negotiated and will be issued in due course.

Although the BIMCO clauses are a starting point for parties, note should be taken that these clauses are not drafted for a particular trade or a particular contract. They are also heavily negotiated, which has resulted in clauses being fairly balanced, but the original clauses are not necessarily worded optimally. We will present a more in-depth analysis of the clauses IMO emissions clauses in our next newsletter.

The ETS – Emission Trading Scheme Allowances Clause for Time Charter Parties ("ETS Clause") is drafted to be generally applicable to emissions trading schemes and is not limited to the EU ETS. The clause addresses both the administration required by the relevant emissions trading scheme as well as the provision and payment of the allowances.

The administration of the information required under the emission trading scheme under the ETS Clause, is placed on the owner. It is the owner that will have access to the data for emissions from the vessels and that is the party responsible for participating in the emissions trading scheme, including providing data and purchasing allowances under the EU ETS.

In line with the "polluter pays"-principle and statements from the EU, the ETS Clause places on the charterer the cost of the allowances. Under time charter parties, it is the charterer that is responsible for providing and paying for bunkers as well as giving instructions on which voyages the vessel is to perform and at what speed. Consequently, it is the charterer that is considered to be the party responsible for the emissions caused by the burning of the bunkers.

The ETS Clause is designed to provide for monthly assessments of the emissions made and for the charterer to provide the quantity of emission allowances required to cover the emissions. The ETS Clause refers to providing emission allowances and not reimbursements of the owner's cost of allowances. The BIMCO guidance notes emphasizes that the reason for referring to transferring emission allowances instead of reimbursing the owner's costs of allowances, is to avoid complications with price fluctuations.

It is worth noting that the ETS Clause contains a set off mechanism for off-hire periods, placing on the owner the obligation to return to the charterer a quantity of emission allowances for emissions during off-hire periods. The intention has been to include a provision corresponding to the allocation of bunker provision during off-hire.

As always, we recommend that parties are carefully assessing their specific trade and needs when negotiating new contracts and clauses.

Industrial contributions to decarbonisation

In addition to the focus from regulators, some elements of the industry have also taken it upon themselves to further contribute to decarbonisation in shipping and general carriage of goods.

On the carrier side, Maersk has made significant progress in decarbonising its marine operations to achieve net zero greenhouse gas emissions, within the current decade. Tangible near-term targets for 2030 have been set, which include a 50% reduction in emissions per transported container in the Maersk ocean fleet, and a 70% reduction in absolute emissions from fully controlled terminals.

In 2023 the company aims to launch the world's first container carrier operating on green methanol. The plan is to operate the vessel on carbon neutral e-methanol or sustainable bio-methanol from day one. Maersk expects to have nineteen methanol fuelled container ships delivered by 2025 and to reduce its emissions by 2,3 million tons yearly as a result.

On the shipper side the Carlsberg Group launched its new ESG programme Together Towards ZERO and Beyond in August 2022, which contains updated targets and new focus areas.

By 2040 Carlsberg aims to achieve a net zero carbon emissions across and throughout the entire value chain - from barley in the fields to beer in the hand. The programme is a redevelopment of the former ESG programme containing updated targets and new focus areas, where the goal of a zero-carbon footprint in 2040 represents one of the new targets. In 2030 they aim to have zero carbon emissions at their breweries and a 30% reduction in their entire value chain emissions.

To achieve these goals the company, amongst other things, aims to deliver their products only by using transportation forms that runs on electrification or renewable fuels.

Written by:

Camilla Bråfelt
Partner, Oslo

Camilla Bråfelt is a partner in the shipping and offshore group in Schjodt Norway and one of the editors of this newsletter (editorial and decarbonisation)

D: +47 23 01 15 31
M: +47 915 35 616
camilla.brafelt@schjodt.com

Sanctions in the wake of Russia's invasion of Ukraine

Last year was characterised by Russia's invasion of Ukraine and the sanctions imposed in response to the same. The EU, acting in concert with the G7 members and others, implemented a total of nine sanctions packages. The broad and frequently changing scope of these sanctions has had implications far beyond the borders of Russia, posing various challenges for a wide array of businesses internationally, including those operating within the shipping and petroleum service sectors. With the war still ongoing and recent reports of the EU working on a 10th sanctions package, the conflict will likely continue to dominate the sanctions news in 2023.

This newsletter highlights some of the main restrictions under EU and Norwegian sanctions, with a particular focus on restrictions relevant for the shipping and offshore service industries.

Restrictions regarding Russian petroleum, including the price cap

One key objective of the sanctions has been to reduce Russian revenues from petroleum exports, while at the same time allowing appropriate exemptions based on energy security concerns. How to strike this balance remains at the core of the sanctions debate regarding Russia.

The content and extent of sanctions are always controversial, due to different views on the role and effectiveness of sanctions in international politics. However, this has been particularly contentious when it comes to the Russian petroleum sector sanctions, considering Russia's position as a major supplier to the EU and the global oil and gas markets. Arguably this has represented a bigger challenge for sanctions policy makers compared to the cases of Iran and other comprehensive sanctions regimes. Rather than imposing general and coherent bans, policy makers have had to adopt a more pragmatic approach to reach compromises. This has resulted in an incremental patchwork of petroleum-related restrictions since the Russian annexation of Crimea in 2014.

The restrictions on Russian petroleum exports include a general ban on the import of Russian crude oil under CN Code 2709 00 and petroleum products under CN Code 2710 into the EU and Norway. There is a wind-down period for certain transactions, but the wind-down period for crude expired on 5 December 2022, and the wind-down period for the petroleum products expires on 5 February 2023. Crude oil delivered by pipeline to Russia into EU member states or Norway is also temporarily exempted from the ban, but further transfer or sale of such crude to other countries is prohibited. There are also certain exemptions for EU member states with a particular dependence on Russian supplies.

Furthermore, there are also restrictions on services associated with Russian petroleum exports to third countries. These include general prohibitions against trade, brokering or transportation, including through ship-to-ship transfers, of crude oil under CN Code 2709 00 and petroleum products under CN Code 2710, and related services. The latter includes technical assistance, brokering services or financing or financial assistance. However, there is a general exemption based on a price cap. The price cap derogation essentially allows such maritime transport (and related services) to third countries if the crude or petroleum product is purchased at or below the price cap as set by the Price Cap Coalition (including EU and G7 partners).

Currently the price cap for crude oil is set at USD 60 USE per barrel. The functioning of the price cap mechanism will be reviewed every two months to respond to developments in the market and will be set at least 5% below the average market price for Russian oil and petroleum products, calculated on the basis of data provided by the International Energy Agency. As the deadline of 5 February is approaching, the EU Commission has recently proposed a USD 100 per barrel cap on premium Russian oil products such as diesel, and a USD 45 per barrel cap on discounted products like fuel oil. However, at the time of writing the cap(s) on petroleum products have yet to be agreed. In the event of changes in the caps, there will be a wind-down period of 90 days.

If a vessel has transported crude oil or petroleum products with a purchase price exceeding the applicable price cap, then it is thereafter prohibited for others to provide any of the aforementioned services (technical assistance, financial assistance, etc.) related to the transport of crude oil or petroleum products by that vessel. Hence, service providers are also required to have in place procedures and routines to verify that the price cap has been adhered to during previous voyages in order to avoid violation of these sanctions.

Furthermore, there are reporting obligations related to natural gas condensates from liquefied natural gas production plants under CN subheading 2709 00 10 originating in or exported from Russia. Such natural gas condensates are excluded from the import and transport bans. However, to prevent circumvention and ensure compliance with restrictions regarding other natural gas condensate products, any transactions for the purchase or transfer into the EU, Norway or third countries of such natural gas condensates under CN subheading 2709 00 10, must be reported within to the competent authorities in Norway or the EU within two weeks. Reports must include information on volumes.

Other key import restrictions

In addition to the restrictions on Russian crude and petroleum products, it is also prohibited to import certain listed goods (as further specified in the appendices) into the EU and Norway within the following categories:

- Coal and other fossil fuel products
- Steel products
- Goods which generate significant revenues for Russia
- Gold

These restrictions are all accompanied by broad prohibitions against associated services, including restrictions on directly or indirectly, providing technical assistance, brokering services, financing or financial assistance related to the listed items.

Port access and road transport restrictions

The sanctions prohibit providing access to ports and locks in the territory of the EU, to any vessel registered under the flag of Russia, except for access to locks for the purpose of leaving the territory of the Union. This applies to all vessels that have changed their Russian flag or their registration to the flag or register of any other State after 24 February 2022. After 8 April 2023, the prohibition also applies to any vessel certified by the Russian Maritime Register of Shipping.

The same prohibition applies to Norwegian ports. However, unlike the EU sanctions, fishing vessels calling at ports in Tromsø, Kirkenes or Båtsfjord are exempt from these port restrictions under the Norwegian sanctions. This exemption for Russian fishing vessels originally applied to all Norwegian ports, but was eventually reduced to increase government control, due to concerns of Norway becoming a transit country for the transport of illegal goods to Russia.

It is also generally prohibited for any road transport undertaking established in Russia to transport goods by road within the territory of the EU and Norway, including in transit.

Provision of goods, technologies and services to Russia

There are extensive restrictions on the sale, supply, transfer or export of listed goods and technologies, to any natural or legal person, entity or body in Russia or for use in Russia, including the following categories:

- Arms and defence-related goods and technologies
- Dual-use goods and technologies
- Goods and technology which might contribute to Russia’s military and technological enhancement, or the development of the defence and security sector
- Petroleum-related goods and technologies
- Goods and technology suited for use in oil refining and liquefaction of natural gas
- Goods and technology suited for use in aviation or the space industry
- Maritime navigation goods and technology
- Luxury goods, and
- Goods which could contribute in particular to the enhancement of Russian industrial capacities.

Some of the lists are characterised by a vague common denominator between the listed items, most notably the lists of goods and technology which might contribute to Russia’s military and technological enhancement, or the development of the defence and security sector and the list of goods which could contribute in particular to the enhancement of Russian industrial capacities. This, combined with the broad scope of several of the listed items and the frequent additions to the lists, has posed significant challenges for businesses seeking to keep up with the scope of the export restrictions at any time. The list on advanced technologies for example includes vessels (surface or underwater) and specially designated components for these and certain equipment for oil production and oil exploration.

Furthermore, all of these restrictions extend to associated services, including on directly or indirectly, providing technical assistance, brokering services, financing or financial assistance related to the listed items.

There are also separate prohibitions against providing certain services, directly or indirectly, to the Government of Russia or legal persons, entities or bodies established in Russia. This includes broad categories of services such as engineering services, IT consultancy services, technical testing and analysis services.

Extension of restrictions to the Ukraine oblasts of Zaporizhzhia and Kherson

In response to the regions of Ukraine, the has been extended to cover all the non-government controlled areas of Ukraine, Donetsk, Luhansk, Zaporizhzhia and Kherson. Any activities involving these areas are generally subject to particularly comprehensive restrictions.

Financial restrictions

There are comprehensive financial sector sanctions in place. These include for example cutting off several Russian banks from the SWIFT system, imposing restrictions on certain transactions with the Russian Central Bank, restrictions on providing new loans or credit to certain entities, and a ban on certain investments in the energy and mining sectors. The cumulative effect of these financial restrictions, makes it increasingly difficult to transfer payments to Russia. This is even more the case when taking account of the fact that several international companies have opted not to trade with Russia due to policy reasons.

Sanctions targeting specific persons and entities

There has been an increase of listing criteria, and a considerable increase in the number of persons and entities being listed as targeted by freezing and blocking measures. This includes for example Russian financial institutions such as Bank Otkritie, Novikombank, Sovcombank and VTB Bank. These measures largely prohibit any form of dealing with the listed entities, including entities owned, controlled by, or acting on behalf/at the direction of those entities.

In addition, there is a general ban against directly or indirectly engaging in any transaction with certain Russian state-owned entities, which includes e.g. Rosneft, Transneft, Gazprom Neft, United Shipbuilding Corporation and Russian Maritime Register of Shipping (RMRS). The above prohibitions also extend to entities owned by or acting on behalf/at the direction of the same.

The frequent expansion of these lists, and the targeting of key businesses in the Russian market, increases the importance of sound due diligence and screening procedures for anyone involved in transactions with a Russian nexus.

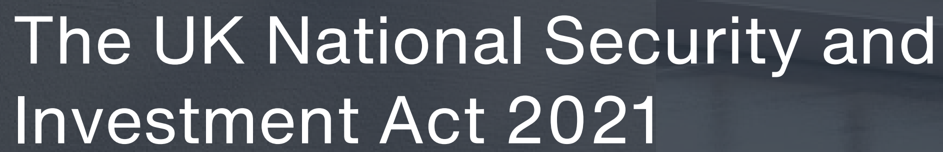
Written by:

Thomas Behné Ramsnes
Partner, Stavanger

Thomas Behné Ramsnes is a partner in the Stavanger office of Schjodt and one of the leaders of the Schjodt sanctions team

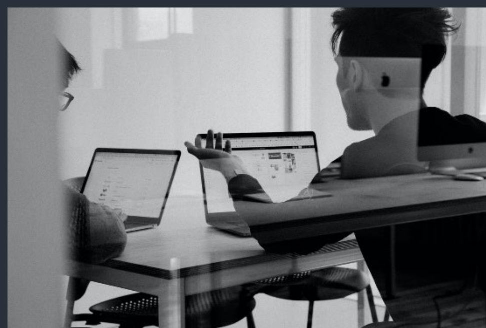
D: +47 51 91 88 39
M: +47 473 68 986

thomas.ramsnes@schjodt.com



The UK National Security and Investment Act 2021

– One Year On



The UK National Security and Investment Act 2021

- One Year On

4th January 2023 marked the first anniversary of the coming into force of the UK's National Security and Investment Act 2021 (the NSI Act), which introduced a new investment approval regime for the UK and granted the Government broad new powers to scrutinize transactions, on the grounds of national security.

With the benefit of a full years' worth of application, the anniversary offers an opportunity to take stock and assess what observations can be made for UK focused investment activity going forward, both on a practical level and from a government policy perspective.

Background

Navigating foreign investment regulations has long been familiar to investors into overseas markets, with different regimes serving a variety of objectives including economic, resource protection and knowledge transfer. Somewhat surprisingly, prior to the introduction of the NSI Act, the UK had no dedicated equivalent. A shifting geopolitical landscape, perceived threats to national and energy security, and concern regarding uncontrolled foreign ownership in critical sectors such as nuclear power and telecoms technology, prompted an increasing trend of national security concerns reframing attitudes towards foreign investment that previously was actively promoted and welcomed and used as a tool to boost UK industry.

The resulting NSI Act contains three key limbs:

- Mandatory advanced notification obligation: making it unlawful to complete the acquisition of control in a qualifying entity involved in identified sensitive sectors of the UK economy, until approval is granted.
- Government "call-in" power: permitting the Government to review non-notified qualifying transactions for up to five years post-completion.
- Voluntary Notification: to mitigate risks of transactions being 'called-in' for review and potentially unwound.

Impact

When first introduced, the primary concern for stakeholders was whether the Act simply represented another practical consideration to factor into the M&A process or posed a genuine execution and completion risk.

Twelve months on, the answer appears to be both.

For affected transactions, there has been an undeniable tangible impact on the deal process. The NSI Act creates an additional due diligence burden – one that, unlike standard legal or commercial due diligence, cannot be easily dismissed given its regulatory nature and the genuine teeth of the NSI Act – failure to comply can result in meaningful sanctions including turnover-based fines and criminal prosecution, as well as the underlying transaction being voided where mandatory notification requirements were missed.

Parties have also had to navigate the interpretation of sometimes vague trigger events; the notification process; the corresponding impact on timing and, in competitive situations, consider their bid strategy, whether to make a pre-emptive notification and the potential disadvantage their profile may now represent when selecting a preferred bidder.

Reassuringly, the Investment Security Unit within the Department for Business, Energy and Industrial Strategy (BEIS) has so far managed the referral and review process efficiently and largely kept to prescribed timelines. The vast majority of referrals are cleared within the initial 30-day review period, a level of response that can hopefully be maintained if a busier M&A market returns and referred cases reach the volumes originally anticipated.

Evolving risks

Whilst data from the first year of NSI Act referrals tells one side of the story, offering encouragement to investors and showing that as few as 10% of mandatorily and voluntarily notified transactions are ultimately escalated by BEIS for more detailed scrutiny (with fewer still subject to measures or remedies), the combination of examples of transactions that have attracted scrutiny and specific sector guidance published around the Act, tell another.

This is particularly notable in the energy sector, which has been the subject of a number of BEIS interventions and which continues to attract political attention. Only this week a government oversight committee highlighted the “very real risk to security” posed by Chinese-backed investments in the UK's energy resources, encouraging the Government to use the powers available to it to curtail this.

This attitude seems to carry across into how BEIS has approached investments into the sector, which BEIS decisions reflecting both a willingness to apply a broad meaning to what constitutes a national security risk: with interventions justified on the basis of: energy supply security; concerns relating to transfer of know-how and technology related to the power sector; and the identity of electricity offtakers; but also a reluctance to adopt any concept of materiality – a recent BEIS decision imposed conditions on the acquisition of a Hong Kong company (XRE Project Alpha), despite its sole UK subsidiary being recently dormant and of modest value.

Further emphasising this expansive approach, guidance released around the applicability of the NSI Act to greenfield downstream gas and electricity projects expands the concept further. Initially, in the absence of any obvious trigger 'acquisition', uncertainty existed as to how the NSI Act treats such projects. With guidance clarifying that a person acquires a right in such projects when it acquires a relevant operating licence, a right to connect to the network or other critical contract, the NSI Act now becomes relevant at the very earliest stages of a project.

Food for thought for investors

One inevitable consequence of the introduction of the NSI Act will be that parties will need to consider long and hard the third parties they decide to align with strategically or commercially, and the potential longer-term consequences of those relationships.

Whether a party is taking in a new equity investor, or raising debt finance, submitting a joint bid for a new project, the risk that the identity of that chosen partner becomes relevant in future should be considered a real one. Whilst the narrative to the NSI Act has always been that the simple involvement of a foreign party or nexus to foreign governments does not in itself create national security risk, it is clear that the involvement of certain countries, connections with sanctioned individuals will exponentially increase the chances of an undesirable outcome.

One area this seems particularly relevant to is the renewable energy sector, where parties bidding for or developing new projects will commonly seek additional partners to manage risk, share financial burden or prove technical credibility. The NSI Act will likely cast a shadow over not only the selection of any preferred bid but also the ability to deliver key operational milestones to relevant projects.

Sellers and parties running competitive processes to attract co-investors will need to be equally attuned to the same issue, with bids increasingly influenced by the bidders’ security risk profiles and not just the financial terms offered.

Written by:

Stephen Woods
Partner, London

Stephen is a partner in our Transactions department, where he leads our London corporate team.

D: +44 204 551 0334
M: +44 7389 777584
stephen.woods@schjodt.com

Interim Early Life Agreements

Introduction

The speed of the energy transition that Europe in particular is undergoing, has over the past 12 months or so led to a proliferation of "early life" agreements, MOUs, research study agreements, co-operation agreements, collaboration, partnering and alliance agreements and so on. Agreements of this type are of course not new, they have been part of commercial contracting practice for a long time now, but the demands of switching to greener energy requires the very rapid development of new technologies and commercial relationships.

Introduction

This development will often be between companies that do not have an established relationship, perhaps most typically between a new "start-up" technology provider and an established energy company or between two established energy companies looking to move into a burgeoning new market and before committing themselves to a long term and potentially complex relationship, they look to test the viability of the technology and its commercial attractiveness through a shorter agreement.

Agreements of this type come in many shapes and sizes. They can be very short "back of an envelope" style agreements or they can be detailed heads of terms stretching to tens of pages that provide a clear pathway to a fully termed agreement. In either case the title of the agreement is, from a legal perspective, unimportant, the distinguishing feature of these agreements is that they are "interim". They are intended to allow the parties to start their commercial relationship, in the expectation that if the relationship develops well, they will proceed to a new, more long-lasting agreement.

It can therefore be tempting to regard such agreements as unimportant and not worthy of too much legal attention. That can however be a mistake. If the underlying commercial relationship is important, then there is value to be obtained from exploring the commercial issues that will arise and structuring and documenting them accurately and clearly and in a way that will facilitate the parties commercial objectives.

The Status of the Agreement

One of the first, and often one of the more difficult issues to consider, is the extent to which the agreement should be legally enforceable. From an English law perspective, there are 3 requirements for a binding legal contract, (1) offer and acceptance, (2) consideration and (3) an intention to create legal relations. These requirements can be met both through an agreement in writing and through an oral agreement, though such oral agreements are relatively unusual in the commercial world.

An offer is an expression of willingness to contract on certain specified terms made with the intention that there will be a legally binding agreement when the offer is accepted. Again, there is no stipulation in English law obliging the parties to sign a written agreement and commercial parties are often "in agreement" to the point of contracting, some time before that agreement is signed. This will often be the case for example in charterparty negotiations where these are conducted on an "accept/except" basis.

An agreement will not however be legally binding unless consideration is provided i.e. something of value is exchanged between the parties. In a commercial context this value will frequently be self-evident. There is no requirement that money be paid or exchanged, and an agreement where the parties provide or exchange services or manpower for the purpose of developing a new technology is likely to provide sufficient consideration for this requirement to be satisfied.

The final requirement is an intention to create legal relations and its corollary that an agreement will not be enforceable if it lacks certainty either because it is too vague or because it is obviously incomplete. This will often be the most complex part of an "early life" agreement because by their nature such agreements are interim. They are intended to document the stage of progress the parties have reached in negotiations with the intention they will in due course be superseded by a more detailed agreement.

There is no contract if the agreement is made "in principle" only and for this reason many MOUs and letters of intent are not legally binding. They represent only a documentation of the progress the parties have been in negotiations, with the intention that this documentation will provide sufficient commercial comfort to both parties to commit the necessary resources to negotiating the full agreement.

The Work

Frequently where the objective of the early life agreement is the development and testing of a new technology, it will be inherent in the agreement that at least one of the parties will be providing manpower and or services for the performance of an agreed scope of work. Here the agreement will need to provide for the scope and timing of the work to be performed, the standard of workmanship, the extent of the resources to be provided and how the work is to be funded.

Terms of this type are clearly capable of being legally enforceable provided there is sufficient clarity and detail to the obligations to be undertaken.

The Next Stage

Generally early life agreements are a mix of enforceable and unenforceable terms, and it will often be sensible to specify which clauses will fall into which categories.

This is relatively straightforward. A more difficult issue however may be the extent to which the agreement can or should specify the terms that will apply during the next stage or even the structure that the joint venture will adopt to market and sell the technology. This will often be a delicate balancing act. On the one hand spelling such terms out in detail will often take many months of discussions, months that could be spent implementing the initial co-operation. On the other hand, spelling such terms out can reduce, significantly, the risk that the parties will be unable to agree the next stage so that the time and money spent on the initial co-operation is wasted.

For this reason, parties will often seek to bridge this gap by including an obligation to negotiate in good faith. Historically English law has regarded contracts to negotiate, whether the negotiations are to be conducted in good faith or through the exercise of best or reasonable endeavours in the same way as "agreements to agree" or contracts to enter into a contract i.e. unenforceable. In Walford v Miles (1992), Lord Ackner regarded an agreement to negotiate in good faith as inherently repugnant because each party in a negotiation is entitled to pursue its own interest so long as no misrepresentation is involved.

In Petromec Inc & Others v Petrobras Brasiliero S.A. and others (2006), the Court of Appeal was willing to regard an obligation to negotiate in good faith as enforceable. However this decision was in the context of an agreement that obliged Petrobras to pay the additional costs of upgrade work in any event i.e. the clause obliged the parties to negotiate those additional costs in good faith but this was a situation where the Court could, if required, determine the appropriate level of the additional costs if such negotiations failed

Exclusivity /LockOutAgreements:

An alternative way of addressing the problem of the agreement being incomplete is through exclusivity or lock out agreements. These do not seek to commit a party to negotiating a full agreement, instead they seek to restrict a party from negotiating a similar agreement with any other party for a prescribed period.

There are obvious difficulties in framing that restriction in a way that is both clear and commercially acceptable. It will often be difficult for example to describe accurately the mechanics of a new technology, the geographical or other ambit of the restriction and sometimes even the type of discussions that are prohibited.

Such restrictions are however in principle enforceable.

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Intellectual Property

One key issue to address in any early life agreement is the ownership of the intellectual property, both the ownership of the intellectual property that each party brings to the venture, and the ownership of the intellectual property produced by the co-operation. Intellectual property in this context will be broader than simply the patent or other registrable rights that accrue from the technology the parties are developing. It will typically also include the full range of proprietary rights, technical information and know-how and will often overlap significantly with a party's confidential business information.

In each case the agreement should consider and set out the position in respect of the ownership, and rights to use, licence and sub-licence the intellectual property owned by each party before the agreement is entered into, and any further intellectual property developed during the period of the agreement. For obvious reasons this part of the agreement should at least be legally binding and enforceable.

The Relationship of the Parties

The agreement should also consider the status of the parties and their relationship, particularly where the parties are contributing in roughly equal proportions to the work being performed. In some civil law jurisdictions, those parties can be treated as if they were operating in a partnership. Under English law however parties acting in partnership or even in concert in a manner consistent with partnership, can find themselves under onerous fiduciary duties that derive from 19th century case law regarding the duties of trustees. Most English law joint venture agreements will therefore specify expressly that the parties are not to be treated as acting in partnership.

Legal Validity

One answer to the problems of certainty and legal validity is to specify in the agreement those clauses that are intended to be legally binding and those that are not. This will usually require the inclusion of both a governing law clause and a dispute resolution clause. Generally speaking (and unless the parties expressly agree otherwise), negotiations between 2 international parties will be governed by the law of the countries in which those parties reside. Discussions between for example a Norwegian company and a Danish company are likely to be governed by the laws of either Norway or Denmark and where there is a dispute as to whether a contract has been formed quite complex conflict of law issues can arise as to which law governs that formation (or otherwise). In these circumstances English law will only apply if it is clearly specified in the agreement.

Written by:

David Gardner
Partner, London

David Gardner is a partner in the London office of Schjodt, the partner responsible for that office and one of the editors of this newsletter (editor and early life)

D: +44 208 078 9497
M: +44 777 166 5372
david.gardner@schjodt.com

Shipping Corner – Case Summaries

K Line Pte Ltd v. Priminds Shipping (HK) Co Ltd

[2021] EWCA 2373 (The "Eternal Bliss")

This dispute arose under a voyage charter for the carriage of soybeans from Brazil to China. Discharge was delayed at the disport by 31 days and, once the cargo was discharged, it was mouldy and caked through. Owners sought to recover the costs of settling the cargo claim from charterers, but charterers contended that demurrage was owners' exclusive remedy and that charterers should not be liable for any further damages.

The Court of Appeal overturned the first instance decision of Andrew Baker J and held that the meaning of the term "demurrage" had a broad meaning and, in the absence of an indication to the contrary, demurrage "liquidates the whole of the damages arising from a charterer's breach of charter in failing to complete cargo operations within the laytime." The Supreme Court has granted owners permission to appeal.

Unicredit Bank v. Euronav NV

[2022] EWHC 957

Unicredit financed the purchase by Gulf Petroleum ("Gulf") of LSFO from BP Oil International Limited ("BP"). Euronav (as owners) discharged the cargo without production of the bill of lading as they were permitted to do under the terms of the charterparty. The sums financed by Unicredit were not repaid by Gulf. Unicredit, as the lawful holder of the bill of lading, brought a claim in damages for breach of contract said to be contained in the bill of lading on account of Euronav delivering the cargo without production of the bill of lading.

Moulder J dismissed the claim. She held that the bill of lading did not contain any contract of carriage at the time of discharge and, even if the bill of lading had contained a contract of carriage at the time of discharge, the discharge of the cargo without production of the bill of lading did not cause the loss claimed.

The CMA CGM Libra [2021]

UKSC 51

This dispute arose out of the grounding of a container ship. Owners claimed general average from cargo interests who then denied liability on the basis that defects in the vessel's passage plan rendered the vessel unseaworthy.

The Supreme Court confirmed that the defective passage plan rendered the vessel unseaworthy. The Court held that if a vessel is unseaworthy, it makes no difference whether negligent navigation or management is the cause of the unseaworthiness or is itself the unseaworthiness. The relevant question is whether a prudent shipowner would have sent the vessel to sea with the relevant defect without requiring it to be remedied. The Court also reaffirmed that the carrier's obligation to exercise due diligence to make the vessel seaworthy requires that due diligence is exercised in making the vessel seaworthy, regardless of who is engaged to carry out that task.

FIMBank plc v KCH Shipping

Co Ltd [2022] EWHC 2400

This dispute related to a claim brought by Fimbank, as the holder of the bills of lading, for the alleged mis-delivery of cargo by the contractual carrier, KCH. The bills were subject to the Hague-Visby Rules, including the time-bar in Article III, rule 6. Fimbank served a Notice of Arbitration on KCH after the time-bar expired. Its position was that that its claim was not caught by the time-bar because (a) the delivery took place after discharge and (b) as a matter of law, the time-bar did not apply to claims for mis-delivery occurring after discharge.

The Court held that Fimbank's claim was time-barred irrespective of whether delivery post-dated discharge. The Court concluded that, as a matter of true construction, Article III, rule 6 of the Hague-Visby Rules applied to claims for mis-delivery of cargo after discharge. This conclusion avoided the need for distinctions as to when discharged ended and accorded with the objective of the rule which was intended to achieve finality and help the shipowner clear its books.

Kyla Shipping v Freight Trading Ltd

[2022] EWHC 1625

The dispute arose out of a series of freight forward agreements (FFAs) entered into in 2007 and 2008 between the first claimant and first defendant. The claimants alleged that there had been a fraudulent breach of fiduciary duty, causing the first claimant to suffer losses in excess of over USD30m. The defendants denied liability and contended that the claim was time-barred.

Andrew Baker J concluded that the time-bar defence should succeed. S.32 of the Limitation Act 1980 applied which provides that where a claim is founded on fraud, the period of limitation shall not begin to run until the plaintiff could with reasonable diligence have discovered the fraud. The claimants could, with reasonable diligence, have discovered the purported fraud far earlier than they did. The claim was dismissed in full because it was time-barred.

Schjødt acted for the successful first defendant.

Herculito Maritime Limited & others -v- Gunvor International BV & others

(The "Polar")

[2021] EWCA Civ 1828

This dispute concerned a claim by owners of the Polar for a contribution in general average ("GA") from cargo interests, which took the form of a ransom payment paid to pirates to secure the release of the vessel. The underlying charterparty included war risks clauses. These clauses provided that any additional premium for war risks would be for charterers' account. Cargo interests argued that they weren't liable to contribute to GA because the bills of lading incorporated the charterparty terms, and the charterparty terms conferred on them the benefit of the war risks.

A London arbitral tribunal initially found in favour of cargo interests. Owners successfully appealed to the Commercial Court and cargo interests then referred the dispute to the Court of Appeal. The Court of Appeal held that the widely drafted incorporation of the charterparty into the bills of lading was not sufficient to draw in the war risk clauses, with the effect that owners would be deprived of their claim for GA contributions from cargo interests. It would also not be appropriate to manipulate the terms of the bills of lading to render cargo interests liable to pay for additional war risks / war risk premium, which at the same time would amount to a general waiver of owners' right to seek a GA contribution.

SK Shipping Europe Ltd v Capital VLCC 3 Corp and another company

(The “C Challenger”)

[2022] EWCA Civ 231

The dispute arose out of alleged misrepresentations made by owners of the C Challenger to charterers regarding the vessel's fuel consumption capabilities. Owners circulated the vessel's speed and consumption figures to the market in order to find a long-term charter and the charterparty then contained consumption warranties in the standard form. Throughout the charter period, the vessel's fuel consumption exceeded the warranted levels. The charterer initially asserted that the consumption capabilities had been misrepresented and reserved its rights and then purported to rescind the charterparty several months later.

The Commercial Court found in owners' favour. The Court of Appeal then upheld the decision of the Commercial Court and held that owners had not made any representations as to the vessel's future or expected performance. It also confirmed that an offer to contract will not generally be regarded as amounting to a representation about future performance. The Court of Appeal also held that by continuing to perform the charterparty for several months after raising the misrepresentation argument, charterers had affirmed the charterparty and lost the right to rescind.

Shipping Corner – Case Summaries

MUR Shipping BV v RTI Ltd

[2022] EWHC 467

The dispute concerned the construction of a force majeure clause included in a contact of affreightment, which provided that an event would not constitute a force majeure if it could be overcome by the affected party's "reasonable endeavours". Owners invoked the force majeure clause on the grounds that US sanctions imposed on the charterers' parent company would prevent owners being paid in US dollars, as required under the contract of affreightment. Charterers claimed that, in refusing to accept an offer of payment in Euros, Owners had failed to use "reasonable endeavours" to overcome the effect of the US sanctions and could not rely on the force majeure clause.

Charterers succeeded in their claim at arbitration and owners challenged the award. The Commercial Court held in favour of owners. Charterers obtained permission to appeal. The Court of Appeal held in favour of charterers that the "reasonable endeavours" obligation to overcome a force majeure event ultimately required owners to accept non-contractual performance and that owners should have therefore accepted payment in Euros.

Trafigura Maritime Logistics Pte Ltd v Clearlake Shipping Pte Ltd

(The "Miracle Hope (No.5) [2022] EWHC 2234 (Comm)

The Miracle Hope was subject to a complex chain of time and voyage charterparties. The vessel was arrested in Singapore by a trade finance bank for alleged mis-delivery of a cargo of crude oil. Discharge occurred without presentation of the original bills of lading. This was permitted because indemnity provisions, which covered potential claims against the vessel from lawful holders of the bills of lading, were included in the charterparties. The dispute concerned the enforcement of indemnity claims down the charterparty chain in the region of USD 80 million.

The Court held that, on the true construction of the materially back-to-back voyage charterparties, deemed indemnities had been given comprising a combination of charterparty terms and International Group P&I Club standard wording ("IG Wording"). HHJ Pelling KC concluded that, whilst there was a distinction between "discharge" and "delivery", no such distinction could be drawn from the facts. The Court further held that on construction of the IG Wording, only losses that were in the reasonable contemplation of the parties were recoverable, as would be the case in a typical claim for damages.

Schjødt acted for the successful claimant.

Written by:

Hector Witt
Senior Associate, London

Hector focuses on dispute resolution and advising clients on a broad range of shipping, energy and commodity trading matters.

D: +44 208 078 9504
M: +44 788 794 1438
hector.witt@schjodt.com

Rebecca Coates
Associate, London

Rebecca focuses on dispute resolution advising a range of shipping clients on charterparties, bills of lading, cargo claims, shipbuilding disputes and sanctions compliance.

D: +44 208 078 9498
M: +44 738 976 5124
rebecca.coates@schjodt.com

schjodt.com