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Not in Kansas any more

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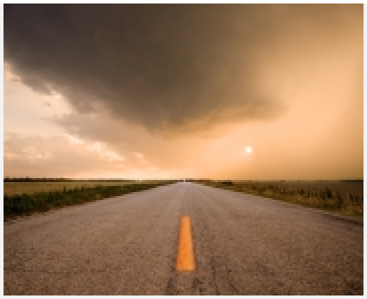

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There's no return to Kansas for the bunker industry

In the classic 1939 Wizard of Oz movie, a tornado has just hurled Dorothy, her dog Toto and their house into the strange land of Oz. Dorothy opens the house door to see a technicolor world of Munchkins, at least one talking lion and a wicked witch. Dorothy takes this in and then famously says to her dog, "Toto, I've a feeling we're not in Kansas anymore."

In the first part of 2014, the world bunker industry lived comfortably in its own Kansas. Crude prices were $108/barrel, a level that supported what was one of 2014's most significant initial public stock offerings (IPOs) and one of Denmark's largest ever, for bunker trader and physical supplier OW. Just before the IPO, OW's apparent strength led a consortium of lenders to extend a $700 million credit line to OW.

Then, just about 10 months later in the first part of November, 2014, with crude prices moving to below $70/b, OW announced that it was insolvent. The lenders consortium had extended OW at least $650 million of their $700 million credit line, and stopped extending OW credit, having already restricted it weeks before. OW, as has since transpired, had weeks before gone from extending its time for paying its trade creditors (who were mostly petroleum suppliers) to not paying them altogether. In doing so, OW made its trade creditors part of its overall credit facility. Consequently, the OW Group by vending product which it never paid for had accumulated about $1.2 billion of receivables at the time of the insolvency. The lenders consortium now claims all of these "receivables" and insists they are not subject to offset from the suppliers whose product, OW never paid for.

There now are at least 837 legal actions around the world arising out of the worldwide OW collapse. They range from bankruptcy proceedings, to interpleader cases (where shipowners deposit funds in court for leading lending consortium member ING and suppliers to fight over), toLondon arbitrations (demanded by ING through OW's sales terms' London arbitration clause), to vessel arrests and asset attachments.

RUBY SLIPPERS

If you remember the Wizard of Oz, you will remember the ruby slippers. The wicked witch wanted the slippers, and so did Dorothy because the slippers would get their wearer back to Kansas. One way to characterize the legal actions around the world is that they are a struggle to get the slippers. Developments over the 15 months since OW's first insolvency filing, however, show that there's no return to Kansas for the bunker industry or those related to it.

The first part of the "geography" OW has changed, is that physical suppliers now will focus on security to assure payment. Before November, 2014, for example, there were rarely if ever questions about whether a bunker broker or trader had, prior to a bunker provision, actually paid its physical supplier. Physical suppliers usually were content - particularly with an apparently well-capitalized trader like OW - to extend traders credit with the understanding that the supplier would be paid at about the time the trader's customer paid the trader. Physical suppliers were almost never concerned about whether they would have to arrest the vessels they supplied, or look hard at the security that their traders (and traders' customers) were giving them in exchange for providing often very significant quantities of product, on credit.

The "Oz" that physical suppliers now inhabit requires them to have sales terms and conditions which reinforce their right to arrest vessels if unpaid. Suppliers also must insure that no other entity has competing claims to the suppliers being paid. They must pay close attention to their sales terms which allow them to retain title over the product they sell until they are paid. Making those sales terms effective requires informed legal advice about what law should control title retention. UK law still gives strong title retention rights, but US law extends some of the world's strongest legal rights to the arrest of vessels. Effective suppliers' sales terms now should include careful choices of both law, UK for title retention, and US for vessel arrest and maritime liens.

TRADING INDEPENDENCE

In Oz, the Munchkins, helped by the Wizard, end up regaining their freedom from the wicked witch. Physical bunker suppliers, of course, have not had the same hard relationship with traders, but, in the new Oz of bunkers, more still may move to operating independently of traders.

Interestingly enough, the regime of physical suppliers selling through brokers and traders is relatively new (at least as it relates to the history of shipping). It started about 1973 with the OAPEC oil embargo. Before that, physical suppliers had sold directly to vessel owners and charterers subject to long-term sale contracts, fixing a price for bunkers for a number of months or longer. The 1973 embargo caused oil prices to spike and physical suppliers to cancel their supply contracts. Vessel owners and charterers had to buy fuel on the open market, and brokers and traders appeared to serve them. Physical suppliers were glad to have these brokers and traders consolidate their sales and be concerned with taking the main risk of extending credit to sometimes risky vessel owners and charterers.

Now, however, the riskier customers for physical suppliers may be the brokers and traders. This is particularly so where the brokers and traders, like OW, have in turn pledged their receivables to secured lenders. In fact, it will be a rare broker or trader which has not made such a pledge. In the event that a trader or broker stops paying, the physical suppler therefore will have to square off with the secured lender, both contending over very few actual hard assets.

Vessel owners and charterers, on the other hand, because of the OW insolvency now face competing claims by OW's claimed secured lenders - the ING-led consortium - and unpaid physical suppliers. The defense of these claims has been very expensive for owners and charterers. It therefore makes sense for some owners and charterers to do business directly with physical suppliers. If the owner or charterer doesn't pay, the physical supplier will have more direct recourse for payment; if the physical supplier becomes insolvent, there should be only one place where the owner or charterer has to pay: the supplier's bankruptcy estate. At least for some customers, credit management for physical suppliers now is more straightforward than ever. Consequently, physical suppliers will likely now seek to establish direct customer relationships with owners and charterers, independent of brokers and traders.

NEW REALITY

Chasing the “ruby slippers” has been expensive for all involved, including OW’s lenders. Before 2014, few lenders to brokers or traders looked past the per-barrel oil price and margins successful bunker brokers and traders were making. They did not consider that relatively risky nature of the bunkers business, turning on security against things that float between different world jurisdictions, sometimes sink or disappear, and that are worth amounts that fluctuate depending on world commodities demand or even, the price of the fuel that the lenders are financing. Investing in ships themselves is risky enough for the average banker, but OW has shown financial institutions vividly that investing in bunker brokers and traders is probably a bridge too far.

On the one hand, the withdrawal of financial institutions from finance for bunker brokers and traders, could be more reassuring to physical suppliers who will be less likely to contend with secured financing, if a broker or trader collapses. At the same time, it will compel physical suppliers themselves to extend more credit including likely to more financially risky owners and charterers, who the physical suppliers before would rather have sold to through brokers and traders. Either that will occur or the physical suppliers will find themselves deciding whether to extend greater credit lines to brokers and traders, and then investing in credit management of those brokers and traders as intensively as the banks that the physical suppliers have replaced.

Many well-capitalized vessel owners and charterers have, from OW, learned that there is a cost of dealing with brokers or traders which are financially stretched. In the new Oz of bunkering, well capitalized owners and charterers will, therefore, seek out suppliers (which can include well-capitalized traders and brokers) who they can be assured, are in turn paying their customers and will not cause those owners and charterers another “OW problem.” It therefore will become more difficult for new traders and brokers to enter the market, or for less known or more thinly-capitalized traders and brokers to remain in the market. New or less-capitalized brokers and traders will have to sell to riskier customers. But, at the same time there may be fewer new or less-capitalized brokers or traders, as fewer physical suppliers will extend credit to them and less financial institutions will take a risk on them.

When producers made the original Wizard of Oz movie, they felt it ran too long; they cut 20 minutes from it to make the version now considered classic. All involved can agree on one thing, that the OW-related litigation already is over-long, but it is likely to continue for at least several years or longer to come. To put this into context, after the Titanic capsized in 1912, the related litigation extended into the 1920s. Observers of maritime history mark the Titanic capsizing as an event which pushed shipping to a new world, never to return to the old. The OW insolvency has done the same for the bunkering industry, as the litigation related to the insolvency plays out. The industry is not in Kansas anymore, and will never be again.

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