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BUNKERSPOT

# THE END GAME

## THE RISE AND FALL OF OW BUNKER

# Look and learn

## The global bunker industry is still reeling from the impact of OW Bunker's exit from the market. Steve Simms of Simms Showers takes a measured and incisive look at the lessons to be learned from recent events

The collapse of OW Bunker at the beginning of November 2014 left some 150 bunker traders, brokers and supplier creditors of OW companies around the world owed a reported collective $80 million – the eventual figure may be more.

This figure does not include the further amounts owed to smaller marine fuel industry creditors, and this may well increase the OW indebtedness impact of the collapse on the marine fuel industry to $200 million or more. Some of the best known and, at the time, best-capitalised companies in the global bunker industry have been affected by OW's collapse. They range from physical suppliers to brokers, traders, and direct competitors of OW companies which had participated in trades with OW.

Before November this year, OW companies were regularly reported to be underselling much of the market, even as petroleum prices dropped. OW had risen rapidly to hold about a 7% share of the global market for marine fuel, and leading physical suppliers, brokers and traders all sought to share in what appeared to be OW's success and profitability. Because it seemed that almost everyone in the marine fuel industry was doing business with OW, then undertaking business with OW seemed to be a relatively good risk. To be clear, for some it was. One source shows that the OW Group's largest 150 creditors had done business with the group in a volume over an unspecified time period of nearly $80 billion. A $200 million loss at the time of OW's collapse, however, remains significant.

The next months and years will confirm whether the OW collapse has been a turning point for the marine fuel industry. The event may well serve to highlight forces which have been building in the industry for years. The fact is that today's marine fuel industry is not the industry of ten or even five years ago. There are lessons which bunker traders, brokers and suppliers should learn now from the OW collapse, to embrace present industry realities.

Now, well over a month after the OW Group collapse there are at least nine lessons to be learned from the event for the bunker industry. There certainly will be more lessons to to taken onboard as the causes of the collapse become even better known.

### Lesson 1: Economics happen in all industries – the bunker sector included

There is a notion that because of the perceived historic community of maritime commerce, in some way the economics of the bunker industry is different from that of other industries. 'Trust me' somehow in the maritime industry becomes a greater value than 'trust, but verify'. The OW collapse shows that the bunker industry, despite its relatively close relationships, is not independent of rational economic analysis and straightforward 'due diligence'.

Just six years ago, in 2008, there was a collapse similar to OW's, although in a different industry. Lehman Brothers had apparently achieved significant success in the market for sub-prime real mortgages. It had borrowed significant amounts to fund investments in assets related to the housing market, making it vulnerable to a decrease in market values. There was very little spread between the values at which it bought real estate assets, and its borrowing rates to acquire the assets. As an investment bank, Lehman Brothers was also substantially unregulated, unlike depository banks. The institution had generated significant profits during the time that its real estate assets were relatively highly valued, but it plainly disclosed in its public financial disclosures and offering statements that if the value of those assets fell, so also would Lehman Brothers.

Faced with the deterioration of the value of its assets, Lehman Brothers sought emergency financing and potential buyers. Unsuccessful in these efforts, it filed for Chapter 11 bankruptcy in September, 2008. The Lehman Brothers' bankruptcy had a vast impact on the world real estate market, leading to a market downturn which, to some extent, continues today.

Significantly, just like the potential difficulties with the Lehman Brothers' investments, the difficulties in OW's business model were disclosed as early as its initial public offering (IPO) prospectus. That prospectus was part of what became the second largest initial public offering in Denmark since 2000. With the relatively high marine fuel prices at the time, the offering appeared very attractive to many investors, particularly to those institutional investors looking for a higher than standard market yield and who may also have barely understood what a bunker was.

The OW Bunker IPO prospectus, however, disclosed significant risk, including the following:

> *The overall risk limit set in our Marine fuel and Marine fuel component price risk management policy is defined by a maximum net open (unhedged) position for the group. Currently, the maximum net open position approved by the Board of Directors is 200,000 tonnes.*

The document continued:

> *We change our hedge position daily to offset movements in our inventory, sales and purchases, which has supported our stable financial results in recent*

*years despite the volatility in marine fuel prices… While our business model and risk management said system are designed to estimate our sales and secure appropriate hedging, **our risk management tools may be inadequate** [my emphasis] and we may overstate or underestimate the underlying risks and, therefore, not secure appropriate hedging.*

Somehow, 150 marine fuel industry creditors of OW chose not to read or at least credit this clear warning as they watched the price of oil drop significantly into the third and fourth quarters of 2014. Instead, they overlooked the warning, overlooked the obvious operation of basic economic fact (lower value assets, less profit and thus decreased ability to repay debt financing), and relied on the industry standard. 'trust me'.

Lesson 1, therefore, is, 'trust, but verify'. With that read, now ask some questions – and one key question should be: 'Prices are dropping; what are you going to hedge?'

### Lesson 2: Read each others' mail

There can be few other global industries where large amounts of money fly by wire on not much more than an email or two, between people who believe they know each other, but frequently do not.

There are now a good number of excellent counterparty research firms with experienced researchers (or you might call them 'mail readers') who know the marine fuel industry and have good contacts across the sector. They, at a relatively low cost, can provide valuable information about potential trading partners, the risk that they are bearing (including their debt burden), and their abilities to pay.

Some of these firms were issuing cautions about OW well before the collapse (just as some analysts warned about Lehman Brothers before its collapse). Again, the marine fuel industry is like any other industry in the economy. Relationships are important, but the economic facts behind them are more important. Remember, the purpose of looking into the relationship is to assess economic risk. It is entirely different from esteeming your friend, or buying him or her a drink.

There are also a smaller number of law firms across the world that work with a range of marine industry creditors. They are aware of trends and market movements, which are significant in assessing the risk and advisability of marine fuel transactions. Legal risk, including the possibility of recovery if a transaction goes wrong, is an important part of 'mail reading'.

Lesson 2, therefore, is to use trusted advisors. Because of their access to information which you (must admit that you) do not have, they will help you make the best choices about credit and counterparty risk.

### Lesson 3: Verify trust

If Lesson 2 is 'trust but verify', then Lesson 3 is 'verify trust'.

The main losses in the OW situation may be called 'downstream losses'. They were, and are, entirely avoidable.

In the case of direct sales to vessel owners or charterers, when there has been the need for vessel arrest (where the charterer or owner didn't pay), then the supplier, trader or broker in direct contact with the owner or charterer has looked to its sales terms and conditions along with the direct provision to the vessel.

The OW situation, however, typically involved the sale from a physical supplier and, depending on the magnitude of the financial transaction involved, one or two brokers or traders, through to the OW entity, which then had the direct contractual relationship with the vessel owner or charterer.

In each of the 'downstream' transactions, between the OW entity and then back to each broker or trader, and then to the physical supplier, each, to varying degrees of success, purported to incorporate into the transaction the same sales terms and conditions that the supplier, broker or trader would use to sell directly to a vessel charterer or owner. This makes no direct sense.

In most marine legal systems of the world, it is, by general rule (to which, there are multiple exceptions), only the entity which directly contracts with the vessel owner or charterer – which holds the right to arrest a vessel when the owner or charterer fails to pay for the marine fuel provide to the vessel.

At the same time, if the direct contracting entity gets paid, but the 'downstream' brokers, traders or suppliers don't, then those 'downstream' entities may never be paid and may never have rights to arrest the vessel and be paid, under what are their 'standard' sales terms and conditions, drafted for direct transactions with vessel owners or charterers.

Consequently, Lesson 3 is that for 'downstream' transactions where, for example, a physical supplier is selling to a trader or broker, which then is selling to the entity, which sells directly to the vessel charterer/owner, the sale should be subject to different terms and conditions – unique to the transaction.

First, the sales terms and conditions should make clear that the 'upstream' entity, which owes the funds, is acting as the trustee and collection agent for the funds owed to the 'downstream' entity. For example, in a transaction between a physical supplier and a broker, the sales terms and conditions should provide that the physical supplier is collecting, receiving and holding until paid, funds which are the property of the physical supplier. They should further provide that it is the responsibility of any 'upstream' broker or trader to assure that any further 'upstream' from them has accepted (by sales terms and conditions or otherwise) the responsibility of being the collection agent and trustee, from any further 'upstream' broker or trader.

Why is this important and does it makes all the difference? Because, otherwise, entities claiming security interest in, or assignment of, 'receivables' of an ultimate supplier, broker or trader (as OW entities were in many instances) can claim that any money to be paid from charterer or owner customers to that ultimate entity belong to the entity holding the security interest or receivable assignment. If each entity in the line of supply is the agent of those down the line, however, that makes it plain that the receivable is not the property of the secured or assigned financing party (or any insolvency estate). Instead, the funds received are the property of the 'downstream' broker and/or physical supplier, and must, regardless of security interest, assignment,

> 'These suppliers, traders or brokers had nothing in their sales terms and conditions providing that they could immediately accelerate the right to payment if OW became financially insecure'

or insolvency, be released to the trust/agency beneficiary (physical supplier or broker) which has the property right in the receivable.

Second, where there is an 'upstream' sale involved to an ultimate, direct seller to a vessel owner or charterer, there should be an assignment of any right of arrest.

The sales terms and conditions should provide that until there is full payment received, in exchange for the custody (but not title, for reasons which will next be explained) of the product sold, the 'downstream' supplier, broker or trader receives the right to arrest the vessel, under the applicable law, from the entity ultimately in direct contract with the vessel owner or charterer.

At the same time, the sales terms should require that any 'upstream' supplier require the same from any further such supplier, broker or trader, so that the right of arrest extends back to the ultimate, physical supplier to the vessel.

If the vessel charterer or owner has not paid the entity directly, contracting with them to supply the vessel, then those 'downstream will have the assigned right to arrest the vessel.

Third, in all sales terms and conditions between 'down and 'up' stream marine fuel suppliers, brokers and traders, there should be terms that state that the 'upstream' provider is the agent of the charterer, master, operator or agent of the vessel which ultimately receives the marine fuel. This reinforces the right of the unpaid 'downstream' supplier to arrest the vessel, claiming that it was, by reason of agency, the direct provider of the marine fuel to the vessel.

Fourth, marine fuel sales terms and conditions should provide that the provider retains title to the fuel, until the provider receives the fuel price. This is different than the right of possession and custody of the fuel. Title, however, allows the downstream provider to claim, if the fuel is not paid for, that it may reclaim the fuel and detain the vessel on which the fuel was loaded (whether for consumption or sale). There is an industry perception that title retention may lead to environmental claims liability in the event of a spill or some similar event. However, the benefit of title retention for recovery in the situation of unpaid fuel supplies, in most occasions, has far overcome the risk of an environmental liability claim.

Fifth, sales terms and conditions can provide for security interests. If the sale is in the United States, such interests must be perfected (basically, made legally confirmed) by a properly-filed Uniform Commercial Code (UCC) Form '1'. In other jurisdictions, they can be perfected by a non-public agreement. But, sales terms and conditions can provide that when there is a sale, the seller takes a security interest in any receivable from the sale and any other receivable of the buyer. Even if the interest taken might later be subordinate to an earlier interest, should the buyer (like OW entities) enter insolvency, that still may be an interest paid in priority to other interests.

Sixth, sales terms and conditions for 'upstream' sales should provide for access to financial records, trading (including hedging) records, sales terms and conditions, invoicing, etc. There is nothing wrong about transparency. Read the mail, and be open to others reading yours. If the presumption of the marine fuel industry to date has been mutual trust, then transparency furthers that.

Competent legal counsel, who understand the present state of the marine fuel industry, can help you draft and implement distinct 'upstream' sales terms and conditions, appropriate to (and necessarily different than) the sales terms and conditions you may (or should) use for direct fuel supplies to vessel owners or charterers.

So, in short, the summary of Lesson 3 is, when selling to 'upstream', but not ultimate receivers of marine fuel, use different sales terms and conditions, incorporating terms like those above.

## Lesson 4: Don't be handcuffed

The recent opinion of the Singapore High Court in *The STX Mumbai,* [2014] SGHC 122, shows the inadvisability of difficult to counteract, time-payment terms, that otherwise handcuff swift action by bunker suppliers, brokers and traders.

In brief, the fuel provider to the *M/V STX Mumbai*, like all at the time to STX vessels, noted the STX Group's collapse and correctly anticipated that STX would not be able to pay the supplier. Even though the invoice to STX was not due (the time from supply to payment due date was less than the 30 day terms), the bunker supplier nevertheless arrested the vessel.

The fuel had been supplied, and to this date, apparently, has never been paid for. Nevertheless, the Singapore High Court held that STX had an action for wrongful arrest, because the supplier prematurely (before the payment terms had run on the invoice) arrested the vessel.

Many suppliers, brokers and traders involved with the OW situation, when OW's dire financial situation arose, were in the process of fulfilling deliveries as a part of contracts with OW or had provided fuel to vessels through orders related to OW, but the time for paying the invoices for that fuel had not run.

These suppliers, traders or brokers had nothing in their sales terms and conditions, providing that they could immediately accelerate the right to payment if OW became financially insecure. Therefore, they risked the same situation as the marine fuel provider to the *M/V STX Mumbai*. That is, even if it was plain that OW (or the vessel owners or charterers) never would pay them, the providers to the vessel faced wrongful arrest because of the very own handcuffs that they had placed on the timing of their right to payment.

Now, when (as there certainly was at the beginning of November 2014 with OW) there is reasonable grounds to expect insecurity of payment, most legal systems allow the seller to demand, within a reasonable time, what may be referred to as 'adequate assurance of performance'. This still leaves open for contention, however, what is a 'reasonable time', and what is 'adequate assurance'.

Firm time periods for payment unreasonably handcuff what may need to be a real-time reaction to insolvency. For example, in the OW situation, there first was the Denmark probate court insolvency. At the time, it could be assumed that other insolvency proceedings would follow, and this has since has proved to be the case. In such a situation, sales terms must not handcuff affirmative actions, including the arrest of vessels and attach assets.

Consequently, Lesson 4 is make sure that your sale terms and conditions provide for immediate action, if you, in your own judgment (hopefully, with the benefit and awareness of Lessons 1-3 above) believe that you are financially insecure. It is not an exaggeration to say that seconds can make the difference between a great loss and a manageable one, and there is no reason for the delay and loss to be any more of your own making.

## Lesson 5: Be nationally (legally) sensitive

The OW Group has, and had (not all at the time of writing are involved in insolvency proceedings), at least 29 subsidiaries and affiliates across the world. Until the collapse, all roads led to Copenhagen. OW represented itself to be one relatively unified sales and receivables entity. Now, there are any number of OW entities (United States, Dubai, Malta, Spain, Singapore) declaring their legal independence, and to a notable extent, they are right to that to take that position.

Providing bunkers to a vessel in Singapore in contract to a Singapore company does not give you the same security rights as providing to a vessel in the United States through

> 'Recognise that you are operating in one of the relatively most financially risky industries in the world'

a US company. In the former, a bunker provider (with the adequate sales terms and conditions, discussed above) might have an arrest arrive if the vessel has the same owner and charterer as it did at the time of supply. In the United States, in general, it doesn't matter: there is an arrest right *in rem*, whether the same owner or charterer at the time of supply exists at all at the time of arrest.

The point of Lesson 5 is to look to whom, and where, you are selling. And look very closely – the logo of the letterhead of your customer's conformation may be the in the same colours and graphics as the (hypothetical) 'Reliable Bunkers Company' you last sold to in the United States. In fact, the sale may be to some affiliate in a jurisdiction where you would have no vessel or other arrest rights.

So, pay close attention when you make, broker or supply a vessel to the law that applies. Some courts will recognise your sales terms and conditions and the choice of law. Some, however, will only look to the vessel flag, some will look to the nationality of the vessel owner or charterers (and some will just do what they want to do). Legal counsel who are familiar with world vessel arrest jurisdictions can, again, be essential to assessing the risks involved.

### Lesson 6: Not all sales support vessel arrests.

In general, world vessel arrest regimes only allow arrest where the vessel has needed or used the marine fuel provided to the vessel to operate the vessel. Where the supplier has provided the fuel as cargo to the vessel, there is no right to arrest the vessel, because the vessel has not needed the fuel to operate.

Consequently, where physical suppliers have sold fuel to OW, which OW has used only to sell, and not consumed (for example, on tankers which OW has filled to fuel other vessels), the physical suppliers cannot arrest the vessel. Instead, they must have (as set out above) been able to claim that they have (before what otherwise is the end of the time payment term) ended the sale contract, and had a right to reclaim the fuel.

So, Lesson 6 of the OW situation, for sellers of inventory to upstream suppliers, is that, first, you must retain title (until payment) to the product, insist that all upstream suppliers be your collection agents and trustees (and verify that in their sales terms/conditions), and insist that you are the transferee of all arrest rights over the vessel to which your product is provided, until payment. Without this you may not have a right of payment – at least from the vessel to which you provided your product, or from the charterer which ordered it from its direct trader or broker.

### Lesson 7: Hedge

The ultimate OW problem (as it was with the case of Lehman Brothers) is that hedging, as it turned out, was inadequate.

The reference to 'as it turned out' is important. That is, one can go to the casino roulette wheel, place a series of $1,000 bets, hit every time and make a multiple of the bet placed, or lose all of it. At some point, the skill of the gambler runs short of the pure odds, and that's where the casinos make their money. What the casinos lack is the ability to reclaim the shortfall of the declining real estate market that Lehman Brothers experienced, or the experience of OW with a falling oil market.

So the answer is hedging. It is not complicated; it can be as simple as buying credit insurance. The term 'hedging', at its simplest, means taking measures to reduce risk. Just as you buy your home, car and life insurance, and make deposits into a bank which insures those deposits, hedge your risk. Recognise that you are operating in one of the relatively most financially risky industries in the world. A sale on a handshake and relationship is good in many respects, but it also literally can, and may, sail away.

### Lesson 8: This is a new world for the bunker industry

We can reach each other in multiple ways on a 24/7 basis. We can send a message with a payment confirmation and respond with payment instructions, electronically and instantaneously, and we believe that the promises of those we email (but may never have met or even spoken with) will be sufficient to receive or send millions of dollars.

In the marine fuel industry, it is imperative to recognise that the 'new world' has been here for some time – before it was convenient, or necessary, for us to recognise it. There are new challenges in achieving profit which overlook the relationship on which the bunkering community historically has depended.

The point of the Lesson 8 is that, this is not your father's bunker market. It moves fast. It turns mainly on profit, not relationship. Its funding comes from sources which do not differentiate between vessels, aircraft, hogs or grain.

These sources do not care to know about the details of the market – it is up to you to know the details and to assess your risk, including ( remember Lesson 2) with trusted advisors – and incorporate sales terms into how you sell, and which are right for you and your customers. Customers which question these terms, deserve your questions.

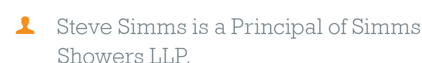
### Lesson 9: Keep learning

All of this is not to say that no one should have done business with OW companies. Remember that OW Group's largest 150 creditors had done a volume over an unspecified time period of nearly $80 billion of business with OW.

However, at the same time, OW's IPO prospectus very openly and publicly warned that there would be significant financial losses 'if our employees fail to comply with our policies and procedures with respect to hedge trading undertaken on the basis of our risk management positions, for example by failing to hedge a specific financial risk or to observe limits on exposure'.

Even considering this, doing business with an entity such as OW will still be an acceptable financial risk. But only if suppliers, traders and brokers doing so learn from the present lessons emerging from the OW collapse, and take steps to put them into action.

Just as the Lehman Brothers collapse flagged up a change in the US securities industry which had been developing long before the common media recognised it, the OW collapse may serve to highlight the changes in the marine fuel industry which had occurred long before the demise of OW. Let us hope that the bunker industry will acknowledge the present realities, benefit from at least the nine lessons outlined above (with surely more to come from the OW situation), and not find itself needing to re-learn them a second time.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