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Contents

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WHY GERMAN K/G FUNDS CAN NOW LEASE U.S. FLAG ASSETS

By H. Clayton Cook, Jr. of Seward & Kissel LLP

Editor's note: In his Marine Money January 2003 article "Lease Financing for Vessels Engaged in the Coastwise Trades," Mr. Cook examined the origins and status of the 12106(e) controversy, and the difficulties being experienced by maritime financing counsel in providing transaction opinions. In this article Mr. Cook reviews the text of the Coast Guard's February 4th Final Regulations and concludes that they contain "safe haven" qualification rules for financial institutions that, when coupled with restrictions on non-financial institution ownership and intra-group vessel leasing, will provide significant new vessel lease financing opportunities for U.S. section 2 citizen, and 12106(e) qualified non-citizen, financial institutions in the U.S. coastwise trades.

BACKGROUND

For many years U.S. citizen operators in our domestic trades seeking to acquire vessels in lease financing transactions have been limited to leasing companies that met the citizenship requirements of section 2 of the Shipping Act, 1916 (the "1916 Act"). This limitation prevented U.S. domestic operators from accessing many non-citizen banks and financing sources that were actively engaged in vessel leasing elsewhere in the world. Congress acted to remedy this situation in the Coast Guard Authorization Act of 1996 (the "1996 Act"), amending section 12106 of title 46 U.S. Code, by adding a new subsection (e), that permitted foreign ownership of vessels that were demised to U.S. citizen operators for a period of at least three years lease financing transactions.

While 12106(e) was intended to provide U.S. citizen operators with new financing sources, the section was soon employed by non-citizen affiliated groups in transactions where the non-citizen owner and the U.S. citizen operator agreed that the vessel would be time chartered to another member of the non-citizen owner's affiliated group, so-called "owner-user" or "charter-back" transactions. While the charter-back participants believed that these transactions were authorized by 12106(e), some U.S. citizen owners and operators did not. As the number of charter-back transactions increased, these U.S. citizen interests became concerned about their impact on the domestic trade opportunities reserved to U.S. citizens under section 27 of the Merchant Marine Act, 1920 (the "1920 Act"). The development of a set of Coast Guard regulations that would resolve this charter-back disagreement, and govern these and other transactions authorized by 12106(e), became the subject of the formal rulemaking proceeding in Coast Guard Docket 2001-8825.

Commenced on May 2, 2001, the Docket 8825 rulemaking was concluded thirty three months later with the publication of a partial set of Final Regulations on February 4, 2004, with the charter-back disagreement largely unresolved. On the same day, the Coast Guard initiated a new Second Rulemaking, Docket 14472, to deal with charter-back and other 12106(e) issues that remained open at the close of Docket 8825.

The Coast Guard's February 4th Final Regulations provide a set of rules that can best be described as a "please come home" call to U.S. section 2 citizen, and 12106(e) qualifying non-citizen, financial institutions for support in vessel lease financing projects in the U.S. domestic coastwise trades.

CITIZENSHIP RULES

A brief review of the citizenship rules under the 1916 Act, and the way in which non-citizen U.S. flag vessel lease financing transactions were structured following the passage of the Merchant Marine Act of 1970 (the "1970 Act"), will be helpful to the reader in understanding the discussion that follows.

CITIZENSHIP REQUIREMENTS

The1916 Act was put in place shortly prior to U.S. entry into World War I to ensure that the ownership and control of U.S. flag ves-

sels would remain in the hands of U.S. citizens. Section 2 of the 1916 Act defines the U.S. citizenship requirements. Section 9 requires that the Maritime Administration ("MARAD") approve all transfers by U.S. citizens of interests in U.S. flag vessels to non-citizens, so that ownership and control of these vessels will remain with U.S. citizens as defined in section 2. Time charters to non-citizens require MARAD approval. From 1916 until 1992, MARAD required the submission of time charters for review prior to MARAD approval. These time charter submissions were eliminated in1992, when MARAD issued a so-called "advance general approval."

MERCHANT MARINE ACT OF 1970

In the decade following the passage of the 1970 Act, non-citizen lease financing played a role in the construction of more than $1 billion in U.S. flag tonnage for operation in the U.S. foreign and domestic trades. In these transactions, the U.S. flag vessels were owned by a leasing company affiliate of a section 2 citizen parent such as Citibank or General Electric, demised to an affiliate of a section 2 citizen operator like Marine Transport Lines or Keystone, and time chartered to a non-citizen end user such as British Petroleum or Shell. All of these non-citizen time charters were reviewed and approved by MARAD under sections 2 and 9. The MARAD charter order approvals were relied upon by maritime financing counsel in providing transaction opinions on citizenship issues.

SECTION 12106(E)

Section 12106(e) was intended to provide U.S. citizen domestic operators with access to non-citizen lease financing transactions similar to those of the 1970 Act period, but in which a non-citizen lessor would now be qualified to be a vessel owner, functioning just as the Citibank or GE section 2 citizen vessel owners had functioned in the 1970 Act transactions. Congress sought to provide this access by adding a new paragraph (e) to section 12106 of Title 46 of the U.S. Code, the section governing the ownership qualifications for vessels entitled to coastwise endorsements.

In 12106(e), Congress authorized the issuance of coastwise vessel endorsements if: (1) the vessel was eligible for documentation; (2) the vessel's owner, the parent of the owner, or a subsidiary of the parent of the owner, was primarily engaged in leasing or other financial transactions; (3) the vessel was under a demise charter to a U.S. citizen eligible to engage in coastwise trade under section 2 of the 1916 Act; and (4) the demise charter was for a period of at least three years (or a shorter period if authorized by the Coast Guard).

The 1996 Act legislative history states that Congress intended to broaden the sources of capital for owners and operators of vessels engaged in the coastwise trades by creating new lease-financing options. At the same time, it cautions that Congress did not intend to undermine the basic principle of U.S. maritime law that vessels operated in domestic trades must be built in the United States and be operated and controlled by U.S. citizens. Congress directed the Coast Guard to issue the regulations necessary to the administration of the new 12106(e).

FEBRUARY 4TH

Coast Guard final regulations, and Coast Guard and MARAD proposed regulations, were published in the Federal Register on February 4, 2004. The publication included Coast Guard final regulations for Coast Guard Docket 2001-8825 (the "Final Regulations") on the requirements for vessel ownership and lease financing transactions that would qualify 12106(e), and the initiation of a new Second Rulemaking, Docket 2003-l4472 (the "Second Rulemaking") that proposed regulations to deal with charter-back transactions, grandfather rights and the Coast Guard's need for expert assistance in 12106(e) administration. MARAD's new rulemaking in Docket 2003-15171 ("MARAD Proposed Regulations") proposed the partial withdrawal of MARAD's current advance general approval of time charters to non-citizens, and would require MARAD review of all charters in 12106(e) non-citizen charter-back transactions.

QUALIFYING REQUIREMENTS

The Coast Guard Final Regulations provide a series of requirements that a non-citizen vessel owner, the section 2 citizen charterer, and the vessel itself must meet in order to qualify under 12106(e). A summary discussion of the most important requirements contained in 46 C.F.R. 67.147(a) that apply for the non-citizen owner will be sufficient for the purposes of this article. 46 C.F.R. 67.147(a) requires that in order to be

qualified to own a vessel eligible for a coastwise endorsement under 12106(e) the non-citizen owner must submit a copy of the demise charter (which must provide that the section 2 citizen charterter is deemed to be the owner pro hac vice for the term of the charter) together with an affidavit certifying that:

1. the person that owns the vessel, the parent of the person, or a subsidiary of the parent of the person that owns the vessel, is primarily engaged in leasing or other financing transactions;

2. the person that owns the vessel is organized under the laws of the United States or a State, its ownership of the vessel is primarily a financial investment without the ability and intent to directly or indirectly control the vessel's operations by a person not primarily engaged in the direct operation or management of vessels;

3. the vessel is financed with lease financing;

4. the person that owns the vessel has transferred full possession and control of the vessel to a qualified section 2 citizen through a demise charter in which the demise charterer is considered the owner pro hac vice during the term of the charter; and

5. neither the person that owns the vessel, nor the parent of the person that owns the vessel, nor the group of which the person that owns the vessel is a member is: (i) primarily engaged in the direct operation or management of vessels; (ii) primarily engaged in the operation or management of commercial, foreign flag vessels used for the carriage of cargo for parties unrelated to the vessel's owner or charterer; or (iii) has a the majority of its aggregate revenues derived from the operation or management of vessels.

The Final Regulations' causes for disqualification, summarized in paragraph 5 immediately above, will exclude from 12106(e) qualification, owners where the owner of the vessel, or the owner's parent, or the group of which the owner is a member, is primarily engaged in the operation or management of vessels, or the operation or management of commercial foreign flag vessels used for the carriage of cargo for parties unrelated to the vessel's owner or charterer, or derives a majority of its aggregate revenues from the operation or management of vessels.

These regulations should effectively discourage further efforts by non-citizen vessel operating or management groups to enter the U.S. domestic trades by making use of 12106(e) to own and time charter vessels to be engaged the carriage of cargo for parties unrelated to the vessel's owner. And, these have been the non-citizen transactions that have caused the section 2 citizen interests their greatest concern as involving direct non-citizen competition for third party cargoes reserved for U.S. owners and operators by the 1920 Act.

Further, non-citizen businesses operating in the U.S. that require the use of U.S. flag vessels to meet domestic transportation needs will apparently now only be able to obtain time charters from vessels owned by section 2 citizens, or by 12106(e) qualified non-citizen lessors that are not related the non-citizen charterer.

NON-QUALIFYING LEASES & DEALS

In addition to the vessel management or operations and aggregate revenues disqualifications summarized in paragraph 5, the Final Regulations prohibit one important class of transactions that has found widespread use since the passage of the 1996 Act. And, the Second Rulemaking may severely restrict the use of a second such class.

First, the Final Regulations prohibit leasing transactions that do not have a financing component. As to these, the Coast Guard states that "the law was enacted to promote 'lease financing' not 'leasing' and to create a vehicle for vessel financing, not an alternative means of vessel ownership." Referencing the Conference Report, the Coast Guard evinces Congress's intent "to prevent the use of specially created 'leasing company' subsidiaries that merely take title to existing vessels, with no financing involved, for the sole purpose of leasing them."

Second, regulations proposed in the Second Rulemaking may almost entirely prohibit charter-back transactions. The Coast Guard is clear that "control of the vessel receiving a coastwise endorsement must be placed in a U.S. citizen." While the Coast Guard states that it is it is uncertain whether it should prohibit charter-back arrangements, it has proposed per se prohibitions with only very limited financing and proprietary

cargo exceptions.

Of course, special purpose leasing companies and charter-back transactions organized by non-citizen vessel operator manager groups have been at the heart of the controversy between the participating non-citizen members and the section 2 owners and operators. But, once the prohibitions against non-citizen vessel operator or manager qualification for vessel ownership are imposed, the transaction has been denied 12106(e) characterization at the vessel owner level, and neither the special purpose leasing company nor the charter-back problem would appear to continue to exist.

However, these Final Regulations special purpose leasing company prohibitions, and the Second Rulemaking proposed charter-back restrictions will seriously impact the post 1996 Act vessel financing structures that have been employed (and are planned for future employment) by major non-citizen affiliated groups (that are not primarily involved in vessel operations and management) with established U.S. operations that require significant waterborne transportation services as an important adjunct to their businesses.

LEASES

Under the initial Coast Guard interpretations of section 12106(e), such non-citizen affiliated groups were allowed to establish special purpose leasing companies to own already financed tonnage which would then be demised to a section 2 citizen operator and time chartered back to another non-citizen group member. The Coast Guard Final Regulations apparently take the position that 12106(e) should be limited to non-citizen lease financing transactions similar to those of the 1970 Act period, but in which a non-citizen leasing company (unrelated to the non-citizen time charterer) would now be qualified to be a vessel owner lessor, just as the leasing company affiliates of Citibank or GE were section 2 citizen vessel owner lessors in the 1970 Act transactions.

All future lease financing transactions involving non-citizen time charterers will presumably be structured on this basis (with an unrelated section 2 citizen or 12106(e) qualified non-citizen owner lessor). But there will likely be significant costs associated with any required unwinds of already completed transactions. The magnitude of these unwind problems will depend up the substance of the final form of the grandfather provisions now under consideration in the Second Rulemaking.

CHARTER-BACKS

The Second Rulemaking proposes blanket prohibitions that would apply to all non-citizen affiliated groups, subject only to proposed "financing" and "proprietary cargo" exceptions. In legal terminology, these charter-back rules are per se prohibitions. The Second Rulemaking discussion of the exceptions leaves many questions unanswered.

In its discussion of the "financing exception," the Coast Guard notes that the proposed regulation itself "does not contain any criteria by which the Coast Guard is to make a determination" on either the "financing" or "control" issues. The Coast Guard then acknowledges that it is currently unable to make informed determinations on either issue itself, and requests public comments that will provide the Coast Guard "with an informed basis for making these determinations."

In the Coast Guard discussion of the "proprietary cargo," the exemption is justified on the basis that it is "similar in principle to the Bowaters amendment [and] consistent with what Congress authorized in the past as a limited exception to the Jones Act." While the Coast Guard reliance on the Bowaters legislation is entirely appropriate for Bowaters' type and size vessels, the Bowaters legislation probably should not be urged as a precedent for larger vessels in deep water trades. The Senate Report which accompanied H.R. 9833 was explicit on this point. See, 1958 U.S. Code Cong. and Adm. News, p. 5190, at p. 5193.

"GRANDFATHER" RIGHTS

The "grandfather" provisions in the Coast Guard February 4th Final Regulations would allow vessels with endorsements issued before February 4, 2004, to operate (with certain specified exceptions) under that endorsement and with renewal endorsements indefinitely. This would presumably allow the vessel's qualification for coastwise endorsements to continue for the vessel's life, so long as its owner continued to be qualified under 12106(e) as that section was interpreted by the Coast Guard on the date that the vessel financing transaction was fixed.

The Second Rulemaking proposes the amendment of the Final Regulations to limit grandfather rights to "a 3-year period as a reasonable amount of time to pro-

vide owners with sufficient time to plan and effectuate whatever restructuring is necessary to comply with the regulations." Thus, the legitimacy of the charter-back transactions, and the "grandfather" rights to be accorded these charter-back transactions, and that of the specially created leasing company structures, remain as a subject matter to be decided in the Second Rulemaking.

The February 4th publication advises that there have been 87 applications for qualification under 12106(e) since the passage of the 1996 Act, of which 30 involved a charter back to the vessel owner or an affiliate of the vessel owner. One may speculate that many or most of these 30 charter-back transactions also involved specially created leasing company subsidiaries.

Most of these transactions required a perceived legal certainty in crafting their specifics. Most were accomplished on the basis of maritime financing counsel opinion advice, and in some instances advice apparently given by the Coast Guard itself concerning the proper interpretation of 12106(e). Had the Coast Guard's advice been different, the transactions would have been crafted to comply with that different Coast Guard advice. Most of the transactions that will be adversely affected will be costly to restructure.

DOMESTIC NEEDS

U.S. domestic transportation needs are expected to result in U.S. shipbuilding contracts in the $4 billion to $5 billion range over the coming decade. The majority of this work is either federally mandated by the Oil Pollution Act of 1990, or involves the replacement of vessels in our noncontiguous trades that have reached the end of their useful lives.

The Department of Transportation and MARAD are currently working to complete SEA 21 initiatives to encourage the development of domestic passenger ferry and coastwise cargo services in line with current European Union efforts to expand the use of water transport. SEA 21 is expected to include the resumption of MARAD's Title XI government guaranteed loan program and the extension of MARAD's Capital Construction Fund tax deferral program to the domestic coastwise trades. MARAD initially refused to accept 12106(e) citizenship for the purposes of its Title XI and CCF programs. But MARAD's position on this has now changed and both programs can be employed.

The Title XI program will allow an owner lessor to achieve a 7 to1 leverage ratio. The CCF program tax deferral provisions can provide an attractive alternative to conventional tax driven leasing which non-citizen lessors must sometimes reject because they do not have sufficient U.S. source income to utilize the tax benefits involved.

CONCLUSION

The Coast Guard's Final Regulations provide new ownership standards for transactions governed by 12106(e). These new standards include clear "safe haven" rules for non-citizen vessel lease financing. The Final Regulations will require important changes in the financing of domestic tonnage that is dedicated to providing transportation services to non-citizen users. Portions of the Final Regulations may be the subject of legal challenge, and certain matters remain open and the subject of a Second Rulemaking. However, these Final Regulations will provide the legal certainty needed for leasing by non-citizen that are able to qualify under 12106(e).

Most established ship financing banks and leasing companies will satisfy the Final Regulation's qualification tests with ease. So long as the transactions fit within these "safe harbor" guidelines, they can be structured with confidence by the financial community and their maritime counsel. With these rules in effect, qualifying leasing companies can assist non-citizen affiliated groups and others in vessel lease financing projects to meet U.S. domestic transportation needs in 12106(e) transactions.

The need for capital to meet vessel construction needs for domestic transportation is enormous. Non-citizen time charter credit was a major factor in the success of 1970 Act lease financing. Perhaps non-citizen equity can play an important role in the coming decade in lease financing transactions under 12106(e).

This situation presents obvious new opportunities for U.S. citizen and non-citizen 12106(e) qualifying financial institution lessors for important vessel lease financing projects in the U.S. domestic trades.