# "SPLITTING THE STEEL" IN SHIPPING JOINT VENTURE AGREEMENTS

9 APRIL 2021 • ARTICLE

**Ship-owning joint ventures are a common occurrence in today's market, whether for the purpose of a collaborative strategic advantage or as a corporate marriage between an equity funder and a shipowner. A mechanism that is somewhat unique to maritime joint venture documents is a so-called "Steel Split".**

> "Although the general concept appears simple, there are many potential pitfalls that need to be borne in mind when drafting an effective Steel Split clause."

A Steel Split describes an approach taken by parties on dissolution, winding-up or exit from the joint venture, whereby the assets in that joint venture are split proportionally between the joint venture partners. This is usually done by way of transfer of the vessels themselves, as an alternative to one party buying out the interests of the other party or the assets or shares of the joint venture being sold to a third party.

Although the general concept appears simple, there are many potential pitfalls that need to be borne in mind when drafting an effective Steel Split clause. This article highlights some of the main factors that need to be taken into account in designing and agreeing on an effective Steel Split mechanism.

## VALUATIONS

The starting point in any Steel Split process will be valuing the vessels. Often there will be an agreed list of acceptable valuation brokers from which the parties can select to conduct the valuations. Sometimes a single valuation from an agreed broker may be sufficient, but to ensure that the valuation is made fairly, the provisions often allow for each party to appoint their preferred independent and qualified valuation broker and to determine the valuation as the average of the two valuations produced. It will be very important that the general terms of reference of the valuation are established, including whether it is on a "desk-top only" or "after-inspection" basis, as well as whether the value of any current charters is to be considered.

## HOW TO DEAL WITH LONG-TERM CHARTERS?

If the business model of the joint venture is to charter out the vessels on a long-term basis, the parties will need to consider whether, if the Steel Split is put into effect, those charters are capable of being transferred along with the vessel by a deed of novation. Because the process of novation under English law requires the agreement of the charterer, a lack of charterer co-operation may prevent a Steel Split mechanism from being completed. Alternatively, if each vessel is owned by a separate single purpose company, the Steel Split mechanism could be achieved by transferring the shares in the single purpose company, instead of the vessel itself.

In the absence of any provisions in the charters that might restrict a change in the ownership structure of the vessel, this can be helpful in circumventing any need for consent from the charterers. In such a case, residual liabilities of the single purpose companies may need to be factored in to the valuations.

> "Invariably, a bespoke approach will need to be taken for each joint venture, taking into account the number of vessels, the respective stake or shareholding of each party in the joint venture, the type of vessels and the capability of the parties to use the vessels post-split."

## WHO CHOOSES THE SPLIT?

There are many ways to skin this particular cat and there is no one correct answer. One option is for each party to take turns in choosing an asset from the fleet. For example, in a two-party joint venture, party A takes first pick, party B the second and third, party A the fourth and fifth, and so on. This method has its limitations though, as it does not work for anything other than a joint venture where the parties all have even proportions of holdings, nor if there are fewer than six vessels. There is also the problem of determining who gets first pick, and the order of selection.

Another option is for an independent third party to determine groupings of the vessels which, when valuations are applied to them, results in a split that most accurately reflects the proportional holdings of the parties in the joint venture. This can work for joint ventures that are not owned by the parties 50/50, but it still leaves the question of who determines which group of vessels goes to which party, especially if all vessels are of a similar value. It may also be that the valuation of a vessel does not truly reflect the full and actual value of the vessel to a particular joint venture party beyond its monetary value. For example, if certain of the vessels are more desirable for a party's own particular trade or more acceptable to or specifically vetted and approved by their own customers, despite having a similar valuation to other vessels in the fleet.

Invariably, a bespoke approach will need to be taken for each joint venture, taking into account the number of vessels, the respective stake or shareholding of each party in the joint venture (which may change over the term of the joint venture), the type of vessels and the capability of the parties to use the vessels post-split. It may be tempting for parties to "kick the can down the road" and not agree on a specific procedure at all, reasoning that the strength of the relationship between the parties now will allow them to agree a mechanism at a later time. We would strongly caution against this approach, given that the precise time at which a Steel Split mechanism is required is when the parties are already in disagreement, which they have not been able to resolve. In such event a fair, clear and well drafted mechanism will be required, to avoid unnecessary complications. This mechanism, however, does not necessarily need to be a Steel Split mechanism, as explored further below.

## HOW TO DEAL WITH AN IMPOSSIBLE SPLIT?

One of the most obvious issues is that it may be impossible to split the vessels among joint venture partners proportionally. For example, if a 50/50 joint venture owns seven vessels, each having a similar valuation, how do you ensure an even split? Even if you can create a proportional split with the number of vessels owned, not all vessels are precisely equal. If vessels have different classifications, sizes and ages, it may simply not be possible to determine a proportional vessel or economic split. In practice, it is highly unlikely in any Steel Split that the value and number of the vessels will exactly align with the joint venture partners' proportionate holdings or interests in the joint venture. A mechanism will likely need to be introduced to ensure that even if the steel is not split proportionally, the resultant economic outcome is proportional.

> "In a poorly documented Steel Split structure, another risk is of the transfer of the vessels to the joint venture parties being unwound on the basis of the transfer being done at an 'undervalue'."

Because of this, parties will need to think very carefully about how they will deal with any potential resulting differences in values that they get out of the joint venture. One way to address this possibility could be by each party purchasing from the joint venture vessels for cash, with the proceeds realised in the joint venture from such purchases then being split proportionally. However, this will necessitate the parties having cash on-hand, and may not be the most efficient use of any such cash. A more common approach is to have a separate netting-off mechanism with a balancing payment between the joint venture partners, to account for any differences. However, if not done correctly this can have tax, transfer pricing and accounting implications.

## DISTRIBUTIONS IN KIND

As an alternative to each joint venture partner purchasing vessels allocated to them from the joint venture, for which actual payment to the joint venture entity may be required for accounting, commercial or tax reasons, it may be possible for ownership of the vessels themselves to be allocated to the joint venture partners by way of "distributions in kind". This involves allocating vessels themselves to each joint venture party instead of declaring dividends in cash. The availability of this as a mechanism very much depends on the laws of the jurisdiction in which the joint venture entity is incorporated, in particular whether they allow the joint venture company to make distributions in kind and subject to what criteria. This approach may also require a balancing payment to be made by one joint venture partner to the other, or to the joint venture entity, to ensure an even economic split.

## RISK OF UNWINDING

In a poorly documented Steel Split structure, another risk is of the transfer of the vessels to the joint venture parties being unwound on the basis of the transfer being done at an "undervalue". This might occur where the joint venture has outstanding creditors at the time of distribution of the vessels and those creditors place the joint venture into a creditors' winding-up procedure after the vessels have been transferred to the parties. If the joint venture entity cannot show that the transfer of the vessels has been made for market value consideration (i.e. as a distribution in kind or for actual cash or other consideration), it is possible in some jurisdictions that the transfer of the vessel from the joint venture to the joint venture party can be reversed, in order that the vessel be resold to pay off such outstanding creditors. It is therefore vital that the Steel Split structure and mechanism be properly documented to reflect genuine consideration flowing from the joint venture party to the joint venture for the vessel.

## THIS SEEMS COMPLEX – IS THERE AN EASIER OPTION?

> "There are many other mechanisms that deal with the distribution of assets of a shipping joint venture in the event that the parties no longer want or need the joint venture structure."

There are many other mechanisms that deal with the distribution of assets of a shipping joint venture in the event that the parties no longer want or need the joint venture structure. These can include any one or a combination of buy-out, sale to market, rights of first refusal to buy, rights of first offer to buy, rights to match and a pre-emptive sealed bid process. Each of these methods have their own pros, cons and variations, but ultimately it boils down to two key things: (a) determining a mechanism that works best for your particular joint venture; and (b) ensuring that mechanism is drafted by experienced lawyers who are familiar with the key issues and potential pitfalls.

*Watson Farley & Williams LLP is an international law firm with expertise in all areas of maritime law including M&A, Joint Ventures and Commercial Contracts. The WFW Corporate maritime team has extensive experience in drafting shipping joint venture documents, including complex Steel Split provisions. Please get in touch with one of our key contacts or any member of the Corporate team if you have any further questions.*

## KEY CONTACTS


**DANIEL SAUNDERS**
PARTNER • LONDON

T: +44 20 7814 8027

dsaunders@wfw.com

**DAMIAN ADAMS**
PARTNER • SINGAPORE

T: +65 6551 9142

dadams@wfw.com