Insolvency and Restructuring in Germany

Yearbook **2017**

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Oil Sector: What a roller coaster!

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Three major sectors)

The oil sector has been in the spotlight of the global economy over the last few years. However, through its specific territorial connection to its natural origins, the involved countries and national economies face different forms of difficulties that shall be discussed.

For a better understanding it appears useful to plainly introduce the oil industry by its usual division into three major sectors: **upstream, midstream and downstream.**

The **upstream industry** *commonly known as the exploration and production (E&P) sector. It includes searching for crude oil fields, drilling exploratory wells, and subsequently drilling to recover and bring the crude oil to the surface.*

The **midstream industry** *involves the transportation by pipelines, rail or oil tanker (and storage) from production sites to refineries, the processing plants (oil refineries) as well as the transport and delivery of crude or refined petroleum products to downstream distributors.*

The **downstream industry** *includes wholesale distribution and retail network of service stations. It reaches the consumer with its products such as gasoline, diesel, jet fuel, kerosene, heating oil and many, many more.*

Sometimes, when the industry is split into only 2 sectors, the downstream comprises the activities of both midstream and downstream.

I. Global economics of the oil industry *(Ivan Guez)*

Introduction

Just three years back, in 2013, when oil "Brent" was trading at $100-$120 per barrel (bbl) range, small to medium size E&P companies were raising money like mad and fairly easy. Now that oil is barely at $50/bbl, it is extremely difficult for these sub-investment graders to raise cash, whether debt or equity. Even PE funds who participated heavily into this recent E&P boom are finding it very hard to raise new money from investors, despite the fact that a number of E&P companies' valuations have collapsed, and therefore presents a presumably more attractive entry point. Why is that? What happened? After all, the oil price adjusted for inflation was only trading at around $30/bbl for the period 1991-2003. So why is $45-$50/bbl considered too low now by the oil industry or oil producing countries? Is the E&P sector the only sector affected? What about the oil service companies and the refining sectors?

Look at the past 20 years

To put things into perspective, let us have a look at the past 20 years to see where we came from. With the Asian crisis in 1998 the World GDP growth rate was

down to only 2.45% and the oil price hit an inflation adjusted post-war all-time low of around $12/bbl ($9.10 nominal). Investments in the oil sector were understandably very low. The economy recovered in 1999 and 2000 with global growth rate of 3.3% and 4.3% respectively. This pushed the oil price to the mid-$30/bbl, but with the aftermath of Sept. 11, the world GDP growth slowed down to around 2% in 2001 and 2002, and the US dollar was very strong at around 0.9 for 1 Euro. Oil price went back to around $20/bbl.

A 5-year period of almost uninterrupted strong growth, then started with 3% in 2003, and around 4% from 2004 to mid-2008. Oil products demand was strong, in particular from 2005 with surging Chinese imports to unseen levels. Oil production increased from both OPEC and non-OPEC countries, but the OPEC, which had been historically very influential on the oil price by cutting or increasing its production, found itself in 2005 with only about 1 million bbl/day of spare production capacity and therefore very little possibilities to tame further increases in oil prices. The price increase was further fueled by the arrival of sizeable commodity funds via the oil futures market. This is how the oil price per barrel crossed $50 in 2004, $60 in 2005, $70 in 2006, $90 in 2007 to finally reach an all-time high of around $150 in July 2008.

Massive price increase

This massive price increase was most felt in the US for two main reasons: On one hand the US$ had weakened significantly during the same 2003-2008 period against all major currencies from around 0.9 to around 1.6 for one Euro, making the oil price increase in non-US$ currencies less acute. On the other hand, the taxes at the pump for a liter of gasoline are much lower in the US than in most OECD countries, making the increase in percentage terms at the pump much higher in the US (it almost quadrupled for US consumers, whereas it less than doubled for European consumers). Given that the US had the highest consumption per capita of transportation fuels (due to high mileage and poor fuel-efficiency cars), the increase of oil in the US family budget became unbearable and resulted in 2008 in material demand destruction.

Demand destruction started in early 2008

This demand destruction started in early 2008 eventually stopped the oil price increase, which had reached speculative bubble proportions, and resulted in a massive sell-out all the way down to about $35 by the end of 2008 partly helped by the managed future funds. This also coincided with the sub-prime crisis, which is why both the financial industry (*Lehman Brothers* bankruptcy) and the automotive industry (*GM* bailout, sale of *Chrysler* to *Fiat*) were hit first and so hard.

Oil price rebound

The oil price rebound was pretty quick to come, since OPEC decided on a massive cut in production of 4.2 million bbl/d in January 2009, China continued to grow at close to 10% with ever stronger oil imports, and all the while OECD countries were in recession in late 2008 and early 2009. The oil price then bounced back to $50 in March 2009, and traded between $60 and $80 from May until the end of 2009, and from $67 to $93 during 2010. The oil E&P companies were, for most of them, able to weather the crisis since the oil price was below $60/bbl for less than 7 months and since E&P companies had accumulated so much profits in the preceding years.

Geopolitical issues in the MENA region

However, geopolitical issues in the MENA region with the Arab spring pushed the oil price above $100 in 2011. While the actual reduction in oil supply was mostly limited to Libyan uprising (-1.6m bbl/d in mid-2011) and to Iran sanctions (-1m bbl/d in 2012), the fear of further supply disruption coming from the Middle East maintained a material risk premium on the oil price which traded between $100 and $120 for more than three consecutive years, from early 2011 to mid-2014, despite the massive increase of oil production in the US with the shale oil revolution (around +3.5m bbl/d in that period). Indeed, such a long period of high prices provided a fantastic incentive for E&P investments, even those with high break-even points ($50/bbl or higher) such as fracking shale oil in the US, oil sands in Canada or certain deep offshore drilling projects. This was particularly noticeable in the US where in addition to the oil majors, many smaller independent E&P firms embarked in drilling programs after raising massive amounts of money, mostly through debt given the historically low interest rate environment. The number of active oil rigs in the US went from around 350 in 2010 to 1600 in 2014.

Oversupplied with oil

By 2014, the world was oversupplied with oil, inventories were rising, and the prices could no longer be maintained above $100. Besides, a change of leadership in Saudi Arabia prompted a change of strategy at OPEC, which abandoned its production ceiling. The Kingdom decided to increase its production level near full capacity, in order to bring the oil price down sharply, increase its market share and try to kill this new unconventional oil competition, even though this meant a few years of reduced revenues and sizeable budget deficits for the Kingdom. As a result, the oil price dropped to $47 in January 2015, recovered above $60 and then dropped again to $27 in January 2016 before stabilizing between $40 and $50 in April 2016. The period of low oil prices is therefore already much longer and severe (almost two years so far) than the price drop in the aftermath of the 2008 financial crisis. And instead of being due to reduced demand like in 2008, the current drop is rather cause by oversupply.

Response from the oil majors

The responses from the oil majors have been focused on several fronts: 1) massive CAPEX reduction with cancellation or deferral of numerous E&P projects, 2) serious cost reductions with sizeable layoffs, 3) disposals of assets, 4) issuance of debt in capital markets in order to maintain high dividends (which, coupled with lower profit projections, resulted in some downgrades from rating agencies). However, the more dramatic outcome is to be found in smaller and highly leveraged firms and the resulting number of bankruptcies. According to a report issued by Moody's in September 2016, amongst E&P companies with more than $100m debt, there were 15 bankruptcies in 2015 and about double that amount in the first 8 months of 2016. Moreover, recovery rates from 2015 bankruptcies were extremely low with 81% for reserve-based loans and a dismal 6% for high yield debt, vs 98% and 30% in E&P bankruptcies in the 1987-2014 period. And yet more bankruptcies are expected in the reminder of 2016 and in 2017. Close to $120bn of secured and unsecured debt are involved in E&P bankruptcies in total for the US and Canada in 2015 and 2016 up to September combined.

Has Saudi Arabia won the battle then? At first glance it seems so, with both Saudi Arabia's and OPEC's market share on the rise, with active oil rigs in the US having declined to about 400 (vs 1600 in 2014) and with many bankruptcies filed or

forthcoming in the E&P shale oil sector. However, US crude oil production has only come down about 10% from its early 2015 peak, though part of the reason may be that a large part of the 2015 production was hedged, which is less true of 2016 and 2017. Still, massive cost reductions and productivity gains have been achieved over the past two years, bringing down the breakeven point and improving resilience of the US shale oil sector. Besides, even if a company goes bankrupt, its wells will keep producing as long as their operating cash costs per barrel are below the market price, and these wells will just find new owners. So shale oil is likely to remain in the E&P landscape for the years to come, at least in North America, and will likely attract new investments when the oil price eventually picks up, as was demonstrated in summer 2016 when a small pick-up in prices automatically resulted in an increase in active oil rigs.

What about other segments of the oil sector, such as Oil Field Services and Equipment (OFSE) or Refining? Were they affected by the oil price drop as well?

Oil field services and equipment segment

In fact the oil field services and equipment segment (which includes seismic testing, drilling, tubing, and a range of services for the E&P industry) also got hit and very badly. Indeed with the massive capex reductions in the E&P industry, to the tune of -25% globally in 2015 to $583 billion and probably another -27% in 2016 (around -40% in North America) according to Barclays, most OFSE companies have seen their revenues drop very severely. This resulted in some bankruptcies, as well as some concentration activity with Technip's $14bn merger with FMC in May 2016, shortly after Halliburton's failed $38bn takeover attempt of Baker Hughes.

Overcapacity

The reduced work volume overall has created overcapacity, which itself has negatively affected day rates and utilizations, resulting in a hard fall in margins. Obviously most companies have embarked into drastic cost-cutting measures or even assets sale in order to survive or becoming more resilient. However, the number of active rigs has stopped falling, which may mean that the OFSE market has bottomed out. Not surprisingly, market valuations of most OFSE companies have also fallen very sharply over the past three years, but seem to have now bottomed out as well, albeit at very low levels. This has prompted some recent interest from PE funds, which is an encouraging sign.

Refining segment

As for the refining segment, its fortunes are primarily linked to the refining margin, i.e. the price difference between refined oil products sold and crude oil purchased, rather than the level of the oil price itself. Furthermore, there is little correlation between the level of the oil price and the refining margins. For example, in 2005 to mid-2008 the oil price had been rising very sharply and the European refining margins were very good, whereas the rise of 2009 to 2011 was accompanied by very poor European refining margins. The difference is that the first rising period was prompted by strong oil products demand and a booming economy, pushing the industry to near full capacity with very strong refining margins. In the second rising period it was the geopolitical risk which put a risk premium on the oil price, especially the crude, making the refinery feed more expensive while the refined oil products had not increased in the same

proportions, therefore squeezing the refining margins which were at times even negative.

Hurricane Katrina

In 2005, during the first rising period with strong refining margin there was a meteorological event in the US which had a two-month impact on margins and the industry far beyond North America. Hurricane Katrina which landed on the US Gulf Coast in late August 2005, forced to shut down about 5mbd refining capacity in the region or about 30% of the US total for the entire month of September. This prompted a spike in refining margins worldwide, and even prompted Conoco Philips to make an incredibly high offer (thought to be close to $2bn) to purchase the sizeable but low complexity refinery in Wilhelmshaven near Hamburg with the plan to spend another $1.5bn Capex to upgrade it to a complex refinery. But in 2009, following the drop in both the oil price and in the refining margins, the Capex program which had started was cancelled and the refinery was subsequently shut down and sold in 2011 as a simple terminal to a PE-backed storage firm for a tiny fraction of its initial purchase price. Because the refinery was owned by an oil major, it did not result in a bankruptcy.

Petroplus

Petroplus, the European independent refiner, did not have the balance sheet of *Conoco Philips* and after three consecutive years of very poor European refining margins in 2009-2011, it became insolvent in January 2012. Only three of its then five European refineries found buyers, including the one in Ingolstadt bought by the oil trading firm Gunvor which is continuing to operate well to this day.

While the refining margins are not directly correlated to the oil price, the oil price still has some impact on refining economics in terms of running inventory value and therefore working capital, as well as of energy costs since a refinery usually burns around 5% to 7% of oil (typically low sulphur fuel oil) to heat up its various units as part of the refining process.

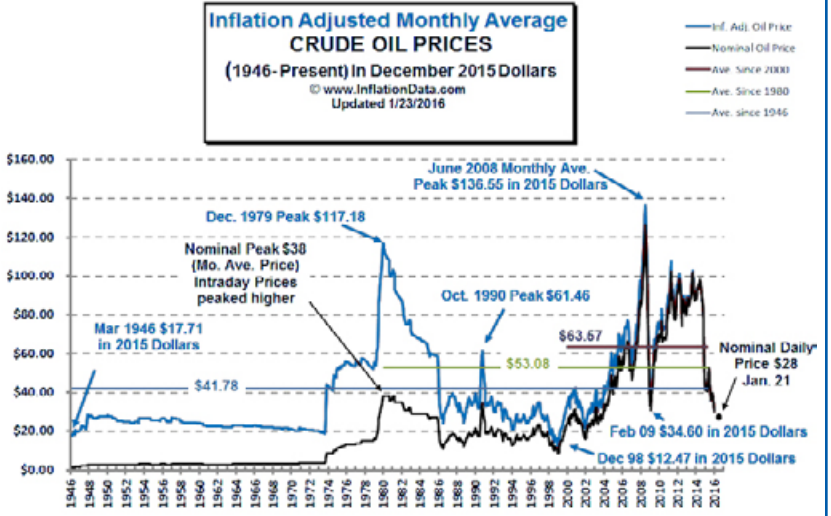
So, where is the oil price heading to?

Massive capex cuts in the E&P oil sector

No crystal ball here. There is still a lot of oil supply around and oil storages are filled to near historical highs. These will need to come down before we can experience any lasting material price increase. However, the massive capex cuts in the E&P oil sector means that gradually depleting wells are not fully replaced by new producing ones. This could well result to a tight supply situation two to three years down the road and subsequently to possibly a rather sharp increase in the oil price.

In the longer run though, demand growth could be curtailed by a political will to reduce the CO_2 footprint following the United Nations Framework Convention on Climate Change, 21st Conference of the Parties (COP21) and by the probably forthcoming electric cars revolution, though it is hard to estimate when the sales of electric and hybrid cars consuming less than 3 liters of oil per 100kms will surpass new sales of more traditionally powered cars. Will it come as soon as in next decade?

In any case, the roller-coaster is likely to continue its course, with lots of opportunities for shrewd investors, good managers . . . as well as restructuring, M&A and insolvency professionals.



Source: www.inflationdata.com

From the global economic overview of the ups and downs of the oil price, the discussion shall narrow down to the crisis of the Norwegian offshore industry and its legal and financial struggles, in the above terminology in particular in the upstream and midstream sector of the oil industry.

II. Offshore crisis and restructuring reform in Norway *(Stine D. Snertingdalen)*

A substantial part of Norwegian industry and economy evolves around the offshore, oil and gas industries. In the past, this has helped Norway in keeping a quite stable economy through financial and sector-based crises, compared to many other western economies. However, Norwegians now find themselves in the midst of a crisis hitting these very industries.

As explored in detail by *Ivan Guez* above, oil prices dropped drastically in September/October 2014 from well over $100 per barrel crude oil to around $50 in January 2015, and plunged further down hitting rock bottom in January 2016 below $30. Though the prices have been picking up slowly in 2016, they have so far only reached approx. $50, i.e. still around half the average price in 2011 – 2014.

Drastic drops in revenue

These drastic drops in revenue over a short period have had severe impact on the market. There are examples of companies losing 30% of their turnover from one quarter to another in Q1 2016. Such companies have been working hard to cut costs wherever possible, resulting in a brutal downsizing of the workforces within offshore and oil related sectors and cancellations of existing contracts and

new projects. However, it has not been possible to cut costs at the same pace as that of the rapid revenue drop.

Furthermore, the cost reducing measures create ripples in the water resulting in less activity, especially with respect to (planning and preparing of) new activities, which further worsens the situation for the market participants. This has again resulted in an overcapacity in related markets, such as rig supply and seismology, and as of 4 October 2016 121 offshore ships were laid up of which were 65 platform supply vessels, 29 anchor handling tug supply vessels and 17 seismic vessels.[1]

Overcapacity of offshore ships

And the numbers are increasing every month. Some say that the overcapacity of offshore ships are as high as 40%, leaving 40% of the Norwegian fleet redundant. Even if the oil prices still increase significantly, there are low hopes of engaging all these ships again, rendering it necessary to demolish several ships. As the Norwegian fleet includes few old ships, and as most ships are mortgaged as security for significant loan facilities, owners (and mortgagees) are reluctant to start the demolition.

The companies and the financers (lenders and bond holders) have attempted to contain the situation by taking an «amend, extend, pretend» approach, waiving breaches of covenants, extending maturity dates and amending terms the companies are no longer able to satisfy. The financiers in the Norwegian offshore market are often bank syndicates, *Eksportkreditt/GIEK* (providing Norwegian export credit) and bondholders investing in secured and/or unsecured high yield bonds.

However, are these steps sufficient to contain and correct the situation going forward, or are the negotiating parties merely postponing an inevitable «meltdown»? The answer lies partly in the crystal ball of when the market will be back to normal and what the «new normal» will be, and partly in whether or not the necessary number of ships will be demolished or find alternative use.

It is expected that many businesses within the affected industries will run out of cash in 2016 and 2017 (and so far a few companies have experienced this), if the oil prices stay low. Even after the recovery, few people believe that the prices will get close to the peak levels prior to the crisis. High yield bonds are traded at levels of 30% and 20% of face value, signalling little faith in any immediate market recovery. Several syndicated loans and bond loans mature in 2016, 2017 and 2018, and it is expected to become increasingly more difficult to raise new capital and credit in markets, which seem to sink deeper into the crisis by the month. If the companies survive the next few years, the next question is whether the necessary (re)financing will be available when the (extended) credit fall due for a number of companies in 4-5 years.

Out of court restructuring negotiations

The out of court restructuring negotiations between creditors, and between creditors and the debtor, involve advanced tactics and are complicated especially

1 The Norwegian website http://maritime.no/ provides updated statistics of laid up offshore ships.

due to the typical combination of syndicated loans, sometimes with different syndicates financing different ships and/or group companies, and with secured and/or unsecured bonds owned by anonymous bondholders changing identities and agendas as the bonds are being traded at lower and lower levels. It is all about finding the right «terror balance» and incitements for all parties involved, as complex plans are suggested to buy the companies another few months or years of time.

All these facts are predictions of a deepening crisis, and that the situation will get worse before it gets better. Although most businesses, especially the larger ones, are expected to manage to stay afloat until the crisis wears off, we will probably see an increase in the number of large restructurings and bankruptcies in Norway over the next two to three years.

Seismic industry

The seismic industry seem to be the first industry to suffer severely, with the Norwegian part of the *Dolphin Geophysical group* undergoing bankruptcy proceedings by winding up in December 2015. Furthermore, the Norwegian *Polarcus group* reached a final restructuring plan in January 2016, saving the company from suffering the same fate. Within the shipping business, *Havila Shipping AS* has made several attempts at reaching an out of court restructuring plan with its creditors, but they have so far failed to reach a consensus, though the expression from the media is that they are getting closer to a solution.

Norwegian debt restructuring regime

These cases, and cases like these that might need restructuring in the future, have directed a new focus on the lacking of the Norwegian restructuring regime. Most restructuring processes in Norway take place out of court, as the Norwegian debt restructuring regime is deemed by practitioners to be inefficient and inflexible, lacking in tools to facilitate restructuring plans tailor-made for complex cases. Thus, it is by some predicted that a few Norwegian international company groups may instead file for Chapter 11 proceedings in the U.S.

Villars-Dahl's support group

In recognizing this problem, the Ministry of Justice and Public Security appointed the Honourable Judge *Leif Villars-Dahl* with Oslo Bankruptcy Court January 2015 to evaluate the current Norwegian debt restructuring regulation, and to suggest legislative changes. The author was a member of Villars-Dahl's support group of four. Judge *Villars-Dahl* delivered his report to the Ministry on 29 February 2016. The report suggests changes to make the regime more efficient and attractive, rescuing more companies and thus keeping values from deteriorating and saving more jobs. His suggestions include the introduction of rules of limited super-priority financing, easing the requirements upon downsizing the work force while under restructuring proceedings, removing the minimum requirement for a dividend payment (today 25%) in compulsory debt negotiations proceedings, allowing for debt to equity swap as part of the solution, etc.

Judge *Villars-Dahl* delivered his evaluation and suggested legislative changes in March 2016, and it is now circulating in various market participants, inviting them to comment on his suggested amendments in the current Norwegian restructuring rules.

New rules are needed

It is the opinion of this author that the most important challenges to an effective restructuring regime in Norway is to open up for more flexible restructuring solutions and to be able to get funding during the restructuring process, as well as to introduce a pre-packed scheme allowing for business or assets being sold just prior to opening of bankruptcy but under the supervision of an objective party. New rules are needed to incentivise debtors and creditors to seek in court restructuring proceedings rather than out of court negotiations, allowing for transparency and protection against single creditor enforcement, thus ensuring equal and fair treatment of all creditors.

Pre-packed solutions

Meanwhile, we have seen a few out of court attempts at «pre-packed solutions», where the business is sold just prior to bankruptcy, and where the bankruptcy estate may be given a right to «claw back» the business should they find a buyer willing to pay more within a certain time limit. However, this solution is high risk for the board of directors and lacks in transparency and an objective party ensuring fair treatment of all creditors involved. The administrator of the bankruptcy estate will usually have problems applying such a claw back right for the estate once the transaction is done and bankruptcy proceedings are opened, and she or he will most certainly go through the transaction very thoroughly to establish if a fair market price was paid, if all creditors were treated fairly and equally etc.

Norwegian Private International Insolvency Law

The implementation of necessary changes in the Norwegian restructuring rules will only get us thus far seeing that businesses become more and more international. The successful application of the restructuring rules on international cases calls for an implementation of new rules on Norwegian Private International Insolvency Law. Mads *Henry Andenæs* delivered a report to the Justice Department addressing these issues in October 2010. This resulted in new rules being passed in June of this year, including rules on the COMI principle whereby bankruptcy proceedings should be opened in the country where the business has its centre of main interest, rules on secondary bankruptcy proceedings and rules on the recognition of foreign bankruptcy proceedings. It is currently unclear when this new regulation will come into force.

Norwegian insolvency practitioners hope that the current crisis will draw focus to the lacking Norwegian rules on restructuring and Norwegian International Insolvency Law, as the time for reform is long overdue and the current crisis shows a desperate need for rules to govern restructuring processes for international company groups based in Norway.

Along the initial value chain introduced at the beginning, various legal issues facing insolvency from a bank's perspective and administering an insolvency from the office holder's perspective in the downstream sector shall be discussed with a view on German law.

III. Legal title in oil – a German law view *(Annerose Tashiro)*

In a restructuring case or the commencement of insolvency proceedings about the assets of a refinery, the risks and legal problems, which arise with regard to

ownership rights of stored oil are subject to some special legal constructions under to German law.

So what are the specialties an insolvency administrator of a refinery or another of the midstream or downstream players faces, when it comes to crude oil to be processed in a refinery?

Changing possession and formats of ownership and security rights

In comprehending the legal situation, the administrator will note that crude oil has to be delivered to its processing destination in the most varied ways and by all sorts of different players. Before the fuel can be sold to a petrol station, the oil has already come a long way with changing possession and formats of ownership and security rights.

For an insolvency administrator, who is in charge of the collective satisfaction of the debtor's creditors by liquidation of the assets and the distribution of proceeds or by various formats of restructuring or rescue sales, it is important to analyse and form a clear view of whether the debtor is the owner of the crude oil and processed oil products bought, delivered and processed in the facilities of the refinery or to what extent and which creditors has valid security rights to which respective fraction of the crude oil or the already processed oil products stored in kilometres of pipelines and tanks of a refinery.

Oil value chain

To briefly recap the (simplified) oil value chain, (1) start is at a crude oil exploration and production site, (2) crude oil is usually sold as blends from various oil streams of numerous oilfields that are gathered and pumped to oil terminals and blended (upstream), (3) from which blends are transported by pipelines or by tankers to the (4) harbors around the world where crude oil is further stored in gigantic tank farms and (5) distributed through special facilities and pipelines to (6) refineries at which the crude oil is processed into oil products (downstream).

International spot market

Refiners buy such blends usually on long-term contracts from E&P companies, to be supplied to their refinery; however, a portion of the crude is also sold on so-called spot markets. International spot market traders buy crude oil from the exploration & production companies and sell it to processors of oil products, which supply for example the processed diesel petrol stations.

Usually refiners have the crude oil pumped from the tank farm to the oil refinery. They contract with the harbor tank farm, the pipeline operator and other transport (midstream) companies to procure the delivery.

Uncountable fluid

Oil however is – apparently – an uncountable fluid that flows constantly through pipelines and tank farms into the refinery with an ongoing refinery process until the oil products are finally delivered at the "exit" of the refinery facilities to resellers like gas station companies, heating oil sellers or the like.

Separate legal entities

However, while the oil is on a constant flow, E&P firms, vessel operators, tank farm operators, pipeline operators, refinery companies are all separate legal entities acquiring possession of the oil.

Until the crude oil arrives at the refining site, one must take into account that oil cannot physically be separated unless put into some form of container. Thus far, crude oil is rarely exclusively delivered through pipelines and stored in warehouses and tank farm, but usually commingled and mixed with crude oil owned by third parties. In addition, refining companies happen to not only refine their own crude oil, but also process oil on behalf of third parties transported nevertheless through the same pipeline to the facility. Refiners, traders, suppliers and also tank farm operators and pipeline companies establish security in favour of lenders and banks with respect to their own (portions of) crude oil, processed oil products and further additives needed for the refining process in order to finance their business.

For insolvency administrators of any of these players it is highly complex and difficult to determine ownership and security rights in crude oil, processed oil and any of the finished oil products.

From a legal perspective, under German law as well as most other legal regimes ownership title ceased to exit upon commingling or processing.

In the simple case, a refiner buys raw material, processes it with its plants and then sells the oil products. It therefore both operates the refining plant and bears the refining margin risk. However, when there is a separate company supplying crude oil to the refiner to be processed under a tolling or processing agreement, the (1) processor being the "manufacturing or industrial refiner" and the (2) supplier or processee being the "economic refiner" bearing the entire market risk of the volatile refining margin (= price difference between oil products and crude oil) while the refiner is entitled to a fixed processing fee per ton without any direct reference to market prices or refining margins can be distinguished.

Processing clause

However, German law provides some solutions for the supplier to maintain ownership title in the products: in general, a processor of goods (and here the refinery) acquires the ownership title in the processed or remodeled goods (oil products), if these processed or remodeled goods constitute new movable assets (products). Separate suppliers need to secure their ownership title by virtue of a certain so-called "processing clause" (*Herstellerklausel*). Such processing clause stipulates that the refiner shall process the crude oil, delivered by the supplier to the refinery, on behalf of and for the account of the supplier, so that the ownership title to these new movable assets resulting from the processing (oil products) will be vested and originate with the supplier who is deemed "(legal) manufacturer" pursuant to section 950 of the German Civil Code and not the refiner.

Otherwise, one may only argue that the value of the processing or the remodelling is substantially less than the value of the processed substance or original parts (see section 950 of the German Civil Code). The small refinery margins help to establish that the refiner does not gain ownership title by virtue of processing somebody else's crude oil.

However, such "easy" answer cannot be found with respect to stored oil, be it either in the tank farm, the pipelines or the storage tanks at the refining facility.

Collective warehousing

Eventhough German commercial law provides some sort of solution that creates joint ownership in case of so called collective warehousing. Pursuant to section 469 of the German Commercial Code, refineries, tank farms or pipeline operators may be defined as a warehouse-keeper, which allows for storing goods together with other goods of the same kind and quality, if all depositors agree. Thereupon, depositors become co-owners of the entire stock in the warehouse for their respective fractions of crude oil. The particular definition of gathering, commingling, fraction and delivery of oil and oil products is a matter of high complexity and understanding the circumstances of the business and the scientific situation, such as that the volume of oil stored varies depending on the temperature.

Transfer of ownership rights in crude oil for security purposes

Transfer of ownership rights in crude oil for security purposes is subject to some special legal constructions under German law. The specialty comes with the constantly revolving stock of the refinery, in other words the constantly commingled and mixed fractions of crude oil owned by the refiner or the different suppliers.

A transfer of title in crude oil located in the refinery for security purposes may be concluded in the format of a transfer of the entire volume of oil stored in a certain defined location (security area) (*Raumsicherungsvereinbarung*). Any uncertainty in defining the exact location of the stored oil however may lead to the invalidity of the security agreement. A fraction of the co-ownership within such security area can also be subject to such respective security assignment. The key here is however the definition of the fraction in addition to the definition of the location.

Usually, the transfer of ownership title is made by reaching an abstract in-rem agreement and an actual handover according to German civil law. While oil is not easily handed over and a bank does not want to store oil in its basement, the actual handover may be replaced by an indirect possession arrangement (*Besitzmittlungsverhältnis*) upon which the refiner or pipeline operator etc. as the transferor holds possession on behalf and in favour of the bank (sections 929, 930 of the German Civil Code). In the event the oil owned by the refiner is located in a tank farm or the pipeline, ownership can still be transferred to the bank for security purposes. If the collateral is in the possession of a third party, the handover can also be replaced by an assignment of the right to recover possession against such third party (sections 929, 931 of the German Civil Code) (*Abtretung des Herausgabeanspruches*).

Future fraction in the co-ownership

Considering the constant flow of oil through tanks and pipelines, determination and specification of the collateral is crucial to perfect the security. Further, under German law it is possible to transfer goods brought to the security area in future to the bank effectively upon their arrival in the security area. In particular, also in case of more than one "users" of the tank farm or pipeline, the future fraction in the co-ownership can be made subject to a security transfer. Above all, specification and determination of such future fraction must be consistent throughout the security agreement and the contracts between the refiner and the pipeline operator or the tank farm or terminal company.

Likewise, in case of crude oil owned by a separate processor stored within a defined security area at the premises of the refinery, the refinery holds possession of the crude oil. As substitute for the handover of actual possession to the bank, the processor and bank agree on the assignment of the processor´s right to recover possession vis-à-vis the refinery concerning the crude oil, which is stored in the security area at the time of the agreement and that in the future from the moment of the actual possession of the refinery.

Only with all these considerations and verification, can the insolvency administrator collect the debtor's own oil, segregate third parties' oil or arrange with the bank for the continuation of the business and the realization of the bank's collateral. Banks that take in security over oil in process of being transported from the production site through oil tankers, to tank farms and refineries must understand the high volatility of their collateral and corresponding requirements for utmost details to the determination of such.

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Kvale Advokatfirma has the experience and knowledge to assist companies, banks, bank syndicates, bondholders and other creditors in refinancing, restructuring and other insolvency issues. *Kvale* is known for its strong oil and gas and insolvency practices, both top ranked in international rankings, and is thus in a unique position to provide assistance in the oil and gas crisis.
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