SEWARD & KISSEL LLP

PRIVATE EQUITY IN SHIPPING

KEY CONSIDERATIONS FOR SHIPPING PRIVATE EQUITY VENTURES

The cyclical nature of the shipping industry and the decline in vessel values have induced traditional private equity investors to explore investment opportunities in shipping. Similarly, the credit crisis and the corresponding dearth of financing from traditional providers of capital to the shipping industry have caused ship owners to seek alternative financing sources. The result has been a significant increase in the number of private equity investors and ship owners strategically aligning their respective interests and forming shipping private equity ventures ("SPEVs"). Set forth below are some key considerations that must be carefully considered by each of the parties to a SPEV:

- ***Purpose***. The purpose of the venture should be agreed between the parties at the outset. If the SPEV will be established for a single transaction or if it is intended to invest in a particular segment of the shipping industry, the parties may wish to limit its purpose so that the entity is not authorized to take any actions outside of the SPEV's stated business purpose. In addition, describing the business purpose with particularity will assist the parties in negotiating and drafting other related provisions in the SPEV's governing documents, such as a narrowly tailored, enforceable non-compete provision. Also, specifically identifying the types of investment activities may affect other business and legal considerations, such as the form and jurisdiction of the SPEV (e.g., whether the SPEV will be investing in Jones Act vessels) or registration with the Securities and Exchange Commission ("SEC") as an investment adviser (e.g., whether the SPEV will be investing in securities of shipping companies or investing in other types of securities). For a description of SEC investment adviser registration issues, please see "SEC Registration For Private Equity Shipping Fund Advisers" contained on page 5.

- ***Form of Entity and Jurisdiction***. The parties will also need to consider the legal form of the SPEV and the jurisdiction of its organization. The determination will be driven primarily by tax and regulatory implications resulting from the types of investors and the nature of the SPEV's activities, as well as the general preferences of the parties. As with any joint venture, a SPEV can be a corporation, a partnership or a limited liability company. Marshall Islands limited liability companies have become the vehicle of choice for SPEVs because of their simplicity, flexibility and the fact that the Marshall Islands Limited Liability Company Act is based on the Delaware Limited Liability Company Act, which provides a well-developed body of jurisprudence. Another advantage to a Marshall Islands limited liability company is

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the ability to elect to be treated as either a corporation or as a "pass- through" entity for U.S. tax purposes. For a discussion of certain tax considerations, see "Tax Structuring Issues For Shipping Investments" contained on page 4.

- ***Economic Terms***. The parties need to consider a number of economic terms, including, among others:

  - the ownership interest each party will have in the venture;
  - the size of each party's capital commitment;
  - the amount and type of initial capital contributions, if any;
  - procedures for capital calls and remedies for defaults;
  - the length of the investment period, including the ability to extend and/or cause an early termination thereof;
  - the term of the venture;
  - the allocation of profits and losses and the distribution waterfall, including whether any parties will be entitled to priority or preferred returns; and
  - the ship owner's compensation for services to the SPEV, including any management or performance compensation, such as a carried interest or other equity incentives, and any related vesting or clawback provisions with respect thereto, and the amount of any commercial and technical vessel management fees.

- ***Governance Issues***. Another key issue is determining how the SPEV will be managed and how much control each party will have in running the business. For example, the parties must determine if there will be a governing body, such as a board of directors or management committee, and if so, how the size and composition of such governing body will be determined. The parties must also decide what decisions will require simple majority approval and which items, if any, will require supermajority or even unanimous consent.

- ***Conflicts of Interest; Non-Competition/Non-Solicitation***. The parties should address potential conflicts of interest that may arise from time to time between the ship owner's existing operations and the SPEV's business. At a minimum, the parties should determine how potential vessel acquisitions, chartering opportunities and vessel dispositions will be allocated between the SPEV and the ship owner or other clients to the extent there is any overlap in the businesses or any potential for conflicts of interest. In addition, during the term of the venture (or at least during the investment period), the parties may wish to consider restricting the other's ability to establish or invest in competing ventures or to solicit the SPEV's clients, customers or employees.

- ***Key Person; Management Issues***. The parties will also need to consider issues relating to the ship owner's involvement in the management of the SPEV's business. For instance, the parties should consider the amount of time that the ship owner and its key personnel need to devote to the SPEV's business and the remedies if such time commitments are not satisfied, including termination of the investment period and/or liquidation of the SPEV. Private equity investors may also want to consider having the right to remove or replace the ship owner as manager if it has engaged in certain proscribed conduct, including material breach of the operative documents and vessel management agreements, if applicable, violations of applicable laws or other similar egregious conduct, as well as any ramifications resulting therefrom, including forfeiture of unvested equity and/or unearned carried interest.

• ***Liability and Indemnity Limitations***. Another important issue that the parties often negotiate is the limitation on the ship owner's liability as manager of the vessels (assuming it is acting in that capacity). Under the "Shipman 98" standard ship management agreement, the ship manager typically would not have any liability other than for losses proven to have resulted solely from the manager's negligence, gross negligence or willful misconduct, in which case the liability would be limited to ten (10) times the amount of the annual management fee. The parties should consider whether similar liability limitations would be appropriate for the SPEV. On the other hand, the SPEV would typically indemnify the ship owner for any actions taken on its behalf other than gross negligence, willful misconduct or fraud. The parties should also consider whether they will be required to recontribute previously distributed capital and/or make additional capital contributions to the SPEV if the entity is unable to meet its indemnity obligations.

• ***Limitation on Transfers; Exit Strategy***. The parties to a SPEV must consider how, and under what circumstances, the venture will terminate and whether a party is free to exit the venture. In order to lock up each party and to prevent a party from transferring its ownership interest in the SPEV to an unwanted third party (such as competing shipping owners or other private equity investors), most joint venture agreements have varying degrees of restrictions on transferability of interests, ranging from a total prohibition to prescribed limited transfer rights, such as rights of first refusal, tag-along and/or drag-along rights, to put-call arrangements, or even a forced sale or liquidation of the venture. The parties should also consider the possible exit strategies for the SPEV itself, such as through a sale of assets or equity in the company, merger or an initial public offering, including preparing for this by granting related registration rights and providing for any necessary appraisal or valuation process.

• ***Deadlock Events and Dispute Resolution Mechanisms***. The parties should try to plan for possible contingencies, including deadlock events. Deadlock events can vary, but typically include a lack of agreement on certain material issues related to the business or management of the venture. The parties should provide for the mechanism to resolve such a deadlock. The mechanisms typically include mediation, arbitration, litigation, forced sale or liquidation of the company, or exercising a buy-sell right.

The above covers only some of the issues that private equity investors and ship owners should consider before entering into a SPEV. Identifying and resolving these issues at the outset should enhance the likelihood of a smooth and successful venture.

TAX STRUCTURING ISSUES FOR SHIPPING INVESTMENTS

The structuring of investments in shipping requires consideration of several tax issues, some of which are unique in the context of private equity investments. These issues may affect sponsors, private equity investors and ship owners in different ways, depending upon their status as U.S. or non-U.S. persons. For example:

- ***Entity Classification.*** The U.S. federal income tax classification of the holding company and its vessel-owning subsidiaries, as well as the investment vehicle utilized by a private equity investor as either a corporation or a pass-through entity must be determined.

- ***Controlled Foreign Corporation.*** If a corporation is used, the level and concentration of the U.S. ownership of the corporation could cause it to be treated as a controlled foreign corporation (a "CFC") for U.S. federal income tax purposes. CFC status can result in current inclusion of undistributed income in certain circumstances and/or the recognition of ordinary income (rather than long-term capital gain) on a disposition of shares.

- ***Passive Foreign Investment Company.*** If a corporation is used, the type of income earned (e.g., bareboat charter income) could cause the corporation to be treated as a passive foreign investment company (a "PFIC") with respect to U.S. investors. Very generally, PFIC status can result in current inclusion of undistributed income or a punitive interest charge on disposition of shares.

- ***Section 883.*** The entity or its investors (if the entity is a pass-through) must determine whether they will be able to qualify for exemption from U.S. federal income tax on their U.S. source shipping income under Internal Revenue Code Section 883. Of particular note is that in order to qualify for the benefits of Section 883 a foreign corporation must generally obtain statements signed under penalties of perjury establishing its ultimate ownership. Private equity funds may have difficulty obtaining such statements from their investors. It should also be considered whether the amount of U.S. source shipping income earned by the venture will be material as such income is generated only when a vessel calls at a U.S. port.

- ***Taxation Upon an Exit Event.*** Finally, the parties should consider how to structure for a tax-efficient exit from the investment (whether by an IPO or otherwise) for private equity investors, taking into consideration that a private equity fund may have investors with different tax profiles (i.e., U.S. taxable investors, tax-exempt investors and non-U.S. investors).

Some or all of the issues discussed above may be relevant to the participants in a particular shipping venture, and the extent of their relevance and the ramifications to each participant may differ depending upon whether the participant is a sponsor, a private equity investor or a ship owner. Although under certain circumstances the interests of these various participants will be aligned, there are times that these participants may have competing interests with respect to certain issues, thus requiring careful structuring and negotiation.

SEC REGISTRATION REQUIREMENT FOR SHIPPING PRIVATE EQUITY FUND ADVISERS

The Dodd-Frank Wall Street Reform and Consumer Protection Act now requires most advisers to private equity funds ("PE Advisers") with over $150 million in total assets under management to register as investment advisers with the Securities and Exchange Commission ("SEC").

Under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), an investment adviser is generally defined as a person or entity who for compensation engages in the business of providing advice to others regarding securities. Therefore, a key factor in determining whether an investment adviser to a private equity shipping fund will need to register with the SEC will be whether the fund is investing in "securities." "Securities" are defined very broadly under the Advisers Act and include, among other things, notes, bonds, evidences of debt, stock, puts, calls, options, warrants, investment contracts, participation interests, etc.[1] Therefore, the investments being made by the fund must be carefully analyzed in order to ascertain if SEC registration is required. For instance, although simply owning and operating vessels or owning wholly-owned subsidiaries engaged in such activities may not result in an investment adviser being deemed to be advising its clients with respect to "securities" under the Advisers Act, a fund that provides debt financing, owns minority equity stakes in ship-owning holding companies and/or engages in sale-leaseback transactions, could be deemed to be investing in "securities," thus triggering SEC investment adviser registration for the investment managers to such funds.

PE Advisers of shipping funds that are required to register with the SEC will now have to operate their business in a regulated environment. Perhaps most significantly, these PE Advisers need to (i) adopt and implement written compliance policies and procedures designed to detect and prevent violations of the Advisers Act, (ii) review these policies and procedures at least annually, and (iii) designate a chief compliance officer to implement, maintain, administer and test the compliance policies and procedures.

Highlighted below are a number of key areas that these PE Advisers need to review and consider in connection with the registration process and establishing their compliance programs.

- ***Carried Interest.*** The Advisers Act generally prohibits registered advisers from charging investors advisory fees based on a share of the capital gains or appreciation of the investor's assets (i.e., taking a "carried interest"). The Advisers Act contains exceptions from this prohibition for "Qualified Clients" as defined in the Advisers Act (generally investors who have a net worth exceeding $2 million, or who, with certain exceptions, are

[1] Section 202(a)(18) of the Advisers Act defines security as any "note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ''security'', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guaranty of, or warrant or right to subscribe to or purchase any of the foregoing."

"Qualified Purchasers" within the meaning of Section 2(a)(51) of the Investment Company Act of 1940, as amended) and investors that are not U.S. residents.

- ***Trade Allocation.*** An adviser is a fiduciary and must always serve the interests of its advisory clients (including fund investors). The SEC expects advisers to treat all clients equitably with respect to its allocation of investment opportunities so that no one group of investors is disadvantaged. The typical standard is a "fair and equitable" allocation over time, subject to certain exceptions. PE Advisers that manage multiple vehicles therefore need to have polices for allocating deal flow and exit opportunities.

- ***Side Letters.*** Side letters are documents outlining preferential terms offered to select investors, such as increased transparency, rights to co-invest, limits on default penalties, reduced fees or similar rights. The SEC expects advisers to provide disclosure to clients regarding such arrangements, and in some cases could view the preferential treatment as inconsistent with the adviser's fiduciary duty.

- ***Performance Advertising.*** Under the antifraud provisions of the Advisers Act, the SEC regulates the content of marketing materials and, in particular, has prescribed very specific requirements governing the presentation of performance results by advisers. PE Advisers need to review their offering documents and other marketing materials to ensure that they comply with SEC guidelines.

- ***Code of Ethics.*** Registered advisers must adopt and enforce a Code of Ethics as part of their compliance program. The Code of Ethics must, among other things, address personal securities trading and require the reporting of personal holdings by certain employees.

- ***Custody of Assets.*** Under the Advisers Act, assets generally must be properly custodied with a "qualified custodian" and account statements are required to be sent to clients. PE Advisers should review the exceptions afforded in the case of certain privately offered securities held by their funds and with respect to funds that provide certain annual audited financials to investors within 120 days of each fiscal year end.

- ***Political Contributions.*** The Advisers Act prohibits an adviser from receiving compensation for providing advisory services to a government pension (through a fund or otherwise) for two years following any contribution, other than certain de minimis contributions, made on or after March 14, 2011, by the adviser or its covered associates to an official of the government entity who is or will be in a position to influence the award of advisory business. In addition, an adviser is prohibited from coordinating, or soliciting others to make, on or after March 14, 2011, contributions for an official of a government entity to which the adviser is providing or seeking to provide advisory services. There are also "look-backs" in certain cases.

- ***Recordkeeping; E-mail Retention*** The Advisers Act requires a registered adviser to make, maintain and preserve certain books, records and emails covering its activities.

Becoming an SEC-registered investment adviser requires preparation and a commitment of time and resources; however, it is a challenge that can be dealt with through proper planning and on-going execution. The first step for any PE Adviser is to analyze its existing and proposed investment activities to determine whether or not registration is in fact required.

JUMPSTART OUR BUSINESS STARTUPS ACT

The Jumpstart Our Business Startups Act (the "JOBS Act") was signed into law by the President on April 5, 2012, making sweeping changes to the U.S. federal securities laws that will significantly impact offerings of private equity and other private fund interests. Set forth below is a summary of some of these key changes.

• ***Removal of Prohibition on General Solicitation and Advertising.*** The JOBS Act directs the Securities and Exchange Commission (the "SEC"), within 90 days of its enactment, to revise its rules to remove the prohibitions against general solicitation and general advertising in connection with offers and sales of securities made pursuant to Rule 506 of Regulation D under the Securities Act of 1933, as amended (the "Securities Act"), which is the offering exemption on which most private funds rely, as well as Rule 144A offerings to Qualified Institutional Investors ("QIBs"). The JOBS Act also provides that securities offerings relying on Rule 506 "shall not be deemed public offerings under the federal securities laws as a result of general advertising or general solicitation." Therefore, a private offering that complies with the amended Rule 506 would not constitute a public offering for purposes of Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940, as amended.

While sales of securities in private funds must still be limited to accredited investors in the case of Rule 506 offerings, or QIBs in the case of Rule 144A offerings, the elimination of the prohibition on general solicitation and advertising should permit funds to undertake direct marketing activities. These may include placing advertisements in publications or on publicly accessible websites, speaking publicly about the fund at industry conferences, giving interviews or otherwise responding to media inquiries and "cold calling" potential investors with whom the fund does not have a preexisting relationship as required under existing law.

• ***Number of Investors.*** The JOBS Act also raises the number of equity holders in a private fund permitted under Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") that triggers public company reporting requirements to 1,999 from 499.

• ***IPO "On-Ramp".*** In addition to creating new private offering opportunities, the JOBS Act may also benefit private equity funds pursuing an IPO exit strategy for their underlying investments or portfolio companies.

The new law creates a class of issuers called emerging growth companies ("EGCs"). An EGC is a company that had total annual gross revenues of less than $1 billion during its most recently completed fiscal year. EGC status would cease on the earlier of (a) the last day of the fiscal year following the fifth anniversary of the first public sale of common equity securities by the company, and (b) the company meeting certain financial thresholds.[2] A company that completed an IPO prior to December 8, 2011, however, will not qualify as an EGC.

The advantages afforded to EGCs in the IPO context include:

• ***"Quiet" Registration Statement Filings.*** The ability to submit IPO

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[2] EGC status would also cease upon (i) the last day of the first fiscal year in which the company achieves annual gross revenues of at least $1 billion, (ii) the date on which the company has, during the previous 3-year period, issued more than $1 billion of non-convertible debt securities, and (iii) the date that the company achieves "large accelerated filer" status under the SEC's rules, which generally occurs when the company has an aggregate worldwide market value of common equity securities held by non-affiliates of at least $700 million.

registration statements to the SEC for confidential review, provided the registration statement and amendments submitted in response to SEC comments are publicly filed at least 21 days before commencing the IPO road show.

- ***U.S. Market Testing.*** EGCs will be able to communicate, in writing or orally, with certain institutional investors, before filing a registration statement to determine the level of interest for securities to be offered by the EGC.

- ***Analyst Coverage.*** Broker-dealer firms, including those participating in the IPO, may provide analyst coverage of an EGC and can publish reports on the EGC without timing restrictions.

- ***Financial Reporting.*** EGCs will only need to include audited financial statements and selected financial data for the past two fiscal years (as opposed to the current three-year/five-year requirement) in an IPO registration statement.

The JOBS Act will also relax or eliminate, for so long as a company is an EGC, certain early stage disclosure and regulatory compliance requirements, such as eliminating auditor attestation reports required by Section 404(b) of Sarbanes Oxley, the "say on pay" shareholder vote required under the Dodd-Frank Act and reduced disclosure requirements concerning executive compensation.

While the effect of the JOBS Act on private placements and IPOs will likely be significant, the ultimate impact will depend on the final rules and regulations adopted by the SEC and rules and interpretative guidance likely to be implemented by other regulatory agencies, such as FINRA.

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