

Cabinet Secretary Finance, Economy and Fair Work

UPDATE ON OPTIONS IN RELATION TO FMEL

Purpose

1. To provide an update on next steps with regard to FMEL.

Priority

2. URGENT.

Background

3. There have been continuing developments with officials and advisors to determine options for securing the future of FMEL, including options for public ownership, receipt of the QC report on Deemed Notice, and the negotiation strategy for surety bond holder HCCI.

Build Out Through Administration Without Ownership

4. At the outset, it is worth noting that as part of the options analysis looking at solutions at FMEL, advisors considered and ruled out the option of building out the vessels in the yard through an administrator (without taking ownership of the yard).
5. In the event of insolvency, an appointed administrator would have to consult with FMEL management, CMAL and 801/2 suppliers in order to provide a new estimated completion timeline as this continues to change and will form an important part of the costs of the administration, as well as the strategy of the administration.
6. The normal process in an insolvency would be for the immediate redundancy of non-key personnel. It will require FMEL and CMAL input to identify the resource required to ensure the delivery of 801/2. The advice we have received also indicates that in seeking to build out under administration, it is likely that a tendering exercise would be required which would add considerable time and uncertainty.
7. An administration could last as long as it takes to deliver 801/2 (currently forecasted for Q4 2020), or as long as an administrator deems there to be sufficient value within the company for the administrator to realise and distribute to creditors. At this point, a decision will be taken by the administrator as to the future of the business.
8. For these reasons, Officials and Advisors recommend that pursuing an option that leads to Public Ownership is in the best interests of the workforce and the client.

Public Ownership Routes

9. There are three possible routes to public ownership. Two through exercising our rights through the loan agreements;

- (i) [REDACTED]
 - (ii) through a fair value process with CBC, and the third:
 - (iii) by seeking to purchase the yard from an administrator.
- [REDACTED]
- [REDACTED]
- [REDACTED]
- [REDACTED]

Fair Value Process

11. CBC are proposing that the shares be purchased through the 'Fair Value' route and have indicated that they see some residual value in the business. This is presumably on the basis of the claim and their view that in the absence of the loans and the CMAL contracts the business would have been successful.

12. Whilst we are confident that there is no value in the business and that ultimately the Fair Value process would arrive at this conclusion, the timescales around this approach would be longer and there is a risk that this could become further drawn out should the assessor of Fair Value seek to explore the detail of the claim. The potential impacts around uncertainty and timescales are not in the interests of the workforce or the customer.

13. CBC had offered that the shares are transferred with the price left outstanding until such a point as an expert can opine on the fair value of the Group. They offer this in response to the need for an expedient solution.

14. We have confirmed to them that there are no circumstances under which Scottish Ministers would grant approval to enter into a transaction in this context, the consideration for which may be uncertain. In fact, we do not consider any party or person would consider entering into such an arrangement as a responsible action.

Seeking to Purchase the Yard from an Administrator

15. Whilst a solvent transaction remains the currently preferred option, it is possible that an insolvency could become preferable / required if for example: our diligence identifies significant new liabilities that SG is unwilling to fund; CMAL, FMEL or HCC take action that precipitates an insolvency and we are unable to complete a solvent sale in the limited timescale available.

16. This scenario could also be enacted in two ways:

- i) We would contact an administrator immediately on appointment and confirm our interest in buying the business and assets. A transaction would be completed in early course
- ii) Contacting the 'administrator in waiting' and negotiating a purchase in advance of an administration for enactment on filing, to minimise disruption and would likely be based on us buying the assets for their market value.

In both cases the administrator would need to satisfy themselves that our offer was the best offer.

17. SG would be able to use its existing debt to 'credit bid' for the business, allowing it to bid significant value without needing to use cash for the whole bid. This should give SG an advantage over other parties (in the unlikely event that other bidders are interested).

18. The advantages in this route would be that any issues surrounding the loan funding from CBC (outlined below) would fall away. However, in taking ownership through a pre-pack we would clearly seek to honour any outstanding commitments the business had to its trade creditors.

Preferred Route to Public Ownership

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

23. Officials therefore aim to write to FMEL on Tuesday or Wednesday next week to clarify the company's plans to repay the debt highlighted during due diligence. Should they be unable to provide a reasonable explanation, we will assume that we have an Obligatory Event and commence serving paperwork on the share transfer.

24. If an Obligatory Transfer Event notice is issued by the Scottish Ministers it should be based on FMEL's cash flow insolvency but it could also make reference to the fact that FMEL is balance sheet insolvent for the sake of completeness.

25. Should it be demonstrated that we have this evidence, it would be our duty to advise Ministers to pursue this option, given this was written into the loan agreements, agreed by both parties and that this would be in line with the approach a commercial party would undertake in addition to being in the best interests of the workforce and the customer (and the end users of the vessels).

26. CBC may opt to not to comply or sign the paperwork. At this point Scottish Ministers option would be to pursue this through the courts. If required, Counsel for Scottish Ministers would petition the court for an order of specific implement, in order to enforce their contractual right under the agreement for the shares held by CBC to be transferred to Scottish Ministers for £1, and to enforce the signing of the stock transfer form and ancillary transfer documents and actions required to complete the acquisition.

CBC £3m Loan and View on Fair Value

21. As an alternative to the approach outlined above, CBC have been clear to Ministers and officials that their view is that SG should repay its £3m loan and purchase the shares through a Fair Value process.

22. Although this is an option in theory, and offers the possibility of removing CBC from the business in a controlled manner, there are two fundamental challenges -

- Firstly that there is a more efficient and effective method available to us as set out in the loan agreement.
- Secondly, that there is a requirement for the £15m loan to be repaid in advance of any other loans.

23. For both of those reasons, it would be unlikely that any commercial operator would adopt the approach outlined by CBC and could be seen as a departure from the MEOP that has been the basis of SG entering into these agreements in the first place. There would also undoubtable be presentational issues in adopting this approach.

24. CBC have indicated to officials that they may seek to use their options around this £3m to frustrate our operation of the business under public ownership. It is assumed that this is part of its negotiating strategy to push for the Fair Value process and in addition to see some or all of this loan repaid.

25. We have received further advice on the scenarios, risks and remedies relating to the CBC retention of £3m debt in the business – particularly where any share transfer is on a ‘non-consensual’ basis.

26. Should CBC take an option to convert its debt to equity, this may cause issues around the Teckal exemption to enable us to award future contracts to the yard beyond the build out of 801 and 802. Advisors have considered mitigation that could be put in place in these circumstances, in line with those.

27. If we have a reasonable expectation that CBC take this action, then

SG could direct the sale of FME(H)L's shares in FMEL post nationalisation (the "FMEL Share Sale"). This would see SG set up 2 HoldCo companies. The first would take ownership of the FMEL Group and then ownership of FMEL could be transferred to the second company.

28. Should Ministers require to use the remedy above, it will attract criticism from CBC. However, we would be clear (including publicly if needed) that this action had only been taken due to attempts by CBC to frustrate efforts to enact a solvent solution that would allow the vessels to be constructed and the employment secured.

Negotiations with HCCI

29. As Ministers are aware, there are two bonds for hull 801 and 802 that if triggered would release c£25m to CMAL. However, the Bond Holder, HCCI, would then exercise its security over the yard. This would require us to enter discussions for access to the facility, most likely through buying them out at significant cost.

30. As an alternative, we are attempting to negotiate a settlement with HCCI in advance that would give us greater certainty in undertaking any transaction. We had hoped to enter into an NDA around these discussions, but that has not proven possible – we have proceeded without this but have indicated to the Surety that it would be in all of our interests to keep the discussions confidential. A copy of the offer to the Surety is contained in **ANNEX A**.

31. We are proposing a settlement where the Surety will pay a smaller amount than the figure it would likely lose overall in an uncontrolled insolvency. In return for this payment, the Surety would be released from all liability to CMAL, and it would release its security over FMEL. This simplifies the overall position, providing the Surety with a quick exit and certainty over its financial exposure.

32. It is important to note that CMAL (or rather the SG Public Purse) will receive the benefit of the two guarantees but rather than just receiving this value in cash it will be through a combination of benefits including, cash left in the business to progress the vessels, limitation of risk and uncertainty, quick easy access to the vessels, avoiding the costs of being 'ransomed' (i.e. by HCC seeking payment on the basis it is first ranking creditor) and/or needing to transfer the hulls to an alternative site for completion and the associated incremental build costs that would be attached to this.

33. The settlement value being proposed (a net payment from the surety) would in effect be the value of the claim (c.£25m) less the cash available in escrow (£4.5m) and the business (currently c£3m but this will continue to decrease therefore changing the settlement value) at the point of a theoretical administration and a (small) value to reflect the assets in the business.

34. Some of the key risks as we see them are:

- Limited window to agree a settlement with the Surety. While CMAL could still call on the guarantee after an SG acquisition of FMEL there is unlikely to be net value to the public purse from this. While CMAL would receive cash from the Surety,

this would trigger a claim by the Surety on (the now SG owned) FMEL. SG would need to provide FMEL with funds to allow FMEL to repay HCC, otherwise HCC would precipitate an insolvency of FMEL. Therefore any settlement needs to be achieved before SG takes ownership.

- In the event that directors file a Notice of Intention to Appoint Administrators (“NOI”) there is a high risk that the Surety plays for time, recognising that SG is trying to avoid insolvency appointment (i.e. Surety may think that the closer you get to expiry of 5 working day NOI period, the poorer the deal that SG may be willing to accept).
- There is a real risk that the Surety refuses to work consensually, believing that SG will be in a worse position in insolvency than the Surety, or that SG will never allow an insolvency of FMEL to happen, to date this does not seem their stance.

Purchase from Administrator

35. Given the uncertainty around how CBC may react to Ministers exercising their rights to purchase on the basis outlined above – and where we may get to in discussions with the bond holder, officials and advisors would highlight that the option of purchasing the yard through administration would continue to remain under consideration. This may have some benefits in removing complications around the CBC debt, although we would look to structure this in a manner that ensured other commitments to creditors were met.

36. We will review this position prior to issuing any notice to CBC next week.

Planning For Taking Ownership of the Business

37. Officials and Advisors continue to undertake work on the practical day to day issues that need to be considered should we take ownership of the business next week. This includes issues around funding mechanisms, bank accounts and key personnel.

38. A shortlist of Interim Turnaround Directors is being prepared by PWC for consideration by officials on Monday.

39. A list of SG personnel is being drawn up to fulfil Non-Executive Directors roles in the company structure being put in place in addition to the Executive posts we seek to appoint. Given the existing FMEL Directors will potentially remain in place at OpsCo for a period of time. The appointments may not be merely short term (and could involve the individuals becoming directors of multiple entities, all entailing directors duties) and therefore thought is being given to the appropriate candidates.

40. We are also considering options to replace some of the SG personnel with other potential candidates that Ministers could appoint on an interim basis as Non-Executive Directors.

41. In addition to the board members we are also identifying 2-3 SG staff that will

have a presence in the yard in the initial period following the change in ownership to demonstrate Ministers commitment as new owners and support the team in the business.

Scottish Ministers Powers and Advising Parliament

42. The proposal is that Ministers will acquire FMEL in exercise of a right conferred under the terms of the loan agreement between Ministers and FMEL. Ministers may acquire a company in these circumstances in exercise of common law powers, provided they are able to do so within devolved competence.

43. It is not considered that the acquisition of FMEL raises any issue of devolved competence. In particular, there is no interaction with the marine transport reservation in Section E3 of Schedule 5 of the Scotland Act. That reservation is concerned with regulation of matters relating to international and UK shipping, including marine safety and security, navigational rights, regulation of the British merchant fleet and all matters relating to the employment of seafarers. Acquisition of a company concerned with the production of marine vessels does not affect those matters.

44. Common law powers do not extend to the expenditure of money for ongoing funding and investment. There is, however, a broad power in section 70 of the Transport (Scotland) Act 2001 for Ministers to make grants and loans to any person for purposes relating to transport. This power is otherwise unqualified and is considered sufficient to permit Ministers to make initial and ongoing investment in FMEL as need be.

45. The Convener of the Finance Committee will have to be written to, to be advised of the use of the common law powers. This should be done before any “activity giving rise to activity being undertaken” which we would interpret to mean as soon as Ministers make a decision to proceed with public ownership.

Recommendation

46. Ministers are asked to;

- **Confirm that officials should continue to work toward taking the business into public ownership.**
- **Acknowledge the 3 possible routes to public ownership.**
- **Agree officials will write to FMEL Directors next week to clarify Deemed Notice through cash flow insolvency issue [REDACTED]**
- **Agree that officials continue to keep the option of purchasing the business through an insolvency with a pre-pack under review.**
- **Note approach to HCCI for Surety bond conclusion.**

Liz Ditchburn, DG Economy

Copy List:	For Action	For Comments	For Information		
			Portfolio Interest	Constit Interest	General Awareness
First Minister					X
Deputy First Minister					X
Cab Sec Finance, Economy and Fair Work	X				
Cab Sec Transport and Connectivity			X		
Minister for Energy, Connectivity and Islands			X		
Minister for Public Finance and Digital Economy					X
Lord Advocate					X

Officials and SPADS as per cover email.

Add letters – surety – fair value argument .

Without prejudice

Refund Guarantee No. BS/LO/00830 made between HCC International Insurance Company plc, Caledonian Maritime Assets Limited and Ferguson Marine Engineering Limited dated 2nd November 2016, in respect of vessel Euro Class B Dual Fuel Passenger Ferry with Builder's Hull Number 801, as extended by amendment letters dated 16th November 2018 (with Bond No. BS/LO/00830/2) and 11th July 2019 (with Bond No. BS/LO/00830)

Refund Guarantee No. BS/LO/00829 made between HCC International Insurance Company plc, Caledonian Maritime Assets Limited and Ferguson Marine Engineering Limited dated 2nd November 2016, in respect of vessel Euro Class B Dual Fuel Passenger Ferry with Builder's Hull Number 802, as extended by an amendment letter dated on or around 16th November 2018 (with Bond No. BS/LO/00829/2)

(together "the Guarantees")

Dear Sirs

Following my telephone conversation with Oliver Williams on 12 July 2019 and our follow up conversations on 15 July 2019 and your email communication with me, we recognise that you, on behalf of HCC International Insurance Company plc and your co-sureties ("the Sureties") have requested that we set out any proposal for settlement of the Guarantees to the surety panel.

I have taken instruction from my client and have also sought guidance from representatives of CMAL and set out my client's proposal below.

Please note that you should make your own enquiries to validate the facts of the situation.

Proposal

We believe that our interests are aligned in wishing to preserve the business's ability to continue to trade and in seeking to reduce uncertainty in this situation.

We propose that the Sureties makes a 'net' payment to CMAL (or, as CMAL may direct, to Transport Scotland) and in doing so releases its security over the assets of FMEL and escrow arrangements. In return, a settlement between all relevant parties is undertaken that reflects a reduced payment from the Sureties to CMAL (or their nominee), while the FMEL business designates the cash available in the business, including that previously escrowed in favour of the Sureties, for the benefit of CMAL (or their nominee) through the build out of vessel 801 and 802.

This proposal allows for CMAL either directly or indirectly to receive the full benefit of the Guarantees whilst limiting complexity, cost and uncertainty for all parties.

We set out the potential scenarios, how the payment will be calculated, and the benefits to the Sureties below.

Scenarios

We envisage that this economic arrangement could be enacted in a number of ways. Our current focus is by way of a solvent acquisition of the business but should this option not be available we are open to exploring alternatives that preserve the business.

This proposal is contingent on Scottish Government agreeing to progress a transaction, and a sale being agreed and fully legally documented and executable. Clearly FMEL's and CMAL's agreement to the detailed agreement would also be required and agreement, detailed steps planning and legal documentation would need to be drafted in advance to enable this.

Payment

As you are aware, the Sureties have provided CMAL with a refund guarantee, with a value of £12.125m, for vessel 801. The same arrangements exist for vessel 802.

We believe the costs to complete both vessels will be significantly in excess of £12.125m and therefore the full sums would be payable if the Guarantees were called by CMAL on the grounds of insolvency or lateness.

801 will not be delivered on time and therefore CMAL has stated to you that it will terminate the contract and call the Guarantees issued in respect of 801 prior to it expiring on 31 August 2019. Terminating the 801 contract will result in a claim being made by CMAL from FMEL. Given the quantum of the claim in relation to 801 in excess of £46m it is our working assumption that this will result in the insolvency of FMEL. Therefore the 802 contract will be terminated and the associated guarantee will also be called.

The Sureties would be required to pay £24.25m to CMAL and seek to recover the sums from taking enforcement action against FMEL which would then be insolvent. Our understanding is (and you should conduct your own enquiries) that the key assets available to the Sureties would be the £4.5m held in escrow and any cash held in FMEL's bank accounts at the date of any insolvency. We propose that the payment required to be paid by the Sureties to CMAL be the net of £24.25m less the escrowed cash and cash freely available to the business (and unencumbered by other parties) within FMEL bank accounts at the point of a transaction to acquire FMEL or its trade and assets. It is our understanding that you are able to confirm the cash at bank value directly with FMEL.

For the avoidance of doubt, the escrow sums would be released to FMEL and the cash at bank would remain with FMEL, both for the benefit of CMAL through the build out of 801 and 802.