



THE UNITED STATES VIRGIN ISLANDS
DEPARTMENT OF JUSTICE
OFFICE OF THE ATTORNEY GENERAL

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ATTORNEY GENERAL

MEMORANDUM

TO: Honorable John P. de Jongh, Jr.
Governor of the US Virgin Islands

FROM: Vincent F. Frazer, Esq.
Attorney General

DATE: December 18, 2014

RE: Response to BR 14-1714, Legislature's Legal Opinion on the Operating Agreement by and among the Government of the U.S. Virgin Islands (the "Government") and Atlantic Basin Refining Holdings, LLC ("Holdings"), Atlantic Basin Refining, Inc. ("ABR, Inc.") with HOVENSA, LLC ("HOVENSA") to Join and Consent to this Operating Agreement (December 15, 2014)

The Deputy Chief Legal Counsel has produced a legal opinion concluding that the proposed Operating Agreement is not "legally sufficient to protect the interests of the Government of the Virgin Islands," because it purportedly "lacks mutuality of assent, mutuality of remedies, and [is] unconscionable, severely limiting the Government's legal remedies," and because "[t]ying all of [the] payment requirements to a nonrecourse mortgage gives the Government no recourse against ABRVI for breach of contract."

This memorandum addresses each of these conclusions, and others stated in the Legal Opinion, and explains why each of them is either factually or legally incorrect.

Assertion 1: The Legal Opinion asserts that the Operating Agreement is unenforceable, because HOVENSA, LLC has yet to execute the Operating Agreement. See Legal Opinion at 6.

The Legal Opinion correctly points out that HOVENSA is not currently a party to the Operating Agreement, but fails to point out that HOVENSA will sign the Operating Agreement at time of closing, when Holdings will acquire the membership interests of HOVENSA and cause HOVENSA to enter into a joinder and consent to the Operating Agreement. For ease of reference, the Operating Agreement provides that HOVENSA is referred to as "ABRVI" for all periods after the closing on the

purchase of its membership interests by Holdings. Accordingly, this Memorandum shall refer to HOVENSA, LLC as ABRVI for all periods after the closing.

The Agreement is *intentionally designed* not to take effect until ABRVI, which is specifically named as a “party” in the Agreement, executes it. *See* §2.1 (defining “Effective Date” as date on which, among other things, “this Agreement has been executed by all Parties.”) The Legal Opinion fails to state that the Operating Agreement will be enforceable against ABRVI when ABRVI executes it, at time of closing.

Once ABRVI has executed the Operating Agreement (thus confirming mutual assent among all parties and satisfying the Statute of Frauds requirement noted in the Legal Opinion at 5), and the rest of the conditions Section 2.1 have been satisfied, the Operating Agreement will be fully effective and enforceable against all parties, including ABRVI.

Assertion 2: Because Holdings is a limited liability company, ABRVI could use it to shelter its assets from the Government. Legal Opinion at 2.

The Legal Opinion points out that Holdings, the entity that will purchase the membership interests in ABRVI, is a limited liability company, and asserts that “if Holdings were to own all or most of ABRVI’s assets and take[] most of its cash in the form of debt payments,” the Government “would have little recourse to get at HOVENSA, LLC’s cash or assets.”

This assertion is incorrect. To the extent ABRVI is in arrears on its payment obligations, the Operating Agreement expressly forbids it to make distributions to Holdings. *See* Section 9.7. More broadly, ABRVI is the primary obligor under the Operating Agreement. Holdings and its parent company, ABR Inc., are both parties to the Operating Agreement and guarantors of ABRVI’s obligations. *See* Section 10.1. If ABRVI should fail to make timely payments, then Holdings and ABR Inc. are liable for those payments. *Id.* If Holdings and ABR Inc. fail to meet ABRVI’s obligations, then the Government may obtain payment from the issuer of the third-party financial assurance. *See* Section 10.2 and Section 17.2(A). If all those mechanisms fail, then the Government has a secured interest in the refinery itself. And if even that remedy is for some reason not available, the Government has the right to terminate the Operating Agreement. *See* Section 17.2(A)(3).

Assertion 3: The definition of “Applicable Law” is somehow flawed. Legal Opinion at 7.

The Legal Opinion finds fault with the definition of “Applicable Law,” which is defined to mean “any constitution, law, statute, ordinance, injunction, rule, regulation, or authorization of any Government authority (excluding any such legislative, judicial, or administrative body, or instrumentality acting in any capacity as a lender, guarantor, or mortgagee) applicable to a Party or its affiliates or subject matter of this Operating Agreement.” The Legal Opinion takes issue with the bolded language, declaring it “mystifying.”

In fact, this kind of exclusion is common in government contracts. Its purpose is to ensure that Government actions that are taken in a non-sovereign or commercial capacity are not considered to be “Applicable Laws” for purposes of (for example) the Force Majeure clause of Article 20. This

provision does not exempt ABRVI or its affiliates from their duty to comply with Territorial, federal, or other duly enacted laws.

Assertion 4: The definition of “Breach” is too narrow, and permits ABRVI to violate most provisions in the Operating Agreement without consequences. Legal Opinion at 8-13.

The Legal Opinion fundamentally misunderstands the way the Operating Agreement addresses breaches and remedies. The Legal Opinion points to the defined term “Breach,” which applies to limited and highly specific varieties of nonperformance, and assumes that the Operating Agreement provides the Government with no remedy at all for other kinds of nonperformance. This is incorrect.

The defined term “Breach” identifies particular instances of nonperformance (specifically, violations of Section 4.1(E), Section 4.2(C), Section 6.2(B), Section 6.4(B)(2), and Section 10.2) that are subject to certain pre-defined remedies (as set forth in Section 17). It does not limit the Government’s right to enforce the Operating Agreement’s other provisions. To the contrary, the Operating Agreement expressly provides that the remedies set forth within it are not exclusive, and do not “prevent the exercise of any right or remedy.” Section 17.4. That is, ABRVI’s failure to perform any obligation under the Operating Agreement, even if it does not fall within the defined term “Breach,” gives the Government the right to employ all the remedies for breach of contract available in the common law.

The important fact is that, unlike the provisions of the current Concession Agreement, the Operating Agreement provides clear and enforceable remedies that go beyond what is available under the common law of contracts—such as, for example, the parent and third-party guarantees. Those remedies are specific and known in advance to the parties, making enforcement substantially easier than would be the case if the Government were left to file suit to enforce the Operating Agreement.

Assertion 5: ABRVI’s failure to operate the Refinery at the agreed-upon baseline levels does not constitute a Breach. Legal Opinion at 22-23.

The Legal Opinion notes that the Operating Agreement requires ABRVI to operate the Refinery at baseline levels of production, but asserts that ABRVI’s failure to meet those production levels does not constitute a “Breach,” leaving the Government powerless to enforce the obligation. Again, this is incorrect. The Operating Agreement explicitly provides that failure to achieve refining production targets will result in a “Breach,” in two situations.

First, under Section 6.2, ABRVI is required to commence “Refining Operations” within 24 months of obtaining Financing (although that date can be extended for a limited period). “Refining Operations” are defined in terms of the Operational Baseline of 300,000 barrels per day of continuous production for six months. If ABRVI fails to begin refining the required percentage of the Operational Baseline within the 24-month period, it is in Breach under Section 6.2(b) and Section 17.1.

Second, once ABRVI has begun refining oil at the required levels, ceasing to do so will trigger a “Refinery Idling Event.” A Refinery Idling Event that lasts more than 6 months becomes an Extended

Refinery Idling Event; and 90 days after that, the Extended Refinery Idling Event becomes a Breach under Section 6.4(B)(2) and Section 17.1.

Thus, ABRVI's failure to operate the refinery at baseline levels is a "Breach," and gives rise to the Government's specific remedies in Article 17.

Assertion 6: The Operating Agreement provides ABRVI with a variety of "escape clauses" that would permit it to operate a storage terminal instead of a refinery. Legal Opinion at 23, 30.

The Legal Opinion several times suggests that the Operating Agreement is flawed because there are circumstances in which it would permit ABRVI to operate an oil storage terminal rather than a refinery. It is correct that the Operating Agreement does permit the use of the facility as a terminal in the event that the refinery never restarts or restarts but subsequently ceases refining operations, but that characteristic is not a flaw. To the contrary, it is an essential aspect of the Operating Agreement.

As a threshold matter, it is critical to understand that upon the closing, the storage terminal is the source of the refinery facility's value. ABRVI's business plan depends on using the storage terminal as the basis for a trading operation that will generate revenues sufficient to support the enterprise (and pay the Government all the monies it is owed under the Operating Agreement) until financing can be obtained for the reconfiguration and restart. If ABRVI was not permitted to operate the terminal, there would be no revenue to support operations pending the financing and renovation.

In the event that (for whatever reason) ABRVI cannot obtain the necessary financing, or obtains the financing but cannot achieve restart, then the terminal operation is critical to ABRVI's ability to make its payments to the Government and to fund the Site Restoration Account.

Although giving ABRVI the right to operate the terminal is important to the economics of the deal, the Government took great care to structure the Operating Agreement to create a strong incentive to restart the refinery (and not just operate the terminal). Following a Breach that results in the refinery not restarting (for example, if ABRVI fails to obtain financing), ABRVI will be obligated to make Fixed Payments and Site Restoration Payments totaling as much as \$40 million per year—a financial burden that would dedicate most of the profit for such payments. Under the economic terms of the Operating Agreement, a terminal-only operation would be vastly less profitable to ABRVI than a refinery operation—an outcome specifically intended to provide ABRVI powerful incentives to restart and continue the operations of the refinery.

Assertion 7: ABRVI's obligation to employ 600 persons, of whom 75% must be Virgin Islands residents, is "illusory." Legal Opinion at 28-29.

The Legal Opinion notes that ABRVI's failure to comply with the employment requirements of Article 8 would not constitute a "Breach," and from that draws the conclusion that the requirement is "potentially illusory," because there are "no apparent consequences" to such a failure.

In fact, there is a significant consequence to such a failure: a substantial increase in ABRVI's tax rate. *See* Section 9.3(C). That increase both punishes ABRVI for failure to comply, and compensates the Government for revenue that would otherwise have been received from employees.

Perhaps more important, making this kind of nonperformance a "Breach" would not be to the Territory's advantage. Occurrence of an uncured "Breach" triggers the process of deconstruction and cleanup of the facility (once the Site Restoration Fund is fully funded)—a process that will ultimately result in reducing the labor force to zero.

Assertion 8: The Government's security interest in the refinery is subordinate to other financings, and thus offers little protection to the Government.

The Legal Opinion accurately states that the Government's security interest in the Refinery and Related Facilities is expressly subordinated to several enumerated financings, including any financing of the reconfiguration and restart costs and any financings used to pay ABRVI's obligation to pay proceeds to the sellers. Based on that, it concludes that "this subordination to all other creditors will foreclose the Government from successfully enforcing" the Operating Agreement. Legal Opinion at 20.

That conclusion is inaccurate. The subordination of the Government's security interest is necessary to ABRVI's efforts to secure more than \$1 billion in financing for the reconfiguration and restart of the refinery. No financial institution would lend such a large amount pursuant to a project finance loan without a first-priority security interest. And since obtaining the financing is a critical aspect of a successful restart, the Government accepted the necessity of subordinating its interest in order to secure the requisite financing.

That said, the subordination of the Government's interest most certainly does not "foreclose the Government from successfully enforcing" its rights under the Operating Agreement. If ABRVI never succeeds in obtaining financing, the Government's interest will be the senior interest, and there will be no obstacles to its enforcement of that interest. Thus, if ABRVI breaches (for example) Section 4.1(E) (the Engineering Certification) or Section 4.2(C) (Financing Certification), no financing will be in place, and the Government's security interest will have first priority. Even if (as all parties hope and expect) ABRVI closes on the financing, the Government's ability to enforce the Operating Agreement is unimpaired.

To understand why, it is necessary to understand that the security interest is the Government's security of last resort. It is intended to be exercised only if all its other remedies fail—and (in stark contrast to the current Concession Agreement) the Government negotiated significant other remedies. Before the Government's security interest even comes into play, the following would have to happen:

- ABRVI fails to make timely payments to the Government; and
- Holdings and ABR Inc. fail to make those payments under the parent guarantee of Section 10.1; and

- The issuer of the Financial Assurance fails to make the payments under the third-party guarantee of Section 10.2.

Only then would even a senior security interest be a practical remedy – and even then, it would not be a *desirable* remedy. Foreclosing on the security interest would result in the Government owning the Refinery and Related Facilities, and thus potentially becoming responsible for liabilities associated with the property. The Government is not a refinery operator, so to derive any value from the property; the Government would have to sell it—a potentially lengthy, expensive, and uncertain process.

In this scenario, the Government may actually be better off holding a subordinated interest, for the following reason: if ABRVI defaults on its payments to its financial backers, the only hope for those financial backers to recover their investment would be to step into ABRVI's shoes and operate the refinery. To do that, they would be required to comply with the Operating Agreement, including its payment provisions. In other words, *the Government may be more likely to get paid its money as a subordinated lender than as a senior one.*

While there are other sections of the Deputy Chief Legal Counsel's legal opinion that are fundamentally flawed, they are too numerous to address in detail here. In any event, they are less significant to properly understanding (i) the economic benefits to the Government of the Operating Agreement, and more importantly, (ii) the multiple layers of protection afforded the Government in the event that ABRVI does not fulfill its obligations, protections that the Government was sorely lacking in the existing Concession Agreement when the current owner ceased operations in 2012.