

Sea Launch — A Unique Business And a Unique Reorganization

By Dennis Connolly

Sea Launch Company, LLC (“Sea Launch”), through its affiliates, provided a unique service — the launching of heavy commercial satellites (4,000-6,000 kg) from a floating platform on the equator in the Pacific Ocean. Like something from a James Bond movie, Sea Launch is a relic of the Cold War — a joint venture formed by Boeing, a Russian rocket manufacturer (RSC Energia), two Ukrainian rocket manufacturers (Yuzhnoye and Yuzhmash), and a Norwegian ship-building company (Aker). With encouragement from the U.S. government in the hope that a commercial rocket program would employ Russian (and Ukrainian) rocket scientists (reducing the likelihood of proliferation to Iran, North Korea and other less savory jurisdictions), the program sought to achieve geosynchronous orbit (at approximately 22,000 miles above the Earth) in the most cost-effective and fuel-efficient manner possible. Sea Launch, conceived in the early 1990s and established in 1995, achieved 27 successful sea-based launches from 1999 to 2009.

Sea Launch’s international ownership and unique capital structure (almost ex-

clusively “partner debt”) and business model (utilizing a series of treaties between the United States, Russia and the Ukraine) engendered a unique reorganization process in that, although the debt was well in excess of \$2.5 billion, Sea Launch had less than 150 creditors. The creditors included the contingent, unliquidated claims of customers in connection with future launches, necessitating separate negotiations with each customer as a part of the reorganization, and a unique and perverse tax issue arose at the end of the reorganization that could have required Sea Launch to withhold significant sums in respect of cancellation of indebtedness income due to a rarely invoked provision of the Tax Code.

Sea Launch’s management and professionals, including Alston & Bird LLP, Buccino & Associates, Inc., and Jefferies & Company, Inc., were successful in negotiating through significant issues including debtor-in-possession financing, litigation issues with the majority claim holders (including Boeing and Aker), and the proposal of a plan that satisfied Sea Launch’s customers, the official unsecured creditors’ committee (the “Committee”) and other stakeholders. Confirmation required resolution of the tax issue and the “migration” of the company first to Luxembourg and finally to Switzerland. This migration was conditioned upon, among other things, approval by the Committee on Foreign Investment in the United States (“CFIUS”). The assets owned by Sea Launch created other regulatory and defense-related is-

ssues, including the fact that the equipment (the vessel and the platform utilized to launch rockets) is subject to the International Trafficking in Arms Regulations (“ITAR”). The ITAR regulations created issues in connection with obtaining DIP financing as lenders were concerned about the ability to liquidate and monetize those assets. All told, with Sea Launch now reorganized and operating in Luxemburg and Switzerland (with the physical assets still in Long Beach, CA), the reorganization was successful and created significant value for the stakeholders and customers.

BUSINESS MODEL AND

CORPORATE ORGANIZATION

Global Market for Launch Services

The commercial satellite industry began as an outgrowth of the military satellites and space missions in the 1950s and 1960s. In 1964, the United States and 84 other nations created the International Telecommunications Satellite Organization (“INTELSAT,” now a private operator of a fleet of communication satellites and a long-standing customer of Sea Launch) to implement a worldwide satellite telecommunications system. The use of satellites continued to increase over the next 20 years and in the 1980s, the U.S. government began to encourage commercial satellite systems to compete with INTELSAT, both in the launching and manufacture of satellites. By the mid-90s, the major players in the industry included International Launch Services, an affiliate of Khrunichev State Research and Production Space Center, another Russian rocket manufacturer,

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and Ariespace, with the Centre National d'Études Spatiales (CNES), the French government's space agency, being the largest shareholder. Since 2000, and projected through 2020, there are approximately 20 launches per year, with ILS and Ariespace each having capacity for only six to eight launches annually (and ILS having a backlog of at least 22 launches). Thus, Sea Launch's business was and is of significant value to the market, in providing both access to space and competitive pricing.

Sea Launch's mobile equatorial launch facility also provides significant value to customers that are not offered by its competitors. Equatorial launch provides the most direct route to geostationary orbit and the "kick" to launch heavier satellites into geosynchronous orbit using less onboard fuel, allowing for increased payload mass or extended spacecraft life, increasing value for customers.

Sea Launch Corporate and Capital Structure

Sea Launch presented interesting corporate and capital structures because the assets were held by limited partnerships incorporated in the Isle of Man and the Cayman Islands, creating a rather Byzantine structure for its operations. Its capitalization consisted mostly of indebtedness to its partners either through direct loans, advances under contracts, or guarantees of bank debt (at the petition date, Sea Launch had roughly \$400 million in bank debt to third parties, which was paid off by Boeing and Aker). At the petition date, the total indebtedness to the partners exceeded \$1.9 billion and total indebtedness to all creditors exceeded \$2.5 billion (including contingent and unliquidated liabilities).

THE BANKRUPTCY FILING

Financial Attributes

Along with its unique business model and the complexity of its operations, Sea Launch faced significant logistical challenges. Vendor costs were high and the supply chain was a constant issue due

to political and business considerations. This was particularly true with respect to sourcing rocket motors, as the manufacturer was required to also supply Russian military and Russian space program launches and, as a result, there were occasions where deliveries were delayed or costs were increased due to conflicting demands. The status of its competitors (being affiliated with foreign governments) had an impact on this market as different regulatory, political and economic pressures were at play with respect to those entities as opposed to the privately incorporated and privately financed Sea Launch. Accordingly, from the mid-90s to the late 2000s, Sea Launch's total losses exceeded \$1.5 billion. The capitalization of the company was both unique and insufficient for ongoing business needs; liquidity was constantly an issue and the partners continued to fund shortfalls over time.

THE 2007 'ANOMALY'

In January 2007, on its 24th sea-based mission, Sea Launch experienced an unsuccessful launch, resulting in the loss of both the rocket and the satellite. Though there was no structural damage to the launch platform, critical launch support equipment was damaged. As a result of the required inspection and repair, Sea Launch was unable to proceed with a launch for Hughes Network Systems, LLC ("HNS"), scheduled to occur in May 2007. HNS entered into a launch contract with Ariespace for the replacement launch and terminated its contract with Sea Launch, demanding a refund of \$44,400,000 in previously advanced payments. Sea Launch contested the validity of HNS' termination, but in March 2009, the International Centre for Dispute Resolution concluded that HNS was entitled to recover payments and costs totaling approximately \$52.3 million. Sea Launch and HNS agreed to a short forbearance on collection, but were unable to reach a full resolution of the claim. On June

22, 2009, to avoid further collection efforts by HNS, and to address with the upcoming maturity of the bank loans, Sea Launch and its affiliates filed Chapter 11 bankruptcy petitions in Wilmington, DE.

THE BANKRUPTCY CASE

Liquidity

On the petition date, Sea Launch had approximately \$6.7 million in unencumbered cash, but had known liabilities in excess of \$1.98 billion, consisting of \$448 million in bank loans, \$53 million relating to the HNS award, \$1.18 billion in partner obligations, trade debt and then unknown customer obligations, which ultimately totaled more than \$272 million. Shortly after the case was filed, Sea Launch retained Jefferies, which began an immediate analysis of Sea Launch's operations to structure a cold lay-up, in essence, to minimize cash requirements as the Company sought financing.

DIP Financing — Challenges and Opportunities

The assets available as collateral were unique, at best, and included the ship and the launch platform held by Cayman and Isle of Man subsidiaries, which were built specifically for Sea Launch for equatorial launching. Both vessels were subject to very stringent security regimes through the State Department and Russian and Ukrainian treaties limiting the use and disposition of the assets on the vessels. Both vessels utilize Russian gauge rail lines (on the command ship to fabricate the rocket for movement onto the launch platform and on the platform to lift the rocket into its vertical launching position). In addition, the command ship has U.S. and Russian designed launch controls to allow engineers to control launches through radio operations. These unique aspects caused concern among the typical debtor in possession lenders, which often focus on the liquidation value of assets and the degree of difficulty to achieve liquidation in determining whether to lend to a debtor.

The Negotiation of the DIP

In November 2009, Sea Launch obtained a \$12.5 million DIP facility from Space Launch Services, LLC ("SLS") and in February 2010, borrowed an additional \$3 million from SLS and another \$9 million from SLS and The Heinlein Prize Trust. In April 2010, Sea Launch obtained a \$30 million DIP facility from Energia Overseas, a joint venture entity related to Energia, one of Sea Launch's original equity holders. Sea Launch was ultimately able to negotiate exit financing from Energia Overseas to provide \$155 million of equity financing and the availability of a \$200 million revolver to support hardware purchases for use by Sea Launch in future commercial launches, with Energia Overseas or one of its affiliates designated as Sea Launch's primary contractor for hardware and launch support services.

The Partner Claims

As noted above, the capitalization of the company largely involved advances and loans from the partners. Early in the case the Committee sought to bring litigation against two of those partners — Boeing and Aker — in order to subordinate, recharacterize, and/or disallow the claims of those partners. Sea Launch's view was that such litigation, especially on a fast track, would be detrimental to its reorganization efforts as the money spent litigating would likely denude the estate of any remaining liquidity. Sea Launch asserted that any negotiation of a restructuring plan would necessarily address these claims or otherwise involve some compromise and, indeed, this occurred in the context of the mediation of the Boeing and Aker claims, through which Boeing and Aker's asserted claims, totaling nearly \$1.7 billion, were settled in exchange for, essentially, a 5% interest in reorganized Sea Launch together with full releases among Sea Launch, Boeing, Aker and the Committee.

Plan Proposal and Negotiation

The plan negotiations consisted of

partner-related negotiations with respect to the supply chain and customer related negotiations with respect to pricing and launch assurance, including the renegotiation of many customer contracts and the satisfaction of customer claims through the issuance of credits towards future launches. Technical issues require Sea Launch to continue to use the same rocket and rocket motor for its launches, which necessitated lengthy negotiations with Energia, Yuzhnoye and Yuzhmash with respect to the hardware and launch services. Customers required a high degree of assurance as to the launch protocols and launch assurance going forward as each launch contract represented a significant investment for the customers.

Tax Litigation

Sea Launch moved to estimate any claim of the IRS at no more than \$250,000 relating to potential liability arising out of Section 1446 of the Tax Code, which requires partnerships, in certain circumstances, to withhold for the income tax liabilities of foreign partners, including taxable CODI. Since its inception, Sea Launch reported losses for tax purposes, giving rise to "net operating loss carryovers" for income tax purposes, reducing or eliminating any Section 1446 liability. Furthermore, the IRS did not file a claim in the bankruptcy case and any claim subsequently asserted or filed was likely to be disallowed as late filed pursuant to 11 U.S.C. § 502(b)(9). Nevertheless, the IRS contested the estimation, but the bankruptcy court appropriately determined that any such claim was indeed a prepetition claim subject to estimation under Section 502(c) of the Bankruptcy Code and, in the absence of any evidence to the contrary, estimated the claim to be (though likely \$0), no more than \$250,000. Notwithstanding the fact that the IRS still has not asserted any claim against Sea Launch, the United States, on behalf of the IRS, appealed the bankruptcy court's estimation of the IRS's putative claim and confirmation of Sea

Launch's plan of reorganization. The parties are currently mediating the appeal.

CONCLUSION

The Sea Launch reorganization represents the successful convergence of a number of factors:

- The inherent value represented by the enterprise, including the technical and management skills of the employees and the unique assets involved;
- The market's (and in particular Sea Launch's customers') recognition of the benefits of a third alternative in the commercial launch market, both in terms of pricing discipline and reliable access to space; and
- The work of the management and the professionals involved to work through the numerous technical and financial aspects of the reorganization to achieve a successful transaction.