

lowering your EXPOSURE

STRUCTURING FINANCIAL TERMS OF A NEW BUILD CONTRACT TO YOUR ADVANTAGE

TEXT BY LISA OVERING

PROTECTING YOURSELF FINANCIALLY with a new-build investment is tricky. There are inherent risks with every payment method and there's substantial risk with an overly attractive price. A firm, fixed price that is fair to both parties is essential. Strangling the yard and leaving it strapped only sets up a situation where the buyer may have no boat, no money or a boat with no pedigree if it ultimately must be finished elsewhere. What the buyer really needs is a smooth ride on the yacht build with the yard absorbing any cost overruns.

That being said, price is only one part of the new build contract. How to pay for the yacht—in milestone stage payments where the builder is working with the buyer's money; or letters of credit, where the bank substitutes its credit for the client's and requires the builder to finance more of the project on its own nickel; or a construction loan—is the real question.

CONSTRUCTION LOANS

A typical construction loan places the yacht owner at risk for draw-downs on the loan because vessel title remains with the yard until the construction loan is converted to permanent funding. The vessel in process is not collateral for the construction loan unless the yard joins the buyer as a co-borrower and pledges the vessel in process as collateral.

If the yard moves to bankruptcy reorganization or liquidation, the buyer could end up with no interest in the vessel, still owe the lender and have to pay twice to see the project to completion.

"The only way an owner can be protected against losing his money because the yard rips him off or goes bankrupt is to have the construction directly in his name although the construction contract is with the shipyard," says Carol Scanu, a yacht designer with Studio Scanu.

Phil Friedman, a yacht building consultant with Port Royal Group, advises obtaining a first security interest in the vessel under the

Uniform Commercial Code if you are in the United States.

"The buyer has a secured interest to the extent of monies paid to date, an interest which has to be satisfied first, before any other party can gain clear possession of the vessel," says Friedman.

Scanu had a client who built a vessel in Turkey and specified that all its parts and components be kept directly in his name. This provided a comfort level for him and was beneficial when the yard went under due to cash flow problems stemming from another contract. While the original yard remains embroiled in legal issues, the buyer can now finish the vessel at another yard.

MILESTONE PAYMENTS

The simplest payment structure is a stage or milestone payment, wherein the buyer makes a payment upon the yard satisfactorily completing a given stage of construction. Anything can be a milestone, but there are usually six to eight payment stages: laying the keel; laying the hull; installing the engines; completing the superstructure; finishing the interior; finishing the exterior; and fairing and painting. If a builder specifies a first installment that is significantly more and disproportionate to remaining stage payments, it

may indicate that the shipyard is short on cash to start the build.

All milestones should have very specific language. A well-known marine surveyor says the engine milestone should indicate that the shaft line and temporary alignment is in for the engines and gear boxes. Often there is open deck space as engines are laid in the engine room but not bolted down or aligned,

which isn't in the true spirit of milestone completion.

Under the milestone payment plan, the vessel usually remains an asset of the yard until final payment is made and title is transferred. If there is a problem mid-construction, e.g. the shipyard files for some form of bankruptcy, the yacht owner can suspend future payments, but that does not help with respect to the payments already made. That is why a buyer should build into the shipyard

But what constitutes a milestone or reaching one is the question.

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contract the right to the aforementioned first secured interest and accompanying lien against the vessel, for all amounts that have been paid to date. Such a lien must be “perfected” legally with the aid of an experienced marine attorney. It establishes the priority of the buyer’s claim over all other claims against the shipyard’s assets.

“Without a perfected first secured interest in the vessel under construction, the buyer who has made deposit and/or milestone payments stands only as an unsecured creditor of the yard, with little chance of recovering fully in the event of bankruptcy or reorganization,” says Friedman.

With one client’s yacht under construction being 90 percent complete after eight of 10 stage payments, attorney Michael Moore of Moore & Company heard rumors that the yard was in financial trouble. He pushed to have his client’s yacht launched, and it did—the day before that yard declared bankruptcy. The yard issued a builder’s certificate to the client, who now owned the vessel and was in a better position than other third parties left unprotected.

PERCENTAGE PROGRESSIVE PAYMENTS

“I like milestones, if I am the one making the payment,” says attorney Mike Karcher of Karcher Canning & Karcher. “I have control with the surveyor, the captain, etc. No one else but you in the milestone decides if the shipyard is paid. Is the hull done? Yes. Pay. Is the deck done? Yes. Pay. Very simple.”

“But what constitutes a milestone or reaching one is the question,” says Friedman. “Most buyers agree to too few milestones, making payment [too far] out ahead.”

Attorney Stephen Hanemann, a partner with Kean Miller, likes the percentage progressive payment, a variation of the typical stage payment plan with more payments for smaller amounts. Payment is made upon the percentage of completion instead of a weakly defined “milestone.” This gives the yacht owner more flexibility as well as the time value of money, as he may earn interest on funds not yet paid to the yard.

Job files must be complete and verified by an independent third party. A payment is made if the vessel is, for instance, 13 percent complete versus saying the engines are set with vague criteria as to what constitutes the engines being set.

IRREVOCABLE COMMERCIAL LETTER OF CREDIT

The world turns on letters of credit or LCs, but normally for small, shipped items, not megayachts. A solvent yard can use the buyer’s LC as a form of collateral to obtain its own construction financing from its regular lender.

There are two types of LCs: documentary and standby. Documentary LCs require that proper documents be shown to be paid and standby LCs pay when the window opens with the bank. LCs only work well if the conditions for draws and final payment are well detailed with someone experienced in construction and contracts—not a banker

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Otherwise, it can be an open checkbook to pay when the yard deems necessary.

or attorney—determining if the yard has met requirements. In either case, the LC is irrevocable and its terms should be very precise. Otherwise, an LC can be an open checkbook to pay when the yard deems necessary. The issuing bank is bound to make payment for the client and will do so if the LC’s terms are ambiguous.

A yacht owner, who prefers to remain anonymous, said the LC

absolutely protects the yacht owner, not just by minimizing risk but by eliminating risk completely. Those statements are made with the caveat that the LC is prepared by an attorney specializing in financial instruments with properly defined trigger terms stated within.

The issuing bank makes payment for the yacht owner whose funds are earning interest in that bank, so the yacht owner’s funds are not at risk. The funds are not released until the terms of the LC are met and the buyer receives the yacht.

Every LC should be tailored to a particular contract and some provide interim draws or delivery draws. In some recent examples, stage payments and LCs have been combined to advance capital to the builder with a nominal payment of 15 to 20 percent. This compromise increases the LC’s liquidity for the builder.

Before the LC is issued, triggers or key objectives should be met with all essential requirements upfront, as items left out can not simply be added at a later date. The LC should not be open-ended. It should have a specific, final execution date with a reasonable delay clause. Any specific quality standards, such as Lloyd’s class or chartering qualities, should be stated. Delays during the build should be addressed as well as standards for paying vendors. Then, upon meeting all the LC’s very specific criteria, the bank should issue the LC to pay the yard.

“You must build safeguards into an LC,” says Moore. “Both banks will pay if terms of the LC are met. The single biggest disasters I’ve seen are with letters of credit.” He recalls instances where a yard went bankrupt and the bank wouldn’t cancel the LC, allowing draws provided by the terms of the LC. If expenses for designers, stylists, project managers, etc., are not wrapped into the build contract price, the yacht owner would still be on the hook for those amounts if the yard hadn’t met the terms of the LC and the buyer pulled the plug on the whole deal. That’s why the LC should be watertight and prepared by a knowledgeable attorney with a supportive banker.

Karcher says he believes the LC exists more to protect the builder and is just another complicating issue in an already complex transaction, inviting new people into the decision-making process and litigation. Hanemann agrees that many yacht owners and attorneys don’t want another third party involved, but that people commencing new construction like LCs and there isn’t much risk if it is drafted properly.

“Only when the yacht owner is happy with the product can the bank release money for LC payment,” says a yacht owner. “Your signature is the only way an issuing bank will pay for product or, if they know you, upon your verbal instruction. When a deal went bad in China, there was no way the builder could get his hands on that money due to specific verbiage in the LC.” ■