

# A Guide to Yacht Finance

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## Introduction

The market for yachts and superyachts has greatly expanded over the past decade and as confidence has been returning to the market the builders of the most exclusive (and expensive) yachts have back-logs on their order books. Over the past few years we have advised lenders and borrowers (i.e. owners) on a significant number of financings of yachts valued at between US\$3,000,000 and US\$130,000,000.

There is no legal definition of the term "superyacht" however it is generally accepted to refer to yachts of 40 – 50 metres or over which are crewed by a full time professional crew and used for pleasure or commercially operated under the Code of Practice for the Safety of Large Commercial Sailing Motor Yachts 1997 (known as "LY2").

The general principles which apply to the financing of an oil supertanker or passenger ferry will also apply to the financing of a superyacht and the structures of the financing and the documentation are very similar. Yacht financing is specific, however, in that where the financing is dependent on charter income, this is generally seasonal and intermittent whereas for commercial ships (save for during general downturns in the shipping market) charter income tends to be more steady and dependable. A further reason why yacht financing is distinct is that superyachts are often designed and equipped to suit individual tastes and so the advice of professional valuers must be sought to ensure that the yacht being offered as security will be readily marketable by the lender on any default by the borrower.

As with commercial ship finance, a yacht financing will almost inevitably have an international element. The home jurisdictions of the lender, owner / borrower, personal guarantor and yacht itself will typically all be different and the yacht could be positioned in any maritime jurisdiction on an enforcement of the lender's security. The international element means that a lender will require advice and legal opinions from each relevant jurisdiction and consideration will also need to be given to any cross-border tax implications of the financing structure.

## Initial Issues to consider

### Yacht-building contract

Although it is common in the commercial shipping world for industry standard form ship-building contracts to be used

and amended as necessary, it is rare for such forms to be used in connection with yachts. Yachts are, by their nature, more likely to be made bespoke and tailored to the purchaser's individual requirements and by a smaller yard. Consequently the standard form contracts will often not be appropriate and the yard (or sometimes the purchaser's lawyers) will produce their own draft forms of contract, which may be the subject of negotiation between the contracting parties and their legal advisers.

As far as the structure of a yacht-building contract is concerned, the main terms will relate to the key obligations of the yard / seller and the purchaser / owner. The yard will deliver the yacht as described in the contract to the purchaser who will receive unconditional title upon payment of the agreed purchase price. The contract is also likely to include detailed provisions concerning the title transfer and warranties against defects. There may be specifically tailored tax provisions, particularly as the transaction will almost invariably be cross border with significant potential tax liabilities. There may also be clauses dealing with confidentiality (often of great importance for ultra high net worth individuals) and may stipulate whether and the extent to which the yard is permitted to use the yacht for publicity purposes either prior to or after its construction.

In respect of the payment terms, the contract will usually require the purchaser to pay a deposit upon entry into the contract and various instalments of the purchase price culminating with a final sum to be paid upon delivery of the yacht to the purchaser. The instalments will become due at various stages during the construction of the yacht in accordance with a payment schedule and upon the issuance by the yard of a "Stage Certificate". If a lender is financing these instalments it should insist on receiving certified copies of these Stage Certificates (counter-signed by an independent surveyor) and invoices from the yard as evidence that the construction of the yacht is on track and that the next payment is due.

The main risk for a purchaser of a yacht and a lender when financing the construction of a yacht is the risk of the yard becoming insolvent prior to the delivery of the yacht. See the section "**Pre-delivery Security**" below for more detail on how a lender (and a purchaser) may be able to protect itself in this situation.

On the other side, because superyachts are often purchased by special purpose vehicles ("SPV's"), in some circumstances a yard may request a performance guarantee in order to avoid the risk of a financial default

by the purchaser.

## Yacht Registration

Each country's shipping registry will have its own eligibility criteria stipulating whether an owner qualifies to be able to register their vessel on that country's shipping register and it will also have a number of requirements for the owner or the yacht to satisfy prior to registration being effected.

Traditionally, ships were registered in the country where the owner was a national and were crewed by nationals of that country. Over the last 60 years or so, countries have opened up their shipping registries to anyone provided that the ship being registered can satisfy certain minimum standards set by the registry as to, for example, age and technical standards. Panama and Liberia have been exceptionally successful as countries with "open registers" and their registries boast two of the largest fleets measured by registered tonnage. Cyprus and the Bahamas are also important open register countries.

As well as open registers, there are also "offshore" registers. These registers are generally established in a colony or dependency of a country, with the aim of attracting the registration of ships from that country which might otherwise go to the open registries. Examples are the Cayman Islands, the Isle of Man and Netherlands Antilles where the ownership eligibility criteria are fairly very relaxed. There is therefore very little practical distinction between open and offshore registries.

It is also worth noting that some shipping registries, for example the Virgin Islands Shipping Registry, impose strict upper limits on tonnage which may be registered, which may make these registers unsuitable. Some registries – such as the Cayman Islands Shipping Registry – have a London presence facilitating registration and closing procedures here.

**The United Kingdom Register:** In the UK, the Merchant Shipping Act 1995 and the Merchant Shipping (Registration of Ships) Regulations 1993 set out the eligibility criteria for ships to be registered on the UK Register. Commercially operated yachts must also satisfy the safety requirements of the LY2 or the equivalent codes for smaller vessels, and the proposed crew must hold the required qualifications.

Other requirements for British registration (which will apply in similar guises to yachts to be registered in a number of countries and not just on the UK Register) include the following:

- a. Certificate of survey and tonnage measurement: the owner of the yacht, or its representative, must employ a surveyor of ships to survey the yacht and ascertain her tonnage in accordance with the tonnage regulations of the relevant country (The Merchant Shipping (Registration of Ships, and Tonnage) Regulations 1999 in the UK). The surveyor will then issue a certificate of survey stating the vessel's tonnage, build and other particulars setting out the identity of the yacht. In the UK, if the yacht is over 24 metres long, the survey must be completed by a surveyor from an approved classification society and an International Tonnage Certificate will be issued.
- b. Name of vessel and home port: every application for British registration must specify the proposed name of the yacht and the name of the home port of the yacht, which will be marked on the stern of the yacht following step (c) below.
- c. Carving and Marking: Once the Registrar has confirmed that the eligibility criteria have been met and he/she has received the application for registration and the certificate of survey relating to the yacht, he/she will then issue a "carving and marking note" which specifies the official number allocated to the yacht. The note will be stamped following an inspection confirming that the official number and registered tonnage have been carved onto the main beam and the name and port of the yacht have been marked on the stern of the yacht.

Local counsel's advice and assistance would of course need to be taken by the owner of the yacht in the proposed country of registration of the yacht. As far as a lender is concerned, it will want to see evidence that the above steps have been taken to register the yacht in the weeks leading up to delivery and that as far as possible all documents are in order for a Certificate of Registration to be issued at delivery. A lender will also be keen to establish when structuring the transaction at the outset that the proposed country of registration has a well-established mortgage registration procedure. See the section "**Mortgage**" below.

## Structural Issues to consider

The exact structure of a yacht financing transaction will depend on a number of factors including:

- whether the loan facility is to be used to purchase a newbuilding by funding pre-delivery instalments

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payable to a shipyard under a yacht-building contract or upon delivery, or whether the yacht is being purchased from an existing owner;

- whether the owner intends to charter the yacht;
- the jurisdiction in which the yacht is being constructed or is presently registered;
- the proposed jurisdiction of registration of the yacht;
- the VAT status of the yacht; and
- the tax status of the ultimate beneficial owner.

Taking the above into account will allow the lender, working with the owner, to consider carefully how the yacht financing transaction is to be structured in order to ensure that the lender obtains maximum security over the structure whilst shielding the yacht from other creditors of the owner and minimising the possibility of any third parties establishing prior ranking claims.

**Mortgage versus lease structures:** The purchase of a yacht may be financed by a leasing transaction in which the lender (the "lessor") acquires legal title to the yacht and then leases it back to the owner (the "lessee") for an agreed term. The finance lease is usually in the form of a demise charter, also called a bareboat charter, and under the terms of the lease the lessee will have exclusive possession and control of the yacht and will be the owner for operational purposes, but the lessor will be the legal owner of the yacht.

In recent years, leasing schemes have been popular in some jurisdictions – Malta and Italy for example – where it has been possible to use such structures to defer payment of, or reduce the amount of VAT that would otherwise be borne on the purchase of a yacht. However, it is now rare that a finance lease will be used to finance the acquisition of a yacht in the UK, essentially because a lender will want to avoid the potential liability it faces as the registered owner.

Consequently, a yacht finance transaction is more likely to follow a basic asset financing structure in which the lender will lend money to the borrower to enable it to purchase the yacht. The principal security for the loan is a registered ship mortgage over the yacht and the borrower will also assign to the lender the insurances over the yacht, any earnings it may generate and any requisition compensation which the borrower will be entitled to in the event of requisition of the yacht by a government in time of war. The lender may also wish to take a general debenture over the borrower's other assets, a charge from the borrower's

shareholder over the borrower's shares and a personal guarantee (from, for example, the ultimate beneficial owner of the borrower).

## The Loan Agreement

Where the lender is financing the construction of a new yacht, the loan agreement will usually provide for advances to be drawn down to pay the pre-delivery instalments or stage payments under the yacht-building contract. Before permitting drawdown in respect of an instalment, the lender will usually require evidence that the relevant stage of construction has been reached and that the instalment has become due. As mentioned above, the evidence will generally take the form of a "Stage Certificate" issued by the builder and countersigned by an independent surveyor or, in the case of a delivery instalment, the protocol of delivery and acceptance signed by the builder and the borrower.

In addition to the usual representations, warranties, undertakings and conditions precedent, the loan agreement should also include specific references to the classification and construction of the yacht, its registration and insurance. It might also include covenants as to how the borrower is permitted to use the yacht after delivery (e.g. specific covenants regarding the terms on which it may charter the yacht and for how long).

With a major newbuilding the basic supervision issues regarding the yacht's construction will be dealt with by the classification society surveyor. The borrower should itself appoint a consultant who will supervise construction. See the section "**Classification**" below for more detail.

## The Security Package

As mentioned above, a lender will always want to obtain maximum security in the yacht it is financing in order to put itself in the best position if there is ever a situation where an event of default has occurred under the Loan Agreement.

We list here the main types of security which a lender would typically look to take. First we consider the security which is relevant where the lender is providing finance pre-delivery of the yacht. We then go on to consider the security a lender will look to take once the yacht is delivered to the owner / borrower.

## **A - Pre-delivery Security**

**Assignment of yacht-building contract:** If the lender is providing pre-delivery finance, it will almost invariably require a security assignment of the benefit of the yacht-building contract including step-in rights. This enables the lender, in the event of the borrower's default, to continue with the construction of the yacht, to take delivery and then to sell the yacht in order to satisfy the outstanding debt. It will also assign the borrower's rights to insurance proceeds in respect of the yacht under construction. It is, however, not an entirely satisfactory security for several reasons.

First of all, if the lender wished to enforce the assignment it would have little option but to pay any outstanding instalments under the yacht-building contract from its own resources in order to complete construction of the yacht, unless it was able to find a purchaser of the yacht who was prepared to purchase the yacht under construction and was willing to take on the remaining obligations under the yacht-building contract. If the lender was unable to find a purchaser, it would need to rely on the market for yachts of the particular type remaining sufficiently strong to enable the yacht to be sold after completion for sufficient an amount to satisfy the outstanding debt due from the borrower and to cover the additional instalments which the lender had paid to complete construction with any additional costs.

Secondly, enforcing its rights as assignee after default would be likely to create administrative and operational difficulties for the lender. Before default, the lender might be content to allow the borrower and its representatives to continue to supervise the construction of the yacht, only engaging a surveyor to inspect progress prior to drawdown of any instalment. After a default, the lender would need to instruct a surveyor or supervisor with the technical expertise necessary to supervise the construction of the yacht properly.

Thirdly, after delivery there would be other operational costs (e.g. insurance, registration fees etc) and, until a subsequent sale, the lender would have a non-earning asset (and an increasing debt). As mentioned, the only way to avoid this following default would be for the lender to find a third party prepared to take an assignment of the yacht-building contract so as to buy out the lender's interest in the yacht under construction.

Further, unless the builder has procured refund guarantees in favour of the borrower (see below), which are then assigned to the lender, the lender will be taking on the

credit risk of the builder as well as the borrower.

In order to perfect the security assignment, the borrower will be required to give notice of the assignment to the builder and (in particular where there are any restrictions on assignment) the lender will require that the builder expressly agrees to the security assignment. Ideally, the builder would also undertake to hold the yacht to the order of the lender and give the lender the right to remedy any default by the borrower under the yacht-building contract before the builder terminates the yacht-building contract due to the borrower's default.

If the yacht-building contract is not governed by English law, local counsel's advice will need to be sought in relation to the security assignment.

**Mortgage of a yacht under construction:** In some jurisdictions, for example the Cayman Islands (but not the UK), it is possible for a yacht to be registered whilst under construction and a lender may then register a mortgage over the yacht on the shipping register of that jurisdiction. However, such a mortgage will not necessarily be enforceable in all jurisdictions. The Netherlands and Germany are examples of jurisdictions whose courts have recognised a Cayman Islands mortgage over a vessel in construction.

**Assignment of refund guarantees:** For high value yacht-building projects, the borrower or the lender may stipulate that the building contract requires the builder to procure refund guarantees from the builder's bank in favour of the borrower to provide security for the return of the pre-delivery instalments paid by the borrower in the event of financial default or the insolvency of the builder. Such refund guarantees are standard under commercial shipbuilding contracts, but are only recently becoming more widely used in respect of yachts.

Where refund guarantees have been granted in favour of the borrower, the lender should take an assignment of the benefit of these from the borrower and give notice of such assignment to the issuing bank. In the absence of refund guarantees or a mortgage over the yacht under construction, the lender will be relying on the credit-worthiness of the builder in respect of pre-delivery instalments drawn by the borrower.

## **B - Post-delivery Security**

**Mortgage:** This would be the main form of post-delivery security over the yacht which would, if necessary, be

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enforced by the lender obtaining possession of the yacht and selling the same.

The loan agreement should provide that upon delivery or purchase (and as a condition precedent to the making of the advance to cover the delivery or purchase instalment) the borrower will create a mortgage over the yacht in favour of the lender and procure the registration of the mortgage (in practice this is usually undertaken by the lender's counsel) in the jurisdiction of registration of the yacht.

The mortgage will usually be in a prescribed one – two page statutory form, the exact form of which will depend on the jurisdiction of registration of the yacht. In jurisdictions such as the UK and those whose system is derived from the UK, the statutory mortgage is a statutory security interest and the lender's power to sell the yacht in the event of default is specifically granted by statute (in the UK, the Merchant Shipping Act 1995).

It is necessary to register the actual mortgage at the relevant shipping registry in the jurisdiction of registration of the yacht, in the manner required by that jurisdiction. It may also be necessary to effect registration in other registries – e.g. the companies registry in the place of incorporation of the borrower, and to take other measures to perfect the security.

The effect of registering a mortgage is to confer on the lender a valid security interest which will be effective against creditors of the borrower (subject to certain liens – see the section “**Liens**” below). No transfer of the registration of the yacht is possible without consent from the mortgagee.

In certain jurisdictions, it is possible for the lender to register a form of priority notice, in respect of a mortgage to be granted in the near future over a yacht. In the UK, this takes the form of a "Notice of Intent" which can be filed on the UK Register and the effect of such Notice of Intent is to "reserve" the lender's priority over the yacht for a period of up to thirty days (consecutive Notices of Intent can be filed so that the period is extended for a further thirty days with each Notice). Although a subsequent lender will still be able to register their interest under another mortgage, that subsequent lender's security interest will rank behind the initial lender that filed the Notice of Intent provided that the initial lender files their mortgage over the yacht within the fourteen day protected priority period.

**Deed of Covenant:** Whereas in some jurisdictions the mortgage itself will contain all the detailed covenants and

obligations of the borrower, in jurisdictions which use a statutory mortgage this will typically be a one page standard form with very limited information concerning the obligations, covenants and undertakings which the lender will require from the borrower. Consequently in these jurisdictions, it is usual for the lender to require the borrower to enter into a separate document called a deed of covenant which would (to the extent such terms are not incorporated in the loan agreement or other security documents):

- i. restate the mortgage on the yacht and charge any further property which may not be covered by the statutory mortgage;
- ii. set out the financial obligations of the borrower in relation to the repayment of the loan facility;
- iii. set out in detail the insurances which the borrower must take out on the yacht;
- iv. assign the insurances and the earnings on the yacht to the lender;
- v. set out the undertakings to be given to the lender in relation to maintaining the registration of the yacht and the technical and operational management of the yacht (e.g. restricting its use except in the permitted manner) and ensuring that no liens or claims are created over the yacht; and
- vi. set out how the lender could enforce the security in the event of a default by the borrower (e.g. the lender being given the right to take possession of and sell the yacht in such an event). These provisions would normally be in addition or supplemental to those rights that the lender would have under the relevant laws of the jurisdiction of registration of the yacht as mortgagee of the yacht.

**Assignment of insurances:** Please see the section “**Insurance**” below which provides an overview of the different types of insurance which a yacht owner / borrower will take out in respect of the yacht.

It will be of crucial importance for a lender that its interest in a yacht's insurance is suitably protected. This can be achieved by the borrower being required to assign the benefit of the insurances to the lender. There are two steps to consider when taking an assignment.

First, the assignment instrument. The assignment will often be included in the deed of covenants, but may also be documented under a separate assignment of insurances or a general deed of assignment dealing with

insurances and earnings. In order for the assignment to be valid, notice must be given in writing to the insurer and lenders will normally require insurers to acknowledge and agree to the terms of the assignment in writing too.

Where the insurance is placed in the London market, there is no restriction on the assignment of yacht, hull and machinery insurance to a mortgagee provided that the notice of assignment is endorsed on the policy. However, it should be noted that the associations dealing with this protection and indemnity insurance (commonly known as "P&I Clubs") do not generally permit the assignment of this type of insurance cover.

The second step to consider is the wording of the loss payable clause which sets out the manner in which the lender requires a hull and machinery insurer or P&I Club to deal with claims following the assignment of the relevant insurance. In the case of hull and machinery risks, loss payable clauses will usually require that, in the event of a total loss or major casualty, the proceeds of any claim shall be paid directly to the lender. In order to take account of a borrower's ability to meet the cost of repair bills following a damage claim whose value falls below the definition of a major casualty, the loss payable clause will often permit such claim proceeds to be paid direct to the borrower, provided there is no current event of default under the loan documents. Because P&I Clubs normally operate on the principle of "pay and be paid" the wording of the loss payable clause on these policies will be different to other loss payable clauses by stating that the P&I Club will only pay a claim to the borrower or the lender after the third party claim has been met by the borrower or lender.

In addition to the above, it will be important for a lender to obtain from the borrower's broker and P&I Club letters of undertaking. The purpose of such letters is for the lender to establish a direct relationship with these entities and to set out their obligations to the lender. As a general rule, whilst some insurance brokers may have some flexibility around the wording of the letter of undertaking, P&I Clubs are unlikely to depart from their approved standard wording.

**Assignment of earnings:** To the extent that there are any earnings or income in relation to the yacht, i.e. through chartering, it will be appropriate for the lender to take a security assignment of these. Typically, the borrower is a single purpose company with no other source of income other than the revenue generated from the charter of the yacht (and maybe not even that, if it is not proposed that the yacht will be chartered out). In the event that the yacht is being chartered out to a third party for some (or all) of the

year, the charter income will then be the primary means by which a borrower is able to service the loan.

An assignment of such income may be included in the deed of covenants or under a separate deed of assignment. In addition, the lender should take an assignment of any amounts payable to the borrower in the event of the yacht being destroyed or damaged or in the event of the yacht being compulsorily requisitioned. Again, in order to be effective as a legal assignment, notice will need to be given in writing to the debtor.

**Additional security:** Since yacht financing transactions are usually undertaken for ultra high net worth individuals (i.e. the ultimate beneficial owners of the yacht), lenders will usually seek a personal guarantee from that individual in respect of the single purpose company borrower's obligations. It is not unusual for the personal guarantee to also contain financial covenants so as to enable the lender to monitor the financial status of their ultimate client.

A charge over the shares of the borrower should also be considered as this will provide the lender with an additional method of enforcing its security over the underlying asset (the yacht) by selling the shares in the borrower as well as being able to take control of the borrower if needs be.

It is not uncommon for lenders also to take a general debenture over all the other assets of the borrower in order to catch any receivables or contracts to which the borrower may be entitled. This will also pick up the benefit of any warranty or customer support obligations of the builder and its sub-contractor to the borrower (though in the case of a newbuilding this should be covered by the assignment of the construction contract).

Lenders sometimes require the borrower to maintain deposits with them in a blocked or charged deposit account sufficient to cover the running and maintenance costs of the yacht for an estimated period (say one year) during which the lender may have to maintain the yacht following enforcement of its mortgage, but before being able to sell it.

If the yacht is to be managed by a third party the lender should consider entering into a tri-party agreement with such third party and the borrower so that should an event of default occur the manager of the yacht can be required by the lender to sail the yacht into lender-friendly waters and co-operate with the lender to

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preserve the lender's security and assist in the sale of the yacht.

## Legal opinions

In addition to the above loan and security documents, we would expect the lender to require opinions to be obtained from lawyers in all relevant jurisdictions to cover: (i) the due execution of documents by the parties to such documents (i.e. the borrower, any guarantor, the shareholder if a charge over shares is being granted and (ideally) the builder of the yacht) in their jurisdiction of incorporation; (ii) the enforceability of the loan and security documents in such jurisdictions; and (iii) the valid registration of the yacht on the ship registry of the appropriate country and the registration of lender's mortgage at such registry too.

The lender may also consider requiring the borrower to provide a legal opinion as to the tax (including for example VAT - see the section "**Value Added Tax (VAT)**" below) treatment of the purchase and / or the ongoing operation of the yacht.

## Miscellaneous

The following sections deal with various miscellaneous issues which a lender will need to take into account on a yacht financing transaction:

### Value Added Tax (VAT)

It will usually be necessary for VAT to be paid on the purchase of the yacht or its importation into the EU, in order for the yacht to be in free circulation within the EU. Certain EU member states have favourable regimes. For example, Malta permits a Maltese company to recover the VAT paid and then to lease the yacht with VAT only being chargeable on a proportion of the lease rentals. Alternatively, it may be possible for the yacht to qualify for relief from VAT under a temporary importation regime.

For these reasons, VAT – and other tax considerations - will have a significant influence on the country of registration of the yacht and the structure of any yacht finance transaction, and the borrower and lender would be expected to obtain bespoke advice from its tax advisors in this respect.

## Insurance

There are four principal categories of insurance for which the borrower should insure the yacht:

- Hull and machinery marine risks;
- Protection and indemnity risks;
- War risks; and
- Mortgagee interest insurance.

If the yacht is registered or is to sail in a less stable jurisdiction the lender may also require political risk insurance to be taken out. Also, if a professional crew have been employed, other forms of insurance cover may be appropriate, such as employer's liability cover and specific insurance for transit on board another vessel for the purpose of relocating the yacht. In each case, it is advisable for the borrower to seek specialist advice from its insurance broker or underwriter as to whether any additional cover is required and the lender may want to review the extent of such cover.

**Hull and machinery** marine risks insurance covers loss of the hull as a consequence of certain events such as perils of the sea, fire, explosion, collision and violent theft. It does not cover, amongst other things, any real or personal property and loss of life, personal injury or illness.

The marine insurance market has developed standard terms which can be used for policies of marine insurance namely the Institute Yacht Clauses (1/11/85) (the "IYC"). Some underwriters have their own policy terms and conditions, which are often closely modelled on the IYC.

Hull insurance placed in London will tend to be in the standard Institute Time Clauses – Hulls(1.11.95) form (note that this standard form insurance contract is subject to regular review and amendment). The lender will need to approve the agreed value and currency of the insurance, the terms of cover (including excesses) and the identity (and credit) of the underwriters.

**Protection and Indemnity risks (P&I)** are third-party liability risks (e.g. fines for breach of pollution, smuggling and immigration laws, the risk of personal injury to or death of a crew member, or the risk of loss or damage of another yacht). This category of insurance may be included in the ordinary hull insurance and can be arranged by entering the yacht with P&I Associations or Clubs or with commercial underwriters. The P&I insurance should also extend to cover claims arising out of use of the tenders and watersport toys belonging to the yacht.

**War risks** placed in London will be in the standard Institute Time Clauses – War (1.11.95) form (subject to

review and amendment). The IYC contains so-called "paramount clauses" which provide exclusions from liability which override any other provisions of the insurance cover. The exclusions cover three war-related categories: war, political acts and nuclear.

The exclusions to any policy of marine insurance always need to be carefully considered to make sure that the boundaries between the different exclusions are clearly spelled out in order to minimise potential difficulties when determining whether or not a loss is covered by the policy. The lender will also need to ensure that the borrower's insurance cover and the terms of the policies meet the minimum requirements which the lender has set out in the Loan Agreement.

## Classification

Yachts, like any other type of vessel, operate under a strict regime of controls and regulations imposed by international maritime conventions (incorporated into English and European law), the flag state, the states where the ship or yacht is operated and by the relevant classification society and their insurers. The application of most of these international and regional rules is limited to vessels of a certain length or gross tonnage.

In order for a ship or large yacht to be insured, it must be entered in a classification society (e.g. Lloyd's Register, Bureau Veritas, American Bureau of Shipping, Register Italiano Navale etc). Classification societies are independent organisations which issue rules and regulations relating to the standards of construction and maintenance of ships. They also act as agents of governments for certain purposes in relation to the enforcement of international safety conventions. Classification society surveyors will inspect the ship or yacht during construction and after regular periods following construction. If any defects are found which cause a breach of the society's rules the surveyor will impose a "recommendation" requiring the defect to be remedied within a set time. If the defect is very serious, the society may withdraw class altogether. It is worth knowing that on grounds of public policy the courts in both the U.S. and UK refuse to impose any liability on classification societies for negligence in carrying out their function.

The lender will wish to see evidence that the yacht is fully classed without recommendation before drawdown. The lender may also try to seek a general undertaking from the classification society that they will inform the lender of any breach of the society's rules or withdrawal of class.

However, in practice such an undertaking may prove difficult to obtain (or furthermore, to enforce). Case law limits a lender's ability to rely on undertakings from the classification society as to the safety of a vessel on the basis that a classification society does not have a duty under the law of tort to ensure the seaworthiness of a vessel to a third party, e.g. a lender. The society's role is to warn of risks, and not to guarantee the safety of every ship it surveys.

## Yacht Tracking

Some lenders insist that the financed yacht is fitted with a "Purplefinder" tracking and monitoring device so that at any time the lender can ascertain the yacht's exact location. An obligation can be inserted into the Loan Agreement requiring the borrower to ensure that such a tracking device is fitted at all times to the yacht.

## Shadow Yachts

Lenders may be requested to finance a shadow yacht, alongside the principal yacht. A shadow yacht is a support vessel which accompanies a main super yacht. It functions as a holding space for additional objects, such as jet skis, helicopters and fuel supplies. It may also contain sleeping quarters for the crew of the main yacht.

Although a single loan agreement is most likely to be used for both the principal and shadow yachts, it is important to note that a separate mortgage must be taken for each vessel. The principal yacht and shadow yacht should be registered in the same jurisdiction and their respective mortgages should be registered in such jurisdiction.

If a different SPV were to act as purchaser of the shadow yacht (and therefore there were two loan agreements), cross-collateralisation would be prudent, so that the collateral of the loan for the purchase or construction of the principal yacht would also be available to the loan in respect of the shadow yacht and vice versa.

In the event of default, the options for the enforcement of a mortgage over a shadow yacht are identical to those for a super yacht (see the section "**Enforcement**" below); i.e. to take possession of the yacht and sell it as mortgagee in possession, or to arrest the yacht and apply for it to be sold by the court. If a shadow yacht is specifically designed and tailored to match its principal

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yacht, its full value may not be recoverable if it were to be sold separately. This poses a large risk for lenders, and so when drafting the security documentation for the shadow yacht, its value, if sold separately, would need to be considered. It may be that both yachts would need to be sold to the same purchaser to recover the outstanding debt effectively.

## Liens

Liens can arise over the yacht. The extent of these will depend on the yacht's location. Examples are liens for port charges and more general maritime liens for crew's wages and salvage.

The key issue here for a lender is that such liens can take priority over the lender's mortgage. For example, if a yacht is involved in a collision, she may need assistance to get to safety and the persons providing such assistance to endangered yachts are entitled as salvors to a salvage reward. The right to a salvage reward will arise irrespective of any lender's right and it is protected by a maritime lien of the highest priority.

## Enforcement

If an event of default occurs, the lender will have to decide whether to reach an agreement with the borrower for the voluntary sale of the yacht or to enforce the security.

The advantages of a voluntary sale is that there is less likely to be a potential dispute over the sale price, and the price obtained is likely to be higher than would be obtained from a forced sale by the lender or a sale by the court.

If the lender has to go down the route of enforcing the security, two main methods of enforcement open to the lender (once the yacht has been constructed) are either:

- i. to take possession of the yacht by appointing a receiver and / or by entering into actual or constructive possession or by arresting the yacht in an action for possession (where the law of the maritime jurisdiction in which the yacht is located permits) and sell it as mortgagee in possession; or
- ii. to arrest the yacht and apply for it to be sold by the court.

A lender will only take possession of a yacht without the assistance of the court if it has the cooperation of the borrower or at least of the master and crew (usually a promise by the lender to pay unpaid wages secures this cooperation). The advantage of selling the yacht as

mortgagee in possession is that the sale can be completed more quickly, without the need to involve the court and incur the attendant additional cost.

If it is not practical for the lender to take possession of the yacht without the assistance of the court, the lender will have to arrest the yacht. The arrest procedure will depend on the jurisdiction in which the yacht is located at the time of its arrest. In the UK the lender would apply to the Admiralty Court. If the yacht has been arrested with a view to obtaining an order for a judicial sale, the court would order the appraisal and sale of the yacht by the Admiralty Marshal. When the yacht is sold, the proceeds of sale are paid into court and an order is made for payment out.

This is a very brief summary of the enforcement procedure and, as mentioned, the exact procedure will depend on the jurisdiction where the yacht is located at the time of enforcement.



# A Guide to Yacht Finance

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