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Reviewing a yacht building contract – a lender’s perspective



Building a superyacht involves several technical and legal challenges not only for the buyer, but also for the lender providing the predelivery financing sought by the owner. The bank will not only look at the main technical features of the project but will also carry out its own review of the contractual terms. In this respect, while the interests of the buyer and the lender are usually aligned vis-à-vis the builder, the buyer should not assume that a financier would take its same approach on certain matters and it should take these into account from the outset to ensure that it can obtain the credit support needed. Dealing with these matters appropriately in the early stages of negotiations with the shipyard will facilitate the credit approval process with the bank.

Taking the above into account we have set out below a non-exhaustive list of points that a buyer should consider if it is willing to ask a bank to finance the construction of a new yacht.

Builder non-performance

The main focus of the buyer and the buyer's financier is on looking out for situations in which the builder might not perform and whether (and if so how) the contract offers satisfactory protection in these unfortunate events. One of the biggest risks, and potential causes of builder non-performance, is insolvency and a lender (as any well-advised buyer should) will look at the creditworthiness of the builder, the track record and capabilities of the shipyard to deliver the promised yacht on time. Only projects to be built by financially solid and technically reliable shipyards will be eligible for pre-delivery financing.

Buyer non-performance

When negotiating building contracts buyers will mostly think about builder non-performance. However, the buyer's lender will need to consider what happens to, and under, the contract if the buyer does not perform. In such a case, the builder will probably be excused from performing and may even be able to terminate, which in both cases means the yacht might not get built or delivered. In most cases the buyer would only have a simple obligation to pay for the price according to the agreed payment schedule. The lender should ensure that there are no unusual provisions allowing the builder to terminate the contract and to have a reasonable level of control over that risk, for instance by requiring that the buyer puts in its equity upfront and that it can secure the future additional funding payments due from the buyer through some other means, e.g. cash deposits or guarantees.

The contract price

This is obviously a key area for all the interested parties, including the lender, because the bank's lending decision will be based on knowing how much the buyer will need to pay and therefore also how much the bank will be funding. The lender will also want to know when the buyer will pay and what protection there is to ensure that it only pays when it is properly due. The lender will also be looking as to whether the price (or at least a major part of it) will be fixed and whether the builder will be able to claim an increase of the price as a result of the price fluctuation of some key materials, like steel.

Change Orders

The more bespoke the design and new the building processes, the more likely it is that there will need to be adjustments to the Specification and the engineering during the construction process. Changes to the Specification can also be brought

about by classification/regulatory changes. A lender would normally want to build into the loan documentation provisions that say that any material changes in price (usually exceeding certain financial thresholds) must be notified to the bank and that consent would be required before the buyer commits to those price increases. This would give the bank the opportunity to decide whether it is willing to fund those additional costs (which it might do if it is adding additional value to the yacht) or whether it would require the buyer/borrower to inject further equity to fund those costs.

Timing of payment

The purchase price is normally payable in instalments at certain stages of the building process. Each of these various stages would trigger an instalment payment and therefore it is important to ensure that the contract has clearly identified those milestones and provides for a process by which those milestones can be verified. The payment provisions would also normally tie into the issue of refund guarantees or title transfer.

Inspection rights

The building contract should contain provisions which entitle the buyer and the lender to inspect work as the construction process goes along. A lender would often want to have the right to send its own independent surveyors to monitor what is being done or at least be given copies of inspection reports for the bank and its advisors to review.

Sub-contracting

Most building contracts will allow the builder a certain amount of flexibility in sub-contracting certain works and the supply of certain equipment. The issue here for both the buyer and its lender is how to monitor and maintain levels of quality and ensure that sub-contractors will not be able to claim retention of title or supplier's liens; and that the builder will obtain guarantees and warranties, and possibly assign those warranties directly to the buyer.

Liquidated damages

Most shipbuilding contracts will include a section dealing with liquidated damages, which represent agreed and fixed levels of damages payable to the buyer as a result of either delay in the delivery of the yacht or failure to comply with certain aspects of the Specification. Damages for delay in delivery beyond the contract delivery date are also usual. While the level of these is left to commercial discussion between the buyer and the builder, the lender will be

interested to know how these liquidated damages will be applied and whether these are netted off against the final delivery instalment or, failing that, are paid by the builder to the buyer.

Builder’s warranty

Lender's interest in this clause is partly to know that if the bank had to take the yacht over in the first 12+ months following delivery it could exercise good quality warranty rights and also partly to know that the buyer has the benefit of such rights, otherwise it will have to fund repairs itself.

Termination by the builder

The buyer's principal obligation will be to pay the instalments of the purchase price as and when they fall due and the ultimate sanction for failure to do so would be to entitle the builder to terminate its obligations under the building contract. The effect of any such termination would normally be that the builder is no longer obliged to deliver the yacht to the buyer and would be entitled to sell the ship to another buyer, either in its unfinished state or following completion of the ship. In any such case, the builder would normally be entitled to apply any proceeds of sale towards all of the costs it has incurred in constructing and selling the ship, together with an element of reasonable profit, and if (after deducting instalments already paid) any balance of the sales proceeds remaining it would be rebated to the buyer. Conversely, if the sale proceeds were insufficient to cover these costs the builder would be able to look to the buyer to recover any deficit. From a lender's perspective, the bank would expect to be aware of when payments fall due and whether they are in fact made, so any default by the buyer ought not to come as a surprise to the bank. Furthermore, as part of the assignment of the building contract, the notice and acknowledgement that passes between the lender and the builder should provide for the builder to notify the lender of a buyer default before the builder exercises any termination rights, thereby giving the lender an opportunity to "step-in" and cure the breach and to be involved in the sale of the yacht to a third party.

Default by the builder

In as much as the buyer's obligations under the building contract are relatively discrete and quite simple to identify, the builder's obligations are extremely broad and varied, and therefore the potential causes of default and breach are equally broad and varied. If the builder fails to build the yacht in accordance with the terms of the Specification, this may either trigger certain

liquidated damages provisions (which do not lead to termination), or, if the defects in the condition and the quality of the yacht are substantial, this may entitle the buyer to reject the yacht and cancel the contract. The situation is most likely to come to a head during the sea trials, and immediately thereafter, where the contract requires the buyer to either accept the yacht or reject it. At this point the lender will want to be involved in the decision-making process that the buyer will need to undertake if it is to reject the yacht. The extent of the rights that a lender may have in these circumstances is a matter for the loan documentation, but in terms of the building contract a lender will need to ensure that the rejection rights are clear and enforceable.

Consequences of the builder's default

Most building contracts give the buyer an option to either: continue with the contract and require the builder to complete the construction and deliver the yacht as soon as possible; or to terminate the contract and reject the yacht. If the buyer opts to terminate the building contract the builder is obliged to repay all of the purchase instalments, together with interest. But often that is all – there is no provision for other consequential losses. For a lender, this is not so much of an issue, because it is only interested in recovering the loan.

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