

July 2021

Superyachts: pitfalls of construction and refit contracts, including the crucial question of owner's security

Introduction

On Thursday 8 July 2021 the Stephenson Harwood Superyacht Team hosted a panel discussion, chaired by Max Lemanski on pitfalls and traps of refit and construction contracts, including how owners can secure their investment during the project. The speakers comprised Daniela Duck, New Build Division Coordinator at Camper & Nicholsons International and Stephenson Harwood Senior Associates Ezio Dal Maso and Emma Nowell. This article summarises the key points raised.

From concept to reality: the new build yacht process from the perspective of a buyer's representative

When assisting yacht owners considering a new build project, it is important that the buyer's technical advisor first ascertains exactly what use the specific owners want from the prospective yacht in order to assist with the production of a basic technical specification and select designers that they consider fit the criteria.

During the selection process, a buyer's representative will have two goals in mind: first, to deliver a yacht that exceeds the owners' expectations and, second, to protect the owners' investment over the long term. To do this, a deep knowledge of the market and the characteristics of the builders (e.g. their track record and financial status) is needed. The historic value depreciation of the vessels built by a particular shipyard should also be assessed to ensure owners are able to resell the yacht at a good price.

A maritime lawyer should always be involved in the pre-contract phase to ensure the contractual documentation is drafted with sufficient detail and clarity to avoid disputes arising over grey areas further down the line.

Important considerations when preparing a construction contract

The following considerations will need to be carefully assessed when preparing the construction contract:

The role of the buyer's representative, and delivery and acceptance

The rights and obligations of the buyer's representative are of paramount importance to ensure an adequate technical supervision of the entire building process. Even though the responsibility of the consistency of the production schedule is the builders', including a provision in the technical specification that said specification is "to be approved by the Buyer's Representative" allows the buyer's representative to spot and raise any irregularity in real time.

At the end of the construction, when the yacht enters the test and trial phase, it is fundamental to have a competent technical survey to follow during this delicate milestone of the project and one can clearly perceive the advantage of having had a professional collaborating with the builders during the entire production process. Here, detailing in the construction contract the main tests to be applied and the precise manner of notices related to delivery and acceptance is essential for a smooth conclusion of any new build project.

Stage payments and relevant milestones in conjunction with the production schedule

A buyer's representative should correctly advise the owners on stage payments and relevant milestones to ensure that there is a good balance of cash flow injected in the project and the construction as it progresses. Furthermore, it would be prudent to establish more than one milestone, all of which being emblematic of the particular production stage the

shipyard states the yacht will be in at the time of payment.

Budget allowances

Another crucial aspect to define in detail is the budget allowances for outfitting the crew and guest areas; the entertainment system; and certain features of the yacht (such as marble, wood and upholstery). The clearer the description and the limits of inclusion defined during the pre-contract stage, the less likely disputes will arise when the owners want or need to include such features.

Change orders

Building a superyacht is a unique experience and, when the project starts taking shape, it is likely that the owners will want to personalise their vessel by adding features which were not thought of at contract closure. Having a clearly defined mechanism regulating change orders is therefore essential. It is recommended that both the builders' operating margin and the cost per hour for white collar and blue collar works should be negotiated and defined, as this will reduce the analysis of a change order to a mere mathematical and objective exercise.

The warranty period

After the yacht is successfully delivered to her new owners, the project enters its warranty phase. With new constructions, even if built with care and surveyed with expertise, it is, however, inevitable that sooner or later technical issues will occur. To ensure that the impact of such unpleasant disruptions on the owners' use of the yacht is as little as possible, an efficient and clear warranty procedure needs to have already been defined during contract negotiations.

Protecting the owner's investment through a refund guarantee

A well-drafted refund guarantee from a reliable guarantor is the most robust security available to owners in new build projects. The purpose of such a guarantee is to secure refund of pre-delivery instalments paid by owners under a build contract in the event said contract is cancelled (e.g. if the builders became insolvent). The guarantor for a refund guarantee will have a primary liability to the owners, which is not dependent on the builders' liability under the build contract.

Refund guarantees are known as *on-demand* guarantees because a guarantor's liability to refund owners will be triggered by the owners making a demand; such demand needing to comply with various requirements as set out in the guarantee.

As refunds under a guarantee are payable on demand, it is important that they are drafted carefully to ensure they have the intended effect and to avoid disputes further down the line.

It is important to note that the value of a refund guarantee to owners as security is dependent on the extent to which it can be enforced against a refund guarantor. Therefore, when preparing a refund guarantee, the creditworthiness and jurisdiction of the guarantor are two major considerations that should be taken into account.

The use of a refund guarantee should be considered as part of the overall project and their details will need to be tailored to the needs of each project. For example, a refund guarantee may not necessarily need to cover all instalments or it may not be necessary for the guarantee to be linked to transfer of title. Although, with that said, whilst it is not an alternative to transfer of title, it should be considered together with the terms of such a transfer.

Progressive transfer of title as alternative security for investment

Transfer of title arrangements are frequent features of yacht building contracts in jurisdictions where the buyer's title can be registered before delivery, such as in Italy, the Netherlands and Germany. Delivery on completion coupled with refund guarantees is regarded to be the default position in most standard commercial shipbuilding contracts. However, there may be reasons to deviate and elect for progressive title transfer in the context of a particular project. For instance, costs involved with refund guarantees may be taken out of the construction price and the shipyard would not have to lock in capital to secure any refund guarantees, which may ultimately result in a price reduction. However, when this solution is adopted, it is essential that it is correctly implemented, and implementation may often be more complicated when compared to a refund guarantee structure.

The idea behind any type of transfer of title arrangement is to give the buyer title to the yacht earlier than delivery, mainly as security for the builders' insolvency. If properly executed, the hull and relevant materials will be out of reach of the bankruptcy estate and the shipyard's other creditors if the builders were to become insolvent. The buyer would therefore have legal title to the hull and, if the contract were terminated, they could finish the construction elsewhere or sell the partly built yacht to other parties.

Important considerations when opting for progressive transfer of title

First and foremost, the title clause of the contract needs to be properly drafted in accordance with the law applicable to the contract. It must also comply with the law under which it may need to be enforced against the insolvency estate. To this end, the buyer's ownership may need to be registered and local law formalities will have to be complied with.

It will then be important to ensure that the title clause covers all materials belonging to the yacht and the type of security the buyers may need to obtain over the machinery and equipment to ensure that the materials and parts belong to them. As materials may have been partly paid for but not delivered to the yard, buyers may also consider a right to step into the yard's main subcontracts. Rights and access to other materials and documents (e.g. drawings, classification society records and builders' certificates) should also be ensured.

If the contractual documentation is correctly prepared, the buyers should be the owners of the yacht and this should also be reflected in the builders' risk cover. The owners should ensure that the insurance terms and values in such cover are appropriate and, more specifically, that they are protected in the event of a partial or total loss and that the building contract provides comprehensive protection to the owners with no gaps in coverage. Ideally, all insurance proceeds should be paid directly to the owners.

The building contract will often say that in the event of the builders' default the buyer is entitled to take possession of the hull and materials and to complete the construction elsewhere. However, enforcing such a clause will involve several challenges from a legal and technical perspective and a buyer should consider these from the outset.

Another point to look at is the buyer's default clause. Where such a clause is triggered, the builders are often authorised to undo the transfer of title and sell the yacht. What we have seen in recent deals is that builders are asking for irrevocable powers of attorney in their favour to act on the buyer's behalf to deal with registration formalities. Builders may also ask for a construction mortgage securing the payment of the balance of the construction price. A buyer will need to ensure that these securities are enforced only if the default is continuing and potentially incurable.

If the buyer sought pre-delivery financing, they should discuss the proposed transfer of title arrangements with the intended lender. The bank would usually ask for an assignment of the building contract as well as of any refund guarantee as

security for the pre-delivery instalments. When the latter is not available, alternative security should be offered. In such circumstances, the buyer may grant in favour of the lender a first ranking mortgage securing the pre-delivery drawdowns.

Lenders would usually also require that, in addition to said construction mortgage, the buyer, the builders and the bank enter into a tripartite or coordination agreement. Said agreement would provide for the subordination of any builders' claim and the right of the bank to repossess and sell the partly built yacht, to step into the buyer's position under the building contract and to discuss with the builders the sale strategy of the yacht in case of the buyer's default.

These points can lead to lengthy discussions between all parties involved and, in our experience, it is advisable that they are raised immediately and not taken for granted.

Contact us



Max Lemanski

Partner, London

T: +44 20 7809 2224

E: max.lemanski@shlegal.com



Neil Noble

Partner, London

T: +44 20 7809 2670

E: neil.noble@shlegal.com



Sean Gibbons

Partner, London

T: +44 20 7809 2613

E: sean.gibbons@shlegal.com



Emma Nowell

Senior associate, London

T: +44 20 7809 2183

E: emma.nowell@shlegal.com



Ezio Dal Maso

Senior associate, Paris

T: +33 1 44 15 82 12

E: ezio.dalmaso@shlegal.com