

# A Guide to Yacht Finance



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## Introduction

Over the past few years we have advised lenders and borrowers (i.e. owners) on a significant number of financings of yachts in both the new-build and second hand markets, the most recent new build being valued at EUR 119,000,000.

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 primarily for pleasure.

The general principles which apply to the financing of a 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 often seasonal and intermittent whereas for commercial ships (save 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 bespoke and designed and equipped to suit individual tastes. The advice of an independent first-class international sale and purchase yacht broker or marine surveyor should therefore be sought by a lender to provide an appraised market valuation at the outset and at regular (e.g. 12 monthly intervals) throughout the term of the loan. The valuations should be for market value (i.e. assuming a willing buyer/seller) and on the basis of a forced sale (where the discount may be between 40–60%). The lender's concern should be to ensure that the yacht being offered as security will be readily marketable 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, yacht manager/crew manager and yacht itself will typically all be different and the yacht could be positioned in virtually 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 normally the yard will produce their own draft forms of contract, which will 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, as well as the delivery mechanics (including delivery location). There may be specifically tailored tax provisions, particularly as the transaction will almost invariably be cross border with significant potential tax liabilities, especially VAT. There may also be clauses dealing with confidentiality (often of great importance for ultra high net worth individuals) and may stipulate whether and to the extent 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.

Given that superyachts are often purchased by special purpose vehicles ("SPVs"), in some circumstances a yard may request a performance guarantee from the purchaser 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, some 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 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 make these registers unsuitable. Some registries – such as the Cayman Islands Shipping Registry and the Bahamas Maritime Authority - have a London presence facilitating registration and closing procedures in the London time zone.

**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 Code of Practice for the Safety of Large Commercial Sailing Motor Yachts 1997 (known as “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:

i. 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.

- ii. 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 (iii) below.
- iii. 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 its proposed country of registration. 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 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 commercially;
- the jurisdiction in which the yacht is being constructed or is presently registered;
- the proposed jurisdiction of registration of the yacht;
- the crewing arrangement;
- 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. Specialist tax/VAT advice should always be sought before entering into any such scheme.

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, evidence will generally take the form of a "Stage Certificate" issued by the builder and counter-signed by the relevant classification society or 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 operative provisions (around facility amount, availability, prepayment, interest rate, loan to value covenant etc.), representations, events of default and boiler plate clauses which are common to any term loan secured facility, the Loan Agreement should also include certain specific "yacht finance" provisions. These include specific yacht undertakings containing detailed requirements as to insurances and the operation and maintenance of the yacht relating, for example to, continued valid registration of the yacht, operation in insured waters only, seaworthiness, being kept in good repair, charters only being on certain terms, permitting access to the yacht for inspections and compliance as to environmental matters, throughout the term of the loan. Covenants can be quite detailed and specific, in some cases even setting out the requirements for special survey drydocking.

The covenants requiring valuation of the yacht should be detailed enough to set out the valuation procedure and how often and at whose cost (pre-and post an event of default) the lender is able to arrange for a valuation in order to monitor the loan value as against the yacht value for the purposes of the loan to value covenant.

The Loan Agreement should also contain specific references to the classification and construction (if relevant) of the yacht. 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 an event of default occurs 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 potentially 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 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 were 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 a sufficient 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 remaining construction of the yacht.

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. There are certain jurisdictional issues relating to refund guarantees, particularly in the Chinese shipbuilding market, and care is required in order to ensure that such guarantees are actually payable if there is a call.

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 can terminate it 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 or equivalent instrument.

**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 under 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, and are 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 creditworthiness of the builder in respect of pre-delivery instalments drawn by the borrower.

## B - Post-delivery Security

**Mortgage:** This is the main form of post-delivery security over the yacht which would, if necessary, be enforced by the lender obtaining possession of the yacht and selling it. Our lawyers regularly advise on arrest and enforcement.

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 may be in a prescribed short 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 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.

In practice, where a delivery is occurring offshore (for example in international waters), in order to ensure that there is the minimum possible amount of time between the Yacht being delivered and placed on the shipping registry of the relevant flag state, and the lender's mortgage being created and subsequently registered on the same shipping registry, the mortgage is often signed under power of attorney (granted in advance by the owner entity in favour, for example, of their solicitor) and physically delivered to the shipping registry (or their London office) by the attorney. It is likely that the shipping registry will require the mortgage to be notarised and/or legalised.

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). Priority ranks from the time of registration in the shipping register. No transfer of the registration of the yacht is thereafter 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 its 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 Covenants:** 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 to two 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 covenants 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 (although this may instead be in a short stand alone agreement);
- 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 can 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.

The Deed of Covenants also allows enforcement in English law proceedings of the same matters covered under the local law mortgage.

**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 is normally 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 to perfect the assignment, 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 protection and indemnity insurance (commonly known as "P&I Clubs") do not generally permit the assignment of P&I cover, although there is a convention of issuing a letter taking note of the lender's interest.

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 contractual 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 or may in the future be 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. Given that this is the case, the lender will wish to be comfortable that the single purpose company has the means to service the loan and pay for the crew etc. it is likely that funds to do this will come from the ultimate beneficial owner. If the funds come by way of loan (as opposed to capital) the lender will wish to see an appropriate subordination deed in place.

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 and banking relationship requirements so as to enable the lender to monitor the financial status of their ultimate client and have recourse to other collateral.

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. This security document would be granted by the shareholder of the borrower and would usually be governed by the laws of the jurisdiction of the borrower (although where a lender wishes to benefit from the Financial Collateral Regulations, English law may be preferred as the governing law, if English law is recognised as a valid choice of law of the jurisdiction of the borrower).

Sometimes lenders also 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 will generally require a borrower to enter into a "deregistration power of attorney" in their favour, in order to allow them *inter alia* to de-register and take possession of the yacht following the occurrence of an event of default under the finance documents. In addition, a lender may require a borrower to execute a "default bill of sale" at the time the purchase/financing. The lender would only be authorised to complete and date such a document following the occurrence of an event of default under the finance documents, thereby effecting the transfer of title of the yacht to the party chosen by the lender upon enforcement.

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.

## Legal opinions

In addition to the above loan and security documents, we would expect a lender to require opinions to be obtained from lawyers in all relevant jurisdictions to cover: (i) the due execution of finance documents by the parties to such documents (i.e. the borrower, any guarantor, the shareholder if a charge over shares is being granted and 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)

VAT is always a major consideration for the owner of a yacht. The general rule is that all privately owned yachts owned by EU residents within the EU or flying an EU flag are required to be VAT paid (with some exceptions) and any yacht operating in EU waters for more than six months in any calendar year (regardless of ownership) is liable to pay VAT at the appropriate time. A sale and purchase (if it takes place within EU territorial waters) is likely to attract VAT liability. The VAT rules differ where a yacht is to be chartered commercially. VAT is collected by the relevant individual member state, rather than the EU itself, so VAT rates and rules vary across the community.

Furthermore, even if a yacht is purchased outside EU territorial waters and legally owned by a non-EU person, if the ultimate beneficial owner/user of the yacht is an EU national, a similar VAT liability may arise. It is also important to note that a VAT paid yacht does not always retain its VAT paid status, for example if it is exported out of the EU for a prolonged period.

For non-EU nationals, the temporary import ("**TI**") regime operates in the EU to facilitate importation into the EU for private non-VAT paid yachts. The condition is that the yacht does not

remain in the EU for longer than 18 months at any one time. An owner wishing to import under this regime will obtain specialist VAT advice here, and in relation to the ongoing operation of the yacht, an experienced captain should take the lead in managing the regulations and ensuring the yacht does not "overstay" its welcome in the EU.

From a lender's perspective, it is often a condition in the Loan Agreement that the owner/borrower has obtained independent tax (including VAT) advice (details of which should be supplied to the lender) and that the owner/borrower will comply with the obligations and requirements set out in such advice so that either (i) VAT on the yacht is not payable, (ii) VAT has been paid in full at the time of purchase or (iii) arrangements are in place for the payment of VAT by way of a legally valid deferral scheme. If the yacht is to operate in EU waters and VAT is payable, there should also be an obligation on the owner/borrower to obtain a VAT paid certificate. Finally, if the yacht is permitted to be made available for commercial charter, it should be a requirement in the Loan Agreement that such commercial charter should be in full compliance with all relevant VAT laws in all relevant jurisdictions (as well as the requirements of the yacht's flag state and all other applicable laws).

## 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.

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**"). For large yachts



many underwriters have their own policy terms and conditions, which are sometimes modelled on the IYC.

Hull insurance placed in London will tend to be in the standard Institute Time Clauses – Hulls 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 may also extend to cover claims arising out of use of the tenders and watersport toys belonging to the yacht. For very large yachts, the tenders may be individually registered as ships in their own right (see the Shadow Yachts section below).

**War risks** placed in London will be in the standard Institute Time Clauses – War 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.

### **Mortgagee interest insurance**

This is insurance for a lender against the confiscation, deprivation or diminution of legal title as mortgagee and against an inability to deregister the yacht. There are many types including: (i) mortgagee rights insurance; (ii) mortgagee P&I insurance; (iii) mortgagee additional perils insurance; and (iv) mortgagee hull insurance. Certain lenders may require the borrower to fund on demand all premiums relating to a mortgagee's interest policy in respect of the yacht.

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.

From a practical perspective, all of the insurance documentation must be lined and up and in order, ready to take effect immediately upon delivery by the builder to the new owner. This is especially important to organise if delivery is taking place at sea

which is often the case.

### **The Manager/Crew Manager**

An owner will often enter into a management agreement with a manager.

An owner will typically wish to appoint a yacht manager to oversee and manage the operation of the yacht. In the case of a superyacht, a separate crew manager may also need to be appointed. A lender's concern here will be that such manager/crew manager is reputable and experienced. The lender will want to review the terms of the Management Agreement/Crew Management Agreement and the owner/borrower would normally be required to undertake in the Loan Agreement that such appointment(s) are not materially amended or terminated without the lender's consent (or without a replacement being appointed concurrently, as approved by the lender).

In addition to the above, a lender will want a direct contractual relationship with any Manager/Crew Manager. This is generally achieved by way of an undertaking/letter of subordination being entered into between the lender and Manager/Crew Manager. Such a letter would contain the following key provisions:

- i. an assignment of the manager's right, title and interest (if any) in the yacht insurances;
- ii. an agreement that all claims whatsoever of the Manager/Crew Manager shall in all respects be subordinate to the lender's rights and claims under the finance documents;
- iii. an undertaking, upon lender's request, to deliver all documents held in connection with the yacht, the owner and the insurances;
- iv. an undertaking to notify the lender immediately upon the yacht being arrested, detained, materially damaged, if the Management Agreement is prejudiced (for example non-payment of fees by the owner), or if the insurances cease to be in effect; and
- v. an undertaking to co-operate and follow the lender's instructions and directions in relation to the yacht if an event of default has occurred under the Finance Documents and the lender is exercising its powers of enforcement (e.g. under the mortgage). The Manager will therefore be required to follow such orders in order to stop the movement of the yacht or to move her to another location.

### **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 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 large yacht to be insured, it must be entered in a classification society (e.g. Lloyd's Register, Bureau Veritas, American Bureau of Shipping and the Register Italiano Navale etc). Classification societies are independent organisations which issue rules and regulations relating to the standards of construction and maintenance of ships (including yachts). 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 yacht during construction and at 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" (i.e. that the requirements of the relevant classification society are satisfied) without recommendation before drawdown. Most commonly this is with the Lloyd's Register, or such other classification society which is a member of the International Association of Classification Societies, as approved by the lender. 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 or yacht it surveys.

## Yacht Tracking

Lenders will often insist that the financed yacht is fitted with a "Purplefinder" tracking and monitoring device and the corresponding codes are provided in order that a nominated representative of the lender can ascertain the yacht's exact location at any time. This would be documented by an undertaking in the Loan Agreement requiring the borrower to ensure that such a tracking device is fitted at all times to the yacht (and a corresponding event of default for failure to do so).

## 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.

Typically a company will never own more than one vessel, for liability purposes. Therefore if a different SPV were to act as purchaser of the shadow yacht, 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 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 include liens for port charges, repairs and supplies and more general maritime liens for crew's wages and salvage. Unlike other types of liens, a maritime lien does not depend on notice or possession.

The key issue here for a lender is that such liens can take priority over the lender's mortgage even though they arise after the date of such 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 an endangered yacht 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.

If a borrower defaults under the Loan Agreement, usually the crew have also not been paid and they would file a claim immediately upon arrest of the vessel and have a lien over it for their unpaid wages.

## **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 its 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 its 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 a court or admiralty marshal.

A lender will only take possession of a yacht without the assistance of the court if it has cooperation - if not of the borrower then 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. However, any sale (other than through a court or admiralty marshal) may leave open maritime liens on the yacht itself which may deter potential purchasers.

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.

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.

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