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A Checklist: What to Expect When Financing Vessel Construction

By [Robert J. Stefani](#) on January 23rd, 2012



When seeking construction financing for a proposed newbuilding, shipowners should understand and be prepared to address the particular concerns that lenders have in assessing risk and documenting vessel construction projects.

When deciding whether to approve a construction financing loan, lenders focus on certain key factors:

- Does the shipyard have the requisite experience, manpower and financial wherewithal to complete the project? To address this concern, shipowners should deal only with established builders with proven records of successfully completing vessel construction projects, preferably involving the type of vessel to be financed.
- What is the credit strength of the shipowner? If the lender will not be financing the entire cost of construction, the shipowner must be able to show that it can fund any unfinanced portion of the cost as well as any owner furnished equipment. As with any loan, the financial strength and operating experience of the shipowner also will be important to the lender's assessment of the shipowner's ability to operate the vessel profitably and make debt service payments.
- Is the shipowner overpaying for the vessel? Shipowners should be prepared to demonstrate that the construction cost is in line with vessels of similar type. Prudent lenders consult with appraisers to help them evaluate the cost.
- How strong will the market demand for the vessel be? As with any business loan, the lender will want to see realistic and verifiable projections of the vessel's earning potential after construction. In optimal cases, a ship is constructed for a specific customer of the shipowner and committed under long-term services agreements or charters with firm competitive terms.

Once the lender has agreed to go forward with financing, it is a best practice to involve the lender in the negotiation of the construction contract so that issues that will be important to the lender can be addressed up front. Nonetheless, in many instances, the shipbuilding contract already has been signed before the shipowner seeks financing. In those cases, lenders will want to review the contract and may request amendments to protect the lender's interests. Items of particular concern to lenders include:



- when title passes to the shipowner;
- the shipbuilder's obligation to certify as to completion of milestones;
- the scope of the shipbuilder warranties;
- the progress payment schedule;
- provisions relating to documentation of the vessel;
- builder indemnities against lien claims of subcontractors as well personal injury, property damage and pollution claims arising during construction;
- the adequacy of insurance coverage during construction; and
- assignability of the contract as security for the loan.

In the typical construction loan transaction, the lender will take an assignment of the construction contract to secure repayment of the loan. Under this assignment, if the shipowner defaults in repayment of the loan during construction, the lender will be entitled to take title to the vessel upon completion and sell the vessel to cover its losses on the loan. The lender will also require that the builder consent to this assignment and agree to subordinate any lien it has in the vessel to the mortgage and other security interests taken by the lender.

As construction progresses, the lender will make advances for progress payments, which are usually repaid on an interest-only basis, until the vessel is completed. To make these interim advances, lenders usually require supporting documentation that may include:

- a shipbuilder' certification that the milestone for which the progress payment is being made has been achieved;
- invoices of the shipbuilder and other vendors or subcontractors for labor, material and equipment covered by such milestone;
- releases of any liens in favor of any vendors, materialmen, or subcontractors the cost of whose services, work, equipment or materials is included in the advance;
- a shipowner-certified advance request;
- surveys, appraisals, certifications or other documents that a lender may require to establish that the advance is for a purpose authorized under the loan documents;



- if an advance is made to reimburse the shipowner for owner-furnished equipment, proof of payment of the expenditures for which reimbursement is sought,

Once the vessel is completed, the construction-phase interim loan will convert to permanent term financing secured by a preferred ship mortgage on the vessel. This conversion usually occurs in connection with the payment of the final milestone payment under the contract and delivery of the vessel. At that time, the lender will require delivery of:

- a term promissory note executed by the shipowner;
- an Application for Documentation [form CG-1258];
- Builder's Certification and First Transfer of Title Document [form CG-1261] signed by the builder;
- a Warranty Bill of Sale executed by the builder;
- a Delivery and Acceptance Certificate, evidencing physical delivery of the vessel to the shipowner;
- a preferred ship mortgage executed by the shipowner in favor of the lender; and
- a certificate of insurance evidencing the coverages [hull and machinery, P&I, mortgagee's interest] required by the preferred mortgage.

Depending on the structure of the deal, the lender may require other security documents such as a security agreement, assignment of charter hire and earnings and/or assignment of insurance policies. The lender will require that the shipowner and shipbuilder coordinate the documentation of the vessel with the Coast Guard with the lender's contemporaneous filing of its preferred ship mortgage, so that mortgage interest attaches at the time of documentation.