

VESSEL HYPOTHETICAL – A LAWYER’S PERSPECTIVE

By Eileen Brown, Thompson Coburn LLP

[It is 1985, a shipowner and broker decide, over drinks at the Four Seasons in New York, that the time is right to build a new vessel.]

After the euphoria of the evening wears off, the questions begin to swirl. How do we choose the right yard? Have we timed the market correctly? Where will we get the money?

We haven’t heard too much about our owner’s business. He has made a good deal of money in the United States – his business is buoyed by Uncle Sam. His is one of the lucky companies that had successfully negotiated Operating Differential Subsidies (“ODS”) with the U.S. Maritime Administration. The U.S. government is contractually obligated to provide these funds to the owner who happens to operate a fleet of primarily U.S. flag vessels in certain desirable liner trades. In 1985, one of these contracts alone is worth up to \$2 million per year per vessel. Despite the collapse in the tanker trades, our owner is doing quite well.

But his success could easily be eclipsed by a making the wrong newbuilding decision – what

will the market demand in two years, when this idea finally results in a vessel? Yes, he has an innovative design that he expects will capitalize on commercial demands and military cargo needs in the coming years. However, is he thinking too big? Will speed and propulsion prove to be more important? Will the addition of ro-ro ramps increase the marketability? Will the design work? Which yard is best suited to build a high quality vessel efficiently with this unique design? Japan, Europe, Scanyards? These questions and many others keep him up at night, but not for long. Soon, he sits down with his counsel and they map out a plan of attack to identify the shipyard, negotiate the contract, secure construction and long-term financing, document the vessel and secure her long-term employment. The uncertainty and risk don’t disappear, but identifying the moving pieces and developing a timeline for the process make everything seem more manageable.

A note on timing: remember that it is 1985 – before the technology boom. The efficiencies that we enjoy from modern conveniences such as e-mail,

cell phones, pdfs, faxes, texting and tweets, couldn’t possibly have been imagined. Deals took time. Negotiations were handled in person. Contracts were typed. It was not uncommon to create redlines or track changes in a document by hand. This work was painstakingly slow but, when compared to today, refreshingly different. Sure, folks spent days – even weeks – holed up in smoky conference rooms, but they were practicing the almost lost art of face-to-face negotiation. Clients sometimes accompanied the lawyers on these ventures but, more often than not, the lawyers were left to negotiate the best deals for their clients. Attorney hourly fees may have risen markedly since 1985, but so has efficiency. It is no longer necessary for one partner to devote the better part of a year to one client’s newbuilding project. In this scenario, we will base our estimate of legal fees on the rate of \$175/hour, which was the rate charged by our most senior partner in 1985. Of course, adjusted to 2010 dollars, this is really \$360 per hour – the billing rate of an associate today.

Our owner’s company is substantial enough to have a

marine architect on staff who travels to various shipyards to evaluate designs and capabilities. (A smaller owner would have had to hire an outside design firm to handle this project.) A Japanese yard is selected based on experience with similar ship design and price. The yard provides general construction terms, which are turned over to lawyers so that problems and opportunities may be identified. No discussion of yard selection would be complete if we didn’t mention that no matter where the yard is located, it almost always comes with an export credit benefit or construction subsidy. Along with the proposed contract terms, the lawyers evaluate these programs and their requirements in order to provide suggestions on how to capitalize on the benefit offered. Remember, in 1985, there is no Wikipedia or program-sponsored website for information. There was always a strong undercurrent of information about subsidies. Brokers often had a good grasp of the available terms, and local investment bankers might specialize in the export programs of the country of build, particularly in Europe. Some governments had well-

organized programs. But, whatever the program or incentive, the lawyers often had to sift through the information in order to learn the requirements by meeting with the appropriate personnel. In the '80s, Japan wasn't really offering subsidies but, rather, the government's plan for nationalizing the shipbuilding industry enabled the yards to offer extremely competitive prices.

This is all before the negotiations begin. These days, contract negotiations are far less dramatic, with all parties and their counsel sitting behind computers in various corners in the world, exchanging drafts and comments by e-mail. In our case, the owner's represen-

tative and attorneys get on a plane to Japan. They begin to hash out contract details in a hot and smoky room at the shipyard. The yard proposes a contract based on its standard design. The owner's attorneys revise the contract to reflect owner's specifications and design type. Who bears the risk of faulty design when the yard is building to owner's specs? The lawyers analyze terms, identify problems and propose solutions that mitigate risk. The yard, hopeful for a contract more in its favor, is eager for the work in 1985 and bends with respect to terms that it might not accept in a better economy. The lawyer's office secretarial pool stays late, typing up contractual terms and revisions.

There is a lot of standing around and sizing up going on as contract drafts and revisions are fine tuned. It is unlikely that this exercise results in a final contract after one meeting. Rather, the scene is probably repeated one or two more times, with some meeting occurring in the States. Finally – agreement. The construction contract is signed and there is an elaborate celebratory dinner.

After his team returns to the States, the owner still can't sleep. This time financing concerns are keeping him awake. Sure, the owner's business success provided him with the liquidity needed for the modest deposit required by the yard, but what about the first

progress payment? He schedules visits with his bankers. There isn't too much shopping around; there are only a handful of players at this point and not many are interested in financing new construction, even in 1985 before the market crash of '87. Banking these days was very relationship-driven. Luckily, for our owner, he has spent a career developing business good-will and it takes him far.

With his vessel construction contract in one hand and a stable book of business, including ODS subsidies in the other, the owner makes rounds of presentations to his banker friends. A couple of banks bite and propose attractive

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financing terms. Once again, our owner calls his lawyers to review term sheets and assist in evaluating bank terms along with business needs for both construction period and long-term financing. After the deposit, our owner needs to come up with cash to pay the yard at various stages of the construction – when the keel has been laid, the engines installed, the vessel launched and, of course, a final payment at delivery. Luckily, the owner was able to secure a parent guarantee from the Japanese yard, so the bank's fears about continuing to throw money at an incomplete vessel are somewhat allayed.

Our owner has a fairly complete project package and, with the help of his lawyers, he strikes a very good deal with a bank that has agreed to provide construction financing as well as take-out financing upon delivery of the vessel. All in all, a good bet for the bankers too, particularly given the risks of marine lending in the '80s. How does the bank get comfortable with construction financing? The bank likely takes an interest in

any unencumbered assets in the U.S. Even though the owner's rights to the ODS contracts may not have been assigned to the bank, the ODS contracts provided competitive advantage and would have reassured the bank of the stability of the shipowner's business. There is no discussion about registering the vessel while it is still under construction so that the owner may obtain a mortgage before its completion.

We have not yet discussed choice of flag. Ordinarily, this is a decision made early in the construction process, along with a classification society. These are important decisions, not only for sound vessel operations and maintenance, but also to provide the bank with much needed comfort that there will be another set of eyes looking after the collateral it has financed. In our case, flag decision is somewhat obviated by the desire to ensure that this new vessel will be eligible to be substituted for one of our owner's older vessels subject to an ODS contract. Our owner will document this vessel under the U.S. registry and flag, but

its foreign construction and operation will have been substantially subsidized by the support provided to Japanese shipyards and operating subsidies provided by the U.S. government after delivery.

Needless to say, negotiating an agreement with the U.S. government to allow the substitution of this vessel for an existing ODS vessel also requires a fair amount of hand-holding by its counsel. Counsel has an easier job working with the bank in negotiating loan and mortgage terms. The bank is thrilled to know that the operation of its collateral will be subsidized by the U.S. government and will be well-looked after by the U.S. Coast Guard and the ABS. No worries about Liberian or Panamanian mortgage law here – the bank's interest is well protected by a U.S. mortgage, in English, documented with the U.S. Coast Guard.

We will assume for this hypothetical that construction progresses on schedule and without dispute, difficulty or significant cost over runs. We

all know, however, that this is the exception, rather than the rule.

And so, the vessel is launched, christened and delivered to an enthralled owner who fondly remembers his evening at the Four Seasons when the idea was born. The happiness, as we know, is short-lived for, in this cyclical business, fortunes are quickly made and lost and bankers just as suddenly tighten purse strings, causing owners and their creative counsel to structure new and different ways to generate cash out of an aging vessel.

Economic Multiplier

Contribution:

Contract Negotiation: \$21,000

Financing:

Borrower's Counsel: \$40,000

Lender's Counsel: \$50,000

Delivery/Closing: \$20,000

ODS: \$15,000

Total: \$146,000

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