



# Strategies for documenting vessel acquisition and financing transactions

By Cherie Bock, Ruthanne Hammett, and Margie Krumholz



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Whether parties are looking to sell one vessel or 1,000 vessels, well-written documentation setting forth the parties' negotiated and agreed-upon terms is essential. While a vessel transfer may be accomplished with a simple bill of sale, most parties choose to formalize the transfer with a comprehensive purchase agreement that includes customary contractual provisions. A well-written agreement anticipating and addressing the potential issues, in addition to what the clients thought were the "business terms," will provide guidance in resolving any disputes and in the long run reduce the chances of litigation.

This article discusses key provisions found in most vessel purchase agreements and provides drafting tips for the transactional attorney involved in vessel acquisitions. The second part of the article addresses various issues that frequently arise during the financing of vessels, whether as part of an acquisition or as part of a stand-alone financing transaction.

## Vessel Acquisition

The central document governing the purchase and sale of a vessel or vessels is the purchase agreement.<sup>1</sup> A typical

vessel purchase agreement looks very similar to any other asset purchase agreement and generally includes standard provisions such as closing logistics, representations and warranties, covenants, conditions to closing and closing deliverables, and indemnification, as well as general miscellaneous contractual provisions such as governing law, integration, amendments, etc.

Listed below is a brief summary of provisions generally present in vessel purchase agreements. Depending on the

<sup>1</sup> This article focuses on purchase and sale transactions involving the buyer and seller of existing vessels. For a transaction covering vessels under construction by a builder, a comparable agreement signed by the builder and buyer should be prepared, negotiated and executed by the parties. Provisions similar to those discussed in this article are often present in vessel construction contracts.

size and nature of the overall transaction, one or more of these provisions may be limited in scope or perhaps eliminated if unnecessary to the closing.

## 1. Asset Identification, Closing Logistics, Purchase Price

This section of the agreement often delineates the specific vessels and other associated assets (such as equipment, contracts and charters) subject to the transaction, the time and place of closing, the purchase price and any excluded rights or obligations. For transactions with multiple vessels, it may be preferable to attach a schedule to the agreement setting forth the vessel names, official numbers (if Coast Guard documented), state identification numbers (if registered in a state), and the portion of the purchase price allocated to each vessel. While it is important to adequately specify the assets subject to purchase and sale by the parties, it is equally advisable to address which assets of the seller are not subject to the agreement to avoid any future confusion or disagreement. Agreed-upon forms of the transfer documents such as the bill of sale<sup>2</sup> and the assignment and assumption agreement<sup>3</sup> may be attached as exhibits to the agreement.

Agreement between the buyer and the seller on the specific time and place of transfer is important for various reasons, including determining responsibility for risk of loss and determining tax liability. Vessels operating in interstate commerce could be in different states and subject to differing tax liabilities.

## 2. Representations and Warranties

The purchase agreement should contain customary representations and warranties given mutually by the buyer and the seller, such as existence, power and authority, due authorization, no conflict, enforceability, no litigation, and receipt of required consents. Buyers and sellers in vessel transactions may also include a representation related to U.S. citizenship.<sup>4</sup> Specific seller representations and warranties may include compliance with and no default under charter documents, good title to vessels, no liens or other encumbrances, and no event of loss with respect to the vessel. Specific buyer representations and warranties may include diligence and non-reliance as well as purchase in the

ordinary course of buyer's business. Additional disclosure schedules or exhibits may be attached to the agreement if necessary to address any of these foregoing items in detail.

## 3. Covenants

A covenants section may be included in the agreement if there are particular items that need to be addressed by the parties post-execution of the agreement and/or after closing and delivery of the vessels. Examples of covenants may include allocation of revenues and expenses of the vessels (including revenue from any charter), actions required after signing (e.g. notification to charterer(s)), and/or a casualty or total loss event that occurs after execution of the agreement, but before transfer of title (risk of loss).

## 4. Closing Conditions

Many purchase agreements contemplate a "sign now, close later" structure. This section sets forth the requirements and deliverables necessary to finalize and close the transaction under such a scenario. Closing conditions for both parties may include a "bring down" of the representations and warranties set forth in the agreement, delivery of certain transfer documents, lien releases and/or payoff letters, satisfaction of any applicable statutory requirements and, for the seller, delivery of the purchase price. In addition, the buyer may require that the seller provide written consents (or waivers) required under the charter documents by the parties thereto.

## 5. Disclaimer of Warranties

Often a heavily negotiated provision, this section generally states that the sale of the vessels to the buyer is "as is, where is" and with all faults.<sup>6</sup> However, the delineated representations and warranties discussed above provided by the seller are generally excluded from this general disclaimer. For example, the buyer would generally expect a representation regarding good title, no liens and the status of the charter documents. However, due to the fact that the buyer is generally provided the opportunity to inspect the subject vessel(s) and evaluate a charterer's financial condition and credit worthiness, the seller will often disclaim any other warranties related to the assets being sold. The scope of the disclaimer will also impact the seller's indemnification obligations discussed below.

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<sup>2</sup>For Coast Guard documented vessels, the CG-1340 form Bill of Sale is recommended.

<sup>3</sup>Typically used for transferring related charters and other intangible assets.

<sup>4</sup>With a few limited exceptions, a buyer of a vessel must be a U.S. citizen (46 U.S.C. §50501 et. seq.) to engage in coastwise trade (46 U.S.C. §12112).

<sup>5</sup>Diligence considerations may include a specific reference to a physical inspection of the vessels by the buyer as well as a review of the seller's records associated with the vessels and any charters.

<sup>6</sup> Sample disclaimer of warranties by seller: "The buyer acknowledges and agrees that the sale of vessels and the other purchased assets hereunder shall be 'as is, where is' and with all faults. Except as expressly set forth in this Agreement, Seller has not made, shall not be deemed to have made, and it hereby disclaims, any representation or warranty, express or implied, now or hereafter, as to the condition, size, design, capacity, operation, seaworthiness, maintenance, value, marketability, merchantability or fitness for use or for a particular purpose of the vessels or any other representation or warranty, whatsoever, either express or implied with respect to the vessels."

## 6. Expenses, Fees

This section delineates the relative sharing of transaction costs and expenses between the parties to the agreement. Generally speaking, the parties to the agreement bear their respective expenses incurred in connection with the preparation, execution, closing and performance of the documents and the transactions contemplated thereby. The buyer normally pays the charges, fees and other expenses related to any and all searches of the National Vessel Documentation Center (NVDC) or the Uniform Commercial Code (UCC) obtained by the buyer in connection with the transaction, as well as and any NVDC filings covering the purchased assets in connection with the closing.

In addition, the buyer and the seller may represent that neither party has incurred any obligations relating to brokerage, finder or agent fees or commissions. If a broker or agent was used by any party to the transaction, such party will often indemnify the other party for any claims, including liens, associated with such fees.

## 7. Taxes

The buyer and the seller normally agree to allocate the taxes<sup>7</sup> between them. Generally, pre-closing period taxes are covered by the seller, while post-closing period taxes are covered by the borrower. All transfer taxes<sup>8</sup> are generally borne by the buyer. The parties may also agree to cooperate by providing each other with information necessary or helpful to claim exemption from transfer taxes and prepare tax returns related to the purchased assets.

## 8. Indemnification

Each party will often mutually indemnify and defend and hold harmless the other party for claims<sup>9</sup> that arise or result from the untruthfulness of such party's representations or warranties in the sale documents or a breach by such party of its covenants and agreements contained in the sale documents. In addition, the buyer may indemnify the seller for any liability of the seller assumed by the buyer or for which the buyer is responsible under the sale documents and for liability under the charter documents or ownership of the vessel(s) after closing.

The parties may agree that any indemnification payments be "grossed up," including deductions, for tax purposes. The indemnification section should include language regarding notice of indemnity claims and may include a "basket," or deductible, whereby the seller is liable for claims only in excess of such basket. The agreement may also contemplate a cap on the total amount of indemnified obligations required to be paid by a party, usually by the seller.

The parties may agree that their sole and exclusive remedy with respect to any and all claims for any breach of any representation, warranty, covenant, agreement or obligation set forth or relating to the subject matter of agreement is pursuant to the indemnification provisions. The representations and warranties in the agreement (and as a result, the indemnification obligations) are often subject to a survival period negotiated by the parties.

## Vessel Financing

Vessel financing, whether necessary in connection with a proposed acquisition or for an owner's cash flow purposes or other capital needs, is generally structured as either a loan transaction or a lease transaction. In a traditional loan structure, the vessel owner retains title to the underlying vessels, and grants the lender a lien on the vessels to secure the loan. In a lease transaction, the lender (lessor) takes title to the vessels, and simultaneously leases the vessels to the lessee. With either structure, the borrower or lessee may immediately charter or sub-charter the vessels to a third party.<sup>10</sup>

## Lender Diligence

In both vessel lending and leasing transactions, lenders<sup>11</sup> will normally conduct a certain level of pre-closing diligence. Listed below is a brief summary of those items that are frequently required to be provided to the lender prior to closing:

- **Appraisal**

Most lenders will require a current appraisal of the vessels being pledged as collateral. This allows the lender to determine the maximum amount of the loan or, in the case

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<sup>7</sup> This includes all federal, state, local and foreign registration, property, ad valorem, or other taxes, assessments fees and charges imposed by any governmental body. The seller is also liable for income taxes resulting from the sale of the vessels.

<sup>8</sup> Transfer taxes generally include goods and services, sales and all use, transfer or similar taxes, fees or duties assessed by any federal, state or local taxing authority arising out of the distribution, sale, transfer or assignment of assets, and/or any related fines, penalties and interest that are imposed in connection therewith, whether assessed to the buyer or the seller but excluding any taxes based on or measured by the seller's income.

<sup>9</sup> "Claims" are often defined broadly to include all liabilities, obligations, losses, damages, settlements, claims, actions, suits, penalties, actual costs and expenses (including, without limitation, reasonable fees and expenses of counsel).

<sup>10</sup> Certain financing structures may be preferred. Lease transactions, for example, often result in advantageous tax treatment for the parties. Owners and lenders should consult with their respective accountants, tax advisors and legal counsel regarding any proposed structure.

<sup>11</sup> For ease of reference, and because in most respects they act and function similarly in these transactions, we refer to both lenders and lessors as "lenders."

of a lease, the remaining useful life of the asset and residual value with respect to the vessel or fleet of vessels.<sup>12</sup>

#### • Lien and Title Searches

If a vessel is documented with the Coast Guard, the lender will require a review of the abstract of title of the vessel and the certificate of documentation.<sup>13</sup> If a vessel is titled with the state, the lender will require presentment of the current certificate of title and a review of any outstanding liens of record. In either case, any outstanding mortgages or liens noted on the abstract or the title may need to be released or subordinated prior to closing.

For vessels under construction or newly-built vessels, an abstract of title or certificate of title will not be available for review. As a result, it is advisable to obtain a certification from the shipyard or builder that the vessel is free and clear of all liens (including any liens or rights in favor of workmen, materialmen, subcontractors, crew or others) as well as a release or waiver by the shipyard or builder of any and all claims it may have against the vessel once the shipyard or builder has been paid.

#### • Review of Contracts

If a vessel is subject to a charter agreement (or if a charter agreement will be entered into as part of the closing), the lender will want to review a copy of the charter agreement to assess the charterer's rights under the charter as well as to determine the revenue generated from the charter of the vessel. Likewise, if a vessel is part of, or will be placed into, a pool of vessels to be managed by a management company, the lender will want to review a copy of the management agreement. Again, the purpose of the review is to assess the management company's rights and obligations under the management agreement as well as confirm the monthly revenue generated from the vessel's placement in the managed pool. The review will also identify the rights of a charterer or manager to create liens on the vessel.

For vessels under construction, the lender will ask for a copy of the construction agreement to assess timing of the construction process and evaluate the shipyard's or builder's rights and obligations under the construction

agreement. In a lease financing, the lessor will need to take an assignment of the purchase agreement in order to take title to the vessel. The assignment will also give the lessor all warranties provided by the builder.

### Financing Documentation

To document a vessel loan, most lenders will utilize their customary forms of loan agreement, promissory note, security agreement, guaranties and other standard ancillary documents. The security agreement for a vessel takes the form of a preferred ship mortgage. Similarly, leases will be documented by customary forms of lease agreements (commonly a charter), guaranties, and ancillary documents, including an assignment of the purchase agreement, as noted above for vessels under construction, or a purchase agreement if a sale/leaseback transaction.

For a vessel that is not documented with the Coast Guard, but is subject to a state certificate of title statute, an owner will need to grant to the lender a security interest by signing a security agreement with an appropriate granting clause. The lender's lien is perfected by notation of the lien on the certificate of title.<sup>14</sup> For any Coast Guard documented vessel, a lender must file the preferred ship mortgage with the NVDC to perfect its lien in the vessel.<sup>15</sup> For all vessels, notwithstanding the documentation status, the lender should require execution of a general security agreement by the owner and the filing of a corresponding UCC financing statement to pick up personal property pertaining to the vessel, such as equipment that may not be deemed to be part of a vessel, accounts receivable and contract rights.

In the case of a lease, the lessor must document title to the vessel (not just a lien) in its own name with the NVDC. The charter (or lease) between the lessor and lessee is not eligible to be recorded with the NVDC, but similarly to other equipment lessors, precautionary UCC financing statements may be filed against the lessee with respect to goods that may not be otherwise covered by the NVDC filing and reference the vessels for purposes of identifying related assets.

With respect to charter agreements, management agreements and construction agreements, in particular the lender may require a separate document to collaterally assign

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<sup>12</sup> Vessel appraisers may use one or more of the following approaches to valuation: 1) The cost approach (the price a buyer will pay should equal the cost to acquire a substitute asset of equivalent utility); 2) The income approach (present value of future economic benefits) and/or 3) The sales comparison approach (appraiser analyzes comparable sales of similar assets). It is important to note that most lenders will not lend against the full appraised value, but instead require an equity cushion, depending on the creditworthiness of the vessel owner and/or the charterer/operator. Appraisals for leases assist in the determination of a fair market value purchase price.

<sup>13</sup> Abstracts of Title (CG-1332) and certified Certificates of Documentation (CG-1270) are requested through the National Vessel Documentation Center.

<sup>14</sup> See Section 9-311 of the Uniform Commercial Code.

<sup>15</sup> The United States Code pertaining to the filing and recording of mortgages and related instruments is 46 U.S.C. §313. The applicable federal regulations are found in 46 C.F.R. Subparts O, P and Q, Sections 67.200-245.

these agreements to the lender. In addition, the lender may seek the acknowledgment and consent of the third parties (e.g. the charterer, management company or shipyard/builder), to the assignment by the owner of these agreements. The third party consents serve to provide the lender a means to step into the owner's shoes to enforce the owner's rights under such agreements as well as receive direct payment of any revenue generated in favor of the owner from such agreements.

## Summary

Because of the complexity and size of the underlying equipment and the involvement of governmental agencies like the Coast Guard, buyers, sellers and lenders are confronted with unique considerations when entering into vessel acquisition and financing transactions.

In this article, we provided an overview of certain documentation considerations the parties on each side of a vessel acquisition transaction should make, as well as a summary of certain requirements often imposed by the lenders backing such an acquisition. Careful documentation during all stages of an acquisition and financing not only facilitates a successful transaction; it also ensures that all parties are protected if a dispute arises later down the line.

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**Cherie Bock** represents financial institutions and borrowers in various secured and unsecured lending transactions, including many different types of financings for the maritime industry. Cherie is a former bank examiner and analyst with the Federal Reserve Bank of St. Louis.



**Ruthanne Hammett** co-chairs Thompson Coburn's Banking and Commercial Finance practice group. She has over 25 years of experience in a wide variety of commercial finance transactions, including secured, unsecured, syndicated, working capital, acquisition and lease financing transactions. She is an active member of the Equipment Leasing and Finance Association and an elected member of the American College of Commercial Finance Lawyers.



**Margie Krumholz** has 30 years of experience representing borrowers, lenders, lessors, and lessees in financing transactions, particularly in the maritime industry. She has worked on many complex financing structures, including transactions that have multiple tiers of debt secured by thousands of vessels. In 2015, Margie was named the Lawyer of the Year for Admiralty and Maritime Law in Washington D.C. by "Best Lawyers."