

J.P.Morgan PRIVATE BANK

Considerations when purchasing, owning and operating a yacht

J.P. Morgan



| Introduction

As a recognised provider of yacht financing, we understand the personal benefits of owning a superyacht—as well as the beauty and craftsmanship that a luxury superyacht represents.

Identifying a shipyard or a pre-owned yacht can be an enjoyable personal project, but it's only a small part of the overall process. Beyond these initial steps, purchasing, owning and operating a superyacht is often a complex arrangement involving a significant number of stakeholders—lawyers, surveyors, yacht managers, tax advisors, sellers, financiers, etc. Navigating these complexities and numerous parties can be daunting, especially for first-time owners, but understanding the full benefits of ownership can bring you peace of mind.

In partnership with some of the leading organisations in the yachting industry, Sam Cook, Head of Specialty Lending, J.P. Morgan Private Bank, EMEA, explores key questions to consider when purchasing, owning and operating a superyacht. Once you have identified a pre-owned yacht or a shipyard to build your yacht, we can help you navigate the process and avoid some of the most common pitfalls.

The purchase of a yacht brings together many highly skilled professionals. Whether you are considering financing arrangements or not, you have access to our lending advisors who understand the complexities of building, purchasing and chartering yachts.

Please contact your J.P. Morgan team if you have any questions. We're here to assist you to make your purchase the memorable experience it should be.

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| The Buying Process: Pre-Owned

Q What are the key considerations when negotiating the purchase agreement of a pre-owned yacht?

A In addition to the purchase price, there are a number of key considerations that should be dealt with in the purchase agreement, including:



WARRANTIES

The buyer should ensure that the seller will provide appropriate warranties as to the title, and that the yacht is free from mortgages, debts, claims and other encumbrances. Because these claims can attach to the yacht and survive the transfer of ownership, once the buyer accepts delivery of the vessel, they would become the buyer's concern, so it is vital to address this prior to completion.



DEPOSIT

Another key question to consider is, "Who will be holding the deposit?" Buyers should avoid paying a deposit directly to the seller, as this places the buyer in a difficult position should any disputes arise. Often, lawyers representing the buyer or the seller, or a third-party escrow agent, act as deposit holders on behalf of both parties.



SURVEY

Finally, the purchase agreement should include an appropriate right for the buyer to conduct sea trials and a condition survey in order to reveal any undisclosed defects. At this point, the buyer has the option to accept or reject the yacht. If the yacht is accepted in spite of any defects uncovered by the survey, the parties may agree to a reduction in the purchase price or an obligation on the seller to repair the defects prior to delivery.

– Thomas Willan, *HFW*

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Q What is the role of a lawyer during this process?

A In addition to ensuring that the sale and purchase contract reflects all of the above considerations, a lawyer can help manage the transaction smoothly, ensuring all contractual deadlines are met and spotting any red flags before they become costly.

There is always some negotiation, and appointing a lawyer who is familiar with the usual legal and commercial issues, as well as the market in general, is critical to ensuring a buyer's interests are protected.

Lawyers will review the delivery documentation provided by the seller to ensure that it is in the appropriate form and, if required, assist with registering the yacht with the relevant flag state registry. They will also assist with any financing arrangements that the buyer intends to put in place for the purchase.

– Thomas Willan, *HFW*

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| The Survey Process

Q How important is the inspection and survey process for buyers?

A Even if a yacht appears to have been well maintained and minimally used, there may be hidden defects that will have an impact on both the vessel's value and its seaworthiness.

It is surprisingly common for a surveyor to identify faults that the seller is not even aware of.

Most large yachts are built and maintained in accordance with the rules and regulations of a classification society such as Lloyd's Register, the American Bureau of Shipping or similar. They will also have to comply with the requirements of the flag state to which the yacht is registered. However, the class and flag surveys cover only the basics of a yacht and do not, for example, refer to exterior fairing and topcoat paint, air conditioning, AVIT, water makers, etc. Class and flag surveys alone should not be relied upon when purchasing a yacht.

The surveyor will diligently review all aspects of the yacht with the purpose of finding any damage, lack of maintenance, errors and defects to protect the buyer and give them confidence. A good surveyor will also provide guidance on areas where the yacht can be improved—either in the short term or when time and funds become available.

– **Andrew Pearson**, *Winterbothams*

Q What is involved in the pre-purchase inspection process?

A Different types of yachts will require distinctive areas of consideration.

The majority of surveyors have a general understanding of the fundamental aspects of most yachts, but logically it makes sense to use surveyors that are the most experienced in the type of yacht being purchased. For example, there are only a few companies in the world that have substantial experience in all aspects of large yacht construction and operation.

The pre-purchase survey of a typical large yacht will consist of:

- **A sea trial**, when the performance of the yacht and its equipment can be tested and assessed
- **A haulout**, when the underwater hull and equipment can be inspected and the hull thickness measured when looking for signs of corrosion
- A couple of days with the yacht afloat in harbour, when all other aspects of the yacht can be **surveyed, measured and seen** in operation

In terms of duration, a typical pre-purchase survey will take four to five days on site, and a similar length of time is needed to write the report.

We strongly advise never to rely on an existing survey report provided by the seller. There are two reasons for this: Firstly, a survey can only reflect the condition of the yacht on the day it was carried out. The vessel may, for instance, have had a heavy grounding the following day, which won't be reflected in the report. Secondly, all reputable surveyors carry professional indemnity insurance, against which a client can claim in the event of the surveyor missing a defect that should have been apparent to a knowledgeable and diligent practitioner.

– Andrew Pearson, *Winterbothams*

| The Buying Process: New Build

Q What are the key elements of a new build contract owners should focus on?

A Unlike a sale and purchase agreement, there is no “industry standard” yacht construction contract. These contracts tend to be drafted as bespoke documents, with each shipyard having its own preferred terms.

Because of the complexity of such projects and the contracts that go with them, shipyards often ask buyers to enter into a letter of intent (“LOI”) before they begin negotiating the contract itself. The LOI sets out the parties’ intentions to enter into a formal contract, and perhaps some key terms, but usually without any legal obligation on either side to proceed.

The Yacht Construction Agreement will include a number of elements relating to the yacht’s construction, modifications, payment terms, timings, warranties and a variety of miscellaneous clauses. Particular attention should be given to:



CONSTRUCTION STANDARDS

In addition to the characteristics of the yacht, the construction agreement should clearly stipulate the precise regulations in accordance with which the yacht will be built and which will ensure that the buyer will be able to register the yacht on its chosen flag upon delivery. The buyer may also wish to set a minimum quality standard in terms of fixtures, finishes and overall appearance. This can be done by referencing either the manufacturer’s own standards for past projects, a specific model yacht or a more general standard, e.g., the “best North European luxury yacht building standards.”



CONTRACT PRICE AND PAYMENT TERMS

Although the headline price is likely to have been agreed at the LOI stage, the construction agreement will need to set out exactly what is, and what is not, included in that price. Larger projects often have a more complex pricing model, which includes budgets or provisional estimates for specific items or areas.

The price is invariably payable in instalments, usually by reference to when the shipyard reaches an agreed construction milestone, and very often with a “not before” date attached to each instalment to allow the buyer to plan and budget accordingly.



TERMINATION

The construction agreement should set out the circumstances under which the agreement can be cancelled by the parties. The buyer will want to ensure that they can terminate the agreement for a variety of reasons, including any suggestion that the shipyard is in financial difficulty. The contract will also need to address what rights and obligations the parties have following termination, which will depend, to a significant extent, on who has the title to the hull. These provisions all require considerable care and attention.

– Panos Pourgourides, *Hill Dickinson*

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Q What protections or security should owners be seeking when negotiating the construction agreement?

A From the buyer's perspective, the security package varies from shipyard to shipyard, but typically comprises refund guarantees (usually from a bank, but sometimes from a parent company), the title for the partially constructed yacht or a combination of the two.

Each approach has its own risks and advantages. Given a choice, a buyer of a fully custom yacht may well prefer the title in order to take possession and look to complete the project elsewhere if the builder defaults, whereas a buyer of a production yacht may simply prefer to get their money back.

The buyer should also understand that even if they have the title, the builder will have a lien over the hull until it has been paid what is properly due. Taking physical possession of the yacht may be difficult, particularly if the shipyard has become insolvent. Taking the yacht to another shipyard for completion would also likely lead to significant delays and additional costs.

The four key points to consider in regard to refund guarantees are: **1) the creditworthiness of the issuer; 2) the amount guaranteed—does it include costs and interest?; 3) the duration of the guarantee**—if not open ended; and **4) the circumstances under which a demand can be made**—an “on-demand” guarantee is always preferable, but rarely available. The cost of any refund guarantees (typically 1% of face value per annum) is also usually passed on to the buyer.

Related to this, the construction agreement should also clearly set out the procedure for the resolution of disputes as well as the law and jurisdiction that should govern the contract. A distinction is often made between technical and legal disputes. Technical disputes are generally determined by a technical expert, appointed jointly by both parties. Legal disputes should be dealt with via court proceedings or by way of an alternative dispute resolution (“ADR”) such as arbitration. The benefit of ADR is that it is usually confidential, and can be a more efficient and commercially flexible way of resolving disputes rather than court proceedings.

— Panos Pourgourides, *Hill Dickinson*

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Q How important is the role of a project manager in ensuring that the delivered yacht is exactly what the owner had envisaged?

A Most superyachts are bespoke, custom-made vessels that are self-sufficient (i.e., generating their own electricity and producing their own water and services), technically sophisticated and operating in a harsh marine environment.

It follows that building or refitting a superyacht is a complex process, with construction, operational, legal and insurance implications to consider.

The appointment by the yacht owner of an experienced independent representative or project manager to provide advice, and to supervise the work, is always strongly recommended. The project manager will be a representative of the owner providing independent guidance and advice to all parties throughout the entire duration of the project—from the first thoughts about building a new yacht (or refitting an existing one) to the end of the warranty period and beyond. Typical advice and guidance provided by the project manager would include the initial shipyard and equipment selection, specification, technical input to the contract, cost versus value, design, choice of materials and a myriad of construction decisions, following every step of the construction process and providing independent quality control.

Experience in ALL aspects of yacht construction and operation should be the primary factor when choosing a project manager. Furthermore, as technology is constantly changing, and rules and regulations evolve every year, familiarity with upcoming requirements to help future-proof the vessel is a must.

— **Andrew Pearson**, *Winterbothams*

Choosing the right ownership structure and registration jurisdiction

Q What are the key advantages of utilising a corporate structure for the ownership and operation of a yacht?

A Even for a small vessel of 10m length, a corporate structure is easily justified, and it is well worth the time to get it planned out correctly.

The primary driver for a corporate structure is risk management for the Ultimate Beneficial Owner (“UBO”). The limitation of liability and ring-fencing benefits of a corporate structure are essential to the proper operation of a yacht, which is a valuable asset.

Having the asset ring-fenced means that issues are addressed, managed, mitigated and successfully dealt with in isolation to other UBO assets and concerns.

Increasingly, another driver is the benefit of anonymity and privacy that a yacht structure represents. The UBO is replaced by experienced, reactive and capable nominee directors, director companies or trusts and an entity name. Family offices and UBOs value the reputational risk management benefits of a corporate structure.

Lastly, of course, and where J.P. Morgan and Equiom work together, is when a yacht is financed. The title of the yacht, registration of liens and mortgage contracts and leasing, together with Lombard loan arrangements, are facilitated through corporate structures.

– Ian Petts, *Equiom*

Q What are some of the most common registration jurisdictions?

A The Red Ensign group of flags is still the most popular. The reason for this is the history, efficiency and protection of British maritime law, political stability, consular services, British Navy protection and commercial confidentiality.

Flag selection criteria are wide, but some flags offer certain advantages such as Bermuda, the Marshall Islands and the Cayman Islands, which allow Yachts Engaged in Trade (“YET”) schemes to operate. YETs are vessels that keep to commercial standards year-round, but are also private yachts that can charter for a limited number of days in French waters.

Further, flags such as the Cayman Islands, the Isle of Man and Malta have a large volume of experienced surveyors, which makes inspecting the yacht during the build easier and more responsive—an important factor since superyachts are highly customised and require the flag state to decide if their design is compliant.

There are other considerations when choosing a flag, including navigational rights, tonnage of the yacht, tax planning, manning requirements and conditions of employment, VAT registration and U.S. cruising permit eligibility.

– Ian Petts, *Equiom*

Q What are the key considerations for clients when selecting the most suitable jurisdiction for both the registration of their yacht as well as the incorporation of the owning entity?

A The rules and regulations of the flag state will govern the operation of the yacht, including matters relating to safety, crewing, training and commercial certification. The most pertinent issues relevant to the choice of flag include:

- Where and how a yacht will be used could have economic and tax implications for the owner. Thought should be given as to where the yacht should be registered to ensure that it can be enjoyed in an economic and tax-efficient manner.
- The reputation of the flag state is also important to many owners, as it may affect the ease of operation and have a bearing on the yacht's image and resale value.
Yachts registered with flag states that are well known to port state authorities and customs officials for having high regulation standards are less likely to be boarded for inspection, and if inspected, are less likely to have further issues raised.
- A knowledgeable and approachable team of flag-appointed surveyors and technical advisers can be important, especially during construction. The Red Ensign Group of flags in particular has played a key role in the development of a series of codes for the construction and safe operation of yachts, and is able to offer extensive support to owners and shipyards during the construction of any yacht intended to be registered with the Red Ensign group of flags" upon delivery.
- Having a network of professional service firms, with established links to the registry and that are able to advise in the jurisdiction of the flag state, can be essential—as is having an established maritime legislative framework. A lender will also be keen to ensure that any mortgage interest it may have over a yacht is regulated by an established legal system, which will facilitate the enforcement of its security.

Occasionally, a determining factor may be the availability of a chosen name, as most flag states only allow the use of one particular name throughout the whole registration, while some flag states allow the same name to be used, but with a different home port.

— Panos Pourgourides, *Hill Dickinson*

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VAT considerations of yacht ownership

Q Over the last few years, tax and VAT arrangements relating to yachts and aircraft have been subject to significant scrutiny. What are the key considerations for owners regarding the VAT implications of their purchase?

A Yes, there are a number of VAT schemes which either are marketed to save VAT or defer VAT.

Various schemes and jurisdictions have been heavily criticised and invalidated by the European Commission. It is really important to consider the details, contracts and holistic management of the scheme through the life of the yacht, through purchase, operation and sale, and use by both the owner, and if chartered, by charter guests and the total holistic cost of the scheme.

Any model needs to be robust and 100% compliant, both now and in the future. There must be substance and logic behind any scheme, it must be of value to the UBO and be practical to operate.

The local laws on many of these schemes have now prevented many of them from being employed, and any new scheme must be thoroughly explored, and correct substance and logic proved.

– Ian Petts, *Equiom*

The VAT on how the yacht is imported, transferred between different jurisdictions, VAT paid on the hull, services and goods and refits, VAT reclaimed or VAT deferred, and VAT offset with any charter activity, is part of a detailed tax study on the purchase, operation and sale of the asset that should be undertaken. A typical study would cover everything from the VAT on the hull, VAT to be charged, and VAT paid to different jurisdictions on charters, as well as VAT on provisions for the owners, guests provisions, owners own use of the yacht, and purchase of services and supplies for both crew and guests.

The key in VAT considerations of yacht ownership is to involve tax specialists and indirect tax specialists as soon as possible in the purchase decision.

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