

THE LAST BEST CHANCE: ANALYSIS OF THE PRE-FINANCING SHIP SURVEY

By Capt. Max Hardberger

Prudent lenders now require a current survey of the ships they are considering for marine financing, but the analysis of a marine survey is an art in itself. Considering that most marine financiers ultimately base their lending decisions on the vessel's survey report forwarded by the loan applicant, a careful review of the information contained in this report, both stated and implied, may be the lender's last best chance to protect himself from investment in a substandard vessel.

Unfortunately, there are no national or international requirements or standards for marine surveyors. Anyone may call himself a marine surveyor and hold himself out as such. Due to the lack of professional standards and the possibility of collusion between a prospective shipowner and a marine surveyor, the financier considering taking a mortgage on a vessel is well-advised not only to examine a surveyor's qualifications and relationships, but also clues within the survey that may reveal the vessel's real condition and situation.

THE SURVEYOR

Normally, a lender wishing to assure himself that a prospective vessel is worth the investment will have to rely on a survey report without any reference to the surveyor's background or qualifications, since the report itself will not include this information. A prudent lender will therefore make a separate enquiry into the surveyor's qualifications.

Some background information may be gleaned from the survey report's letterhead, which will almost always include a reference to the surveyor's membership in an organization, if any. There are two reputable surveying associations in the United States, the National Association of Marine Surveyors (NAMS) and the Society of Accredited Marine Surveyors (SAMS), and one international association, the International Association of Marine Surveyors (IAMS) based in England. There are many highly qualified and professional marine surveyors who do not belong to either, but lenders should regard with caution surveyors who are members of any other sur-

veying association.

There are surveying associations that exist solely for the membership fees they can receive, and whose standards for membership reflect this goal—and at least one that exists in order to accredit the graduates of its proprietary surveying school who cannot meet the experience standards of NAMS and SAMS. Therefore, membership in any organization other than NAMS, SAMS, or IAMS should be a red flag to those relying on a surveyor's reports.

A prudent lender should also request, through the prospective purchaser, a copy of the surveyor's C.V. If one is not forthcoming, this is a warning sign in itself. With today's communication facilities, a failure to provide the surveyor's C.V. in a timely manner should be viewed with caution. The surveyor's C.V. should be analyzed to determine whether the surveyor has the necessary experience in the type of vessel to be financed. For example, a cargo surveyor may be unqualified to opine on vessel condition. Similarly, a

surveyor with an engineering background, without training or extensive experience in hull surveys, may be unable to issue a competent opinion on a vessel's hull condition.

Although the prospective lender may be satisfied with the surveyor's credentials, he should be alert to the surveyor's possible conflicts of interest. A surveyor who inspects a vessel in a port distant from the owner's residence is less likely to know the owner personally, and is therefore less likely to be in collusion with the owner.

However, if the vessel is surveyed in the owner's own country, especially in a port close to the owner's residence, there is the chance that the owner and the surveyor were previously acquainted. They may even be close friends. Such a situation is rife with the possibility that the surveyor has been suborned by the owner to produce a favorable report.

The reasons why an owner would want a misrepresentative—or even fraudulent—survey report are varied. A prospective purchaser

normally wants to borrow as much money as possible, and he needs a good report to support a high valuation. And since the surveyor is paid by the purchaser, his natural inclination is to overestimate the vessel's condition. A professional surveyor will resist this inclination, but an inexperienced surveyor may not have the background or fortitude to support his negative comments in the face of his client's protests.

Even worse, a purchaser may condition payment of the surveyor's fees on the receipt of an "acceptable" survey. Financial pressures may lead the surveyor to

issue a report reflecting the purchaser's wishes. In an extreme case, the purchaser may state explicitly from the outset that he needs a good report or a certain level of valuation, and he will "shop" the assignment among surveyors until he finds one who will agree to these conditions. This arrangement is clearly fraudulent and is intended to deceive the lender.

The lender should also watch for identity of national backgrounds between the purchaser and surveyor. For example, when a lender receives a loan application from a Greek purchaser in New York, accompanied by

a survey report issued by a Greek surveyor in Peru, he should realize that there exists a worldwide network of Greek owners and maritime support personnel whose members routinely work with each other and, to some degree, regard the rest of the world as "fair game." In this case, the lender may be well-advised to request a second survey, although he should be careful, as a matter of courtesy, not to give a specific reason for the request.

A surveyor involved in a collusive scheme to inflate the value or overreport the condition of a vessel will usually, if he is clever, resort

to vague descriptions rather than actually commit himself to untruths. For example, the surveyor may "neglect" to mention the defective oily-water separator rather than state that it is working, or that it is onboard when it is not. Experienced reviewers of survey reports know that the failure to mention important items of equipment is a red flag.

THE CONDITION REPORT

The lender should beware of surveys issued without the usual exclusions and cautions. Very few surveys can encompass the entire vessel. Most vessels are sur-

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veyed in-water, and without having all compartments and tanks opened for inspection. The survey should accurately describe which areas of the vessel were sighted and which were not. A survey that fails to assess the condition of some areas of the vessel, without specifically stating which areas were not sighted, is unprofessional at best and may be deliberately evasive at worst.

The survey report must also contain a reference to where the vessel was surveyed, including the port and berth. Any vessel that was sighted alongside a dock or

at anchor should either make reference to a diver's report or should contain a statement that the exterior of the vessel below the present waterline was not inspected. A failure to include such a statement reflects poorly on the surveyor's professionalism.

Since trading ships are often inspected with ballast-water in their tanks, or with cargo above some or all of the tanks' manholes, the survey should state which of the tanks were inspected. These areas are of critical importance to a vessel's condition—they are normally the areas in the worst condi-

tion—and it is imperative to know whether they have been sighted.

General statements in a survey that "the vessel was sighted in overall satisfactory condition," or "free of significant hull and deck wastage," are virtually worthless. Even if this were true, the survey should state specifically all areas sighted and the fact that each is in satisfactory condition.

Lenders should beware of surveys employing superlatives. The general statements of condition accepted in the industry are as follows:

GOOD: This statement should be used sparingly. Normally, an aspect of a vessel is "good" only if it is in like-new condition.

SATISFACTORY: This is the proper designation for most aspects of a trading vessel that are fit for their purpose.

SERVICEABLE: This designation indicates that the aspect or equipment is fit for its purpose, but is less than satisfactory. It may not need immediately replacement or repair, but it will need remediation within a predictable amount of time.

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UNSATISFACTORY: This indicates that the aspect or equipment is not presently fit for its purpose, and must be replaced or repaired as soon as practicable.

POOR: This indicates that the aspect or equipment must be repaired or replaced immediately, or before the vessel is returned to service.

A report that contains a large number of "GOOD" assessments is suspect, as there are very few trading vessels over five years old whose hull, machinery, and equipment are in overall "GOOD" condition. On the other hand, a report

containing a large number of "UNSATISFACTORY" or "POOR" assessments obviously indicates that the vessel is a poor risk as found.

CLASSIFICATION

A proper survey will include reference to the vessel's class status. Traditionally, lenders, insurers, charterers and governments relied on class status as an affirmation of a vessel's fitness to trade, but today the situation has been clouded by the lowering of class standards among members of the International Association of Class Societies (IACS) and the proliferation of non-IACS

issuers of statutory and class certificates.

Even among the "Seven Sisters," the original IACS members, standards vary wildly. Some IACS members, such as Rina, the Italian class society, do not require their vessels to maintain the same standards as ABS, British Lloyds, Germanischer Lloyd and Det Norske Veritas. Hellenic, the Greek society, is not a full member of IACS, and its standards are even lower. Further, it is well-known that ships classed in Greece or Turkey, even under British or Germanischer Lloyds class,

may not meet the same standards as those classed by surveyors in other countries.

Below these levels are the non-class-society private companies licensed by Panama, Honduras, Belize, Cambodia, and some other "flag-of-convenience" countries to issue "class" certificates. Many surveyors associated with these outfits are highly professional and competent, but the possibility exists that the pressure on these companies to provide the necessary certificates in this highly competitive business will result in the issuance of trading certificates to substandard vessels.

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A prudent lender will request copies of the vessel's class reports, which are normally available to the surveyor onboard the vessel. The lender should not rely on the surveyor to analyze these reports, but should make an independent examination himself. This analysis may reveal hull or machinery problems. For example, a recent grounding followed by rechocking of the main engine will indicate deformation of the hull and a serious reduction in the ship's value, even though she may still be "in class."

Other red flags are withdrawals of class followed by reinstatement, frequent deferrals of repairs, requests for delays in dry-docking, and outstanding "conditions of class" (repair items required by class but not yet accomplished). Obviously, the dropping of IACS class followed by enrollment in a national "class" may indicate that the vessel can no longer meet IACS standards.

THE VALUATION

The assignment of value to a surveyed vessel is of critical importance, and is the area in which the surveyor may cause the greatest loss to the lender. Opinions among surveyors regarding the value of a given vessel may vary widely, depending on the surveyor's experience,

background, and motivation. The prospective lender will give the surveyor's valuation a great deal of weight, and may even base the size of the loan on this assessment. An excessive valuation could cause the lender a loss if the vessel is subsequently abandoned or repossessed, because she was not worth the amount of the loan at the outset.

The worst problem is that it will be difficult after the fact to determine why the vessel was overvalued in the initial survey report. A clever surveyor will always be able to produce reasons why he placed a given value on a vessel, and even if the lender could prove that the vessel was negligently (or fraudulently) overvalued. In any event, it is rare that a surveyor will possess the assets necessary to support legal action against him.

This is an area where the lender's own experience and background are invaluable. A prudent lender will make his own determination whether the vessel is worth the reported value. A competent valuation will clearly state the basis upon which the valuation is made. Properly, the value should be based upon "fair market value" rather than "replacement cost" or "construction cost." It does a lender no good to repossess a vessel

upon which he lent enough money to build another one, when he can only sell her at her fair market value.

An often-overlooked component of fair market value are market forces. The value of most vessels is completely dependent upon the amount of money they can earn, rather than on the cost to build or replace them. A ten-million-dollar cargo ship in a depressed cargo market may only be worth a million or less. If the market is bad enough, she may only be worth her scrap value—the value of the steel in her hull—regardless of the cost to build her.

Large vessels cannot be laid-up to wait for conditions to improve, since their high maintenance costs can only be supported by income. During the shake-out of 1995-1998, goods ships in full class, younger than 15 years old, were sent to India and China for scrap.

CONCLUSION

The trend in ship-finance is for the lender to rely on reports from surveyors known to and trusted by the lender. This reliance obviates most of the problems of incompetence, and almost completely eliminates the possibility of collusion between the purchaser and the surveyor. A lender is completely within

his rights to require that the vessel be inspected by a trusted surveyor, rather than one provided by the purchaser. If the purchaser resists paying for the travel time and expenses of such a surveyor, the lender should consider whether there are other factors involved.

If the lender does not have trusted surveyors available, he should ask other lenders for referrals, or seek out surveyors with no obvious connection to the purchaser. A lender would be well-advised to maintain a file containing the C.V.'s of trusted surveyors, with notations as to the quality and comprehensiveness of their reports, so that one may be nominated to a purchaser when the loan application is made. In any case, even an unknown surveyor nominated by the lender is less likely to be subject to pressure or collusive influence than one hired directly by the purchaser.

As is true in the mortgage industry at large, a close familiarity with the type of ship and its market, coupled with expertise in the form and language of marine survey reports, are a maritime lender's best defense against investing in bad tonnage.