Simply Speaking

Obscure legal concepts or terms in a loan document explained in plain English

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Conditional Payment Instructions

What is it and what does it do?

Conditional payment instructions are commonly used to allow a buyer in a vessel sale and purchase transaction to preposition the balance of the vessel's purchase price with the seller's bank or the seller's lender without releasing the balance to the seller until delivery is complete. Due to time zone differences and because the balance is often transmitted internationally via a U.S. correspondent bank, a buyer and a seller will often agree that the buyer will transmit the balance to the seller's bank one or two days prior to delivery to avoid delays at closing. The buyer will instruct its bank to send the balance to the seller's bank together with a conditional payment instruction to hold the funds in a suspense account and return them to the buyer if the sale does not complete within a certain period. The seller's bank will confirm once it has received the balance and, pursuant to the conditional payment instruction, will hold the balance until it receives a protocol of delivery and acceptance and a release instruction signed by the buyer and the seller authorizing the release of the balance.

Example

The buyer shall, at least one (1) day prior to the expected delivery date of the vessel, make a remittance by way of SWIFT MT-103 and a conditional payment instruction by way of SWIFT MT-199 to seller's bank in a suspense account covering the amount of the balance of the purchase price (the "Balance Amount"), with an irrevocable instruction that the Balance Amount shall be released to the seller against presentation to the seller's bank of a PDF copy of the protocol of delivery and acceptance of the vessel duly signed by both the seller's and the buyer's authorized representatives and a release letter signed by a duly authorized representative of the seller and the buyer specifying the amount to be released to the seller and the amount to be returned to the buyer.

Why is it there?

A conditional payment instruction is similar to an escrow agreement in concept and is used because it provides a compromise solution to the “who releases first” problem of (a) the buyer not wanting to send the purchase price to the seller before taking title to the vessel, (b) the seller not wanting to deliver title to the vessel before receiving the purchase price, and (c) if applicable, the seller’s existing lender not wanting to release its mortgage over the vessel until it is assured that the loan will be repaid. With a conditional payment instruction, each of these three concerns can be sufficiently addressed to allow a sale to complete. First, the buyer can rely on the seller’s bank to not release funds to the seller until the buyer countersigns the protocol of delivery and acceptance. Second, the seller can obtain confirmation that the buyer has paid the purchase price to the seller’s bank before delivering title to the buyer. Third, the seller’s existing lender can obtain confirmation that the funds necessary to repay the existing loan are held by the seller’s bank and will be released to the lender upon completion of the sale.

Why is it important (or not so important) to a lender?

Unless a buyer is assuming a mortgage at delivery (which is uncommon), a standard requirement in vessel sale and purchase transactions is that a vessel is delivered free of any recorded mortgages. Where a seller is repaying an existing loan with the sale proceeds and the buyer will not release the purchase price to the seller until delivery of the vessel, the existing lender will be asked to agree to release its mortgage immediately prior to delivery and to be repaid upon delivery. The existing lender will only agree to release its mortgage prior to repayment if this repayment is assured. Confirmation by the seller’s bank that it has received funds and a conditional payment instruction to release the funds to the lender upon delivery can provide the existing lender assurance that the loan will be repaid so that the existing lender can agree to discharge its mortgage immediately prior to delivery and repayment.

How does it affect a borrower in practical terms?

A seller intending to use sale proceeds to repay an existing loan on a vessel will need to cooperate with the existing lender to agree a closing mechanism acceptable to all parties. The existing lender will typically need to review and approve of the closing memorandum together with the conditional payment instruction and any release instructions to the seller’s bank authorizing the repayment amount to be paid to the existing lender upon delivery. An existing lender may also require additional assurances from the seller, such as an undertaking to record a new mortgage over the vessel if the sale does not complete.

A seller should note that many banks cannot hold funds under a conditional payment instruction, and not all lenders can agree to release a mortgage based on a conditional payment instruction. It is always prudent for the seller to confirm arrangements with the seller’s bank and the existing lender before executing the memorandum of agreement.

Where a seller’s bank cannot accept payment by a conditional payment instruction or an existing lender is not willing to release its mortgage based on a conditional payment instruction, one alternative is for the balance of the purchase price to be remitted to a third-party escrow agent pursuant to an escrow agreement. These escrow arrangements will similarly need to be mutually agreed between the seller, the buyer and the existing lender.

How is it relevant to shipping?

Conditional payment instructions are frequently used in the industry to mitigate some of the counterparty risks in vessel sale and purchase. Parties regularly involved in vessel sale and purchase or finance are likely to encounter conditional payment instructions in many of these transactions.

How is it negotiated?

The memorandum of agreement will often just provide that the balance of the purchase price will be paid together with a SWIFT MT-199 conditional payment instruction. After execution of the memorandum of agreement, the seller, the buyer, the seller's bank and, sometimes, the seller's existing lender will negotiate the terms to be included in the conditional payment instruction together with the closing memorandum. While certain terms, such as the number of days the seller's bank will hold funds in suspense before returning the funds to the buyer, are negotiated, the basic provisions of the conditional payment instruction are similar across transactions.

Questions?

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