

INTERNATIONAL SHIP FINANCE REGIME – COMPARATIVE STUDY OF
CHINESE, AMERICAN, BRITISH AND INTERNATIONAL SHIP FINANCE
REGIMES

AN ABSTRACT

SUBMITTED ON THE TWENTY EIGHTH DAY OF MARCH 2014

TO THE SCHOOL OF LAW

IN PARTIAL FULFILLMENT OF THE REQUIREMENTS

OF THE SCHOOL OF LAW

OF TULANE UNIVERSITY

FOR THE DEGREE

OF

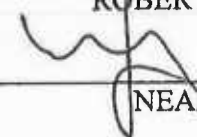
DOCTOR OF JURIDICAL SCIENCE

BY


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ABSTRACT

The purpose of this dissertation is to study on the Chinese, American, British, Korean, Japanese and international ship finance regimes on a comparative basis. The first part of the dissertation introduces various shipping finance sources. The second part of the dissertation focuses on analysis of the loan agreement, security documents and other related legal documentation and their principal clauses as well as implications to the shipping finance practice. The author then researches on the ship lease financing in China, Coastwise Trade Endorsement and Jones Act Sale Leaseback in the United States, Tax Lease regime in the UK and government finance models in Japan and Korea. The author also compares the ship mortgage regimes in China, the United States, Liberia and the Marshall Islands, and illustrates practices and legal issues in connection with ship construction, sale and purchase and classification society. In the final part of the dissertation, the authors proposes alternatives and improvements for Chinese shipping finance and advantages of the U.S., Japanese and Korean regimes which China could learn from.

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A DISSERTATION

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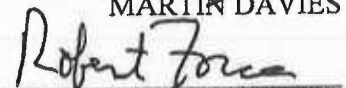
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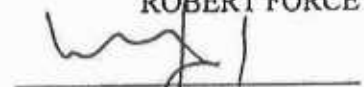

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I. INTRODUCTION

Shipping is deemed to be one of the most capital-intensive industries in the world.¹ It is in constant need of large amounts of capital funds to upgrade and expand the fleet – generally estimated between US\$30-45bn annually.² Due to its high risk but low return nature, especially for the bulk cargo transportation, controlling operating cost is often of paramount concern to shipping companies. Ship financing matters have been taken into account by the overwhelming majority of shipowners in the world in the procurement of newbuilding and second-hand vessels. It is of great importance not only in financing shipbuilding and purchase but also in making shipowners earn much more profits by grasping rapid market chances than by single-mode vessel operation.

In the past few decades, international ship finance has grown fast, and is characterized by diversification in a rapidly changing environment where shipping has made a coupling with the capital markets. Debt rescheduling and bankruptcies of the mid 1980's; K/S Partnerships and asset plays of the late 1980's; and public offerings and high-yield debt of the 1990's and more recent years have all grabbed the headlines.³ Changes have taken place in the commercial vessel financing industry because of the proliferation of commercial vessels of new types, especially the vessels in the energy production field which require new forms of financing, provided by new investing sources, including institutionalized investors such as pension and welfare funds, beyond the traditional

¹ The unit price for container ship or big oil tanker will easily reach a hundred million, such as one LNG vessel will cost over two hundred million dollar. It is estimated that for the field of bulk vessel in 1994 only, 13.6 billion has been invested on new vessels and 7.5 billion on secondhand vessels.

² Stephenson Harwood, *Shipping Finance* 67 (3d ed. 2006).

³ See Anatomy of Ship Finance, available at <http://www.catz.co.uk/docs/file/ShipFinance.pdf> (June 28-July 3, 2009).

sources from banks and insurance companies.⁴ Subsequently, a single lender loan secured only by a ship mortgage has largely given way to more complex financing techniques.

President Obama described the crisis that occurred in 2008 as "the worst financial crisis in a century".⁵ As if overnight, those superior and reliable names on Wall Street in the good old days became desperately ill. Starting in Wall Street, others followed quickly. Since the "Black Friday" sometime in mid-September 2008, the world stock markets have dramatically fallen, large financial institutions have collapsed or been bought out, and the U.S. government had to come up with rescue packages to bail out its financial system. The IMF April 2009 Global Financial Stability Report estimates that "write-downs on U.S.-originated assets by all financial institutions over 2007–10 will be \$2.7 trillion . . . Total expected write-downs on global exposures are estimated at about \$4 trillion, of which two-thirds will fall on banks and the remainder on insurance companies, pension funds, hedge funds, and other intermediaries."⁶

Access to funding and credit for shipping markets was severely curtailed by the global financial crisis and contributed to large swings in asset valuations.⁷ Against the backdrop of this credit crunch, plummeting oil prices and difficult shipping markets in the third quarter of 2008, shipping companies have suffered losses due to the dramatic fall in freight rates.⁸ It is a prime example of the volatility and cyclicity of the shipping

⁴ Semisubmersible drilling rigs proliferate wherever oil has been found. Geophysical research ships, LASH vessels and their barges, LNG carriers, and other types of previously unknown vessels require specially adjusted financing plans.

⁵ Obama's victory speech, *available at* <http://edition.cnn.com/2008/POLITICS/11/04/obama.transcript>.

⁶ IMF loss estimates, *available at* <http://www.imf.org/external/pubs/ft/weo/2009/01/pdf/exesum.pdf>.

⁷ Clarkson PLC, *Annual Report and Accounts 2008* at 10.

⁸ See Watson, Farley & Williams, *Annual Review 2008* 7 (2008).

industry. Although everyone is passionate about the shipping business, it is never a favorite darling to the investors or bankers in the financial sector.⁹ The credit crunch has also called into question the financing capabilities of the traditional sources of shipping credit. Ship financiers are not immune from the wider financial difficulties, as loan facilities are extended at a lower quantum, and some banks have begun re-pricing existing loans.¹⁰

Two years since the collapse of Lehman Brothers, prospects for investment in the shipping industry have become better, according to the latest report from shipping accountants Moore Stephens.¹¹ A survey, conducted in February 2010, showed owners, managers and charterers to be more confident of making a major investment in the near future.¹²

⁹ See Philip Yang, *Ship Finance & Mortgage* 66 (2003).

¹⁰Rodricks Wong, Marine Money Asia,*Financial Crises, Government Response and Maritime Finance*, presentation at 2nd Annual Hong Kong Ship Finance & Investment Forum (25 Mar. 2009), available at <http://www.marinemoney.com/forums/HK09/postprogram/Wong.pdf>.

¹¹ Julian Macqueen, *Confidence returns to ship finance*, Lloyd's List (30 March 2010).

¹² *Id.*

II. SHIP FINANCING SOURCES

Shipping finance is no more a fixed science than is any other sort of finance, however, more than most other forms of finance, ship finance is international.¹³ The asset of shipping rests on the vessel itself, which is a floating asset navigating around the world. From investors' perspective, it is hard to assess and manage the risks, as well as to enforce claims. Both debt and equity can be employed in order to finance a shipping company. However, traditionally, the widely used method by shipping companies to raise capital is commercial bank debt.¹⁴ Institutions providing or arranging ship finance include: commercial banks, investment banks, ship credit banks, finance houses and brokers, leasing companies, and countries that offer shipbuilding credit to domestic and foreign owners.¹⁵

As Martin Stopford, Managing Editor of Clarkson Research Services, has summarized, the main methods of raising ship finance include fourteen options falling under four categories, as follows: 1. Private funds: own funds and private investment, 2. Bank finance: mortgage-backed loan, corporate loan, shipyard credit, mezzanine finance, and private placement, 3. Capital markets: public offering and bond issue, 4. Special purpose vehicles: special purpose company, limited partnership, finance lease, operating lease, and securitization.¹⁶

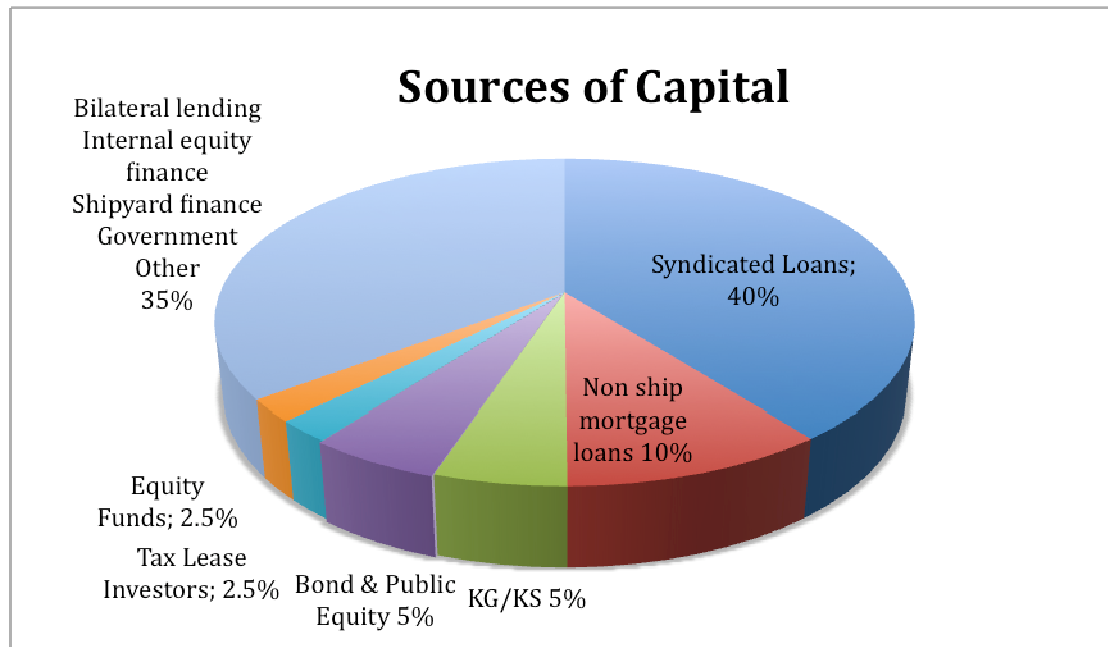
¹³ See Stephenson Harwood, *Shipping Finance* 1 (3d ed. 2006).

¹⁴ See Yang, *supra* note 9, at 66.

¹⁵ See Martin Stopford, *Maritime Economics* 284 (3rd ed. 2009).

¹⁶ See *Id.* at 283.

Figure 1: Financing Sources Breakdown



Source: Lloyd's Shipping Economist, 2005; DVB internal resources

1. Equity Financing

Generally speaking, shipping companies raise capital through debt and/or equity. Equity financing is provided either by shipowners' own funds, or by trading equity shares, publicly or privately, in equity markets.¹⁷ In the past few years, shipowners have made efforts in attracting equity into shipping from sources outside the industry – the capital markets, most commonly by issuing shares of their stocks in the stock exchanges, and through the use of private placements.¹⁸

1.1.Ship-owner Equity

¹⁷ See Dimitrios Tzavaras, *Alternative Sources of Raising Capital in Ship Finance* at 16, MSc in Maritime Economics and Logistics, 2004/2005, Erasmus University Rotterdam.

¹⁸ *Id.*

It is a traditional way to raise capital by the owners from their own funds or retained earnings. The owner's private resources also include the earnings of other ships which he owns, or an investment or loan from friends or family.¹⁹ It is deemed to be the first and most obvious way to finance ships. In countries with a seagoing tradition, such as Greece and Norway, family ownership remains a common form of finance.²⁰ Due to the high cost of the ships, it takes a long time for shipowners to expand their fleets by accumulation of freights and charter hire. It will protect shipowners during a downturn of the freight market, but at the price of shrinking fleets and reduction of investments.

1.2.Public Offerings

This is a method of financing in which a company issues shares of its stock and receives money in return. Shipping experts have stated that “[c]apital markets play a key role in the promotion of shipping business growth and value creation, acting as intermediaries to provide the funds required to finance new investment projects and sustain business growth.”²¹

When a company issues common stock or shares to the public for the first time, the vehicle it used to enter the market is initial public offerings (IPO's). For shipping IPO's, due to the cyclical and unstable nature of the shipping industry, shipping company stocks received little interests from investors in a stock market.²² As Gary Wolfe, Head of the capital markets group of Seward & Kissel LLP, described the situation, “Until the mid-1990s, the U.S. capital markets had virtually no exposure to the international shipping

¹⁹ See Martin Stopford, *Maritime Economics* 285 (3rd ed. 2009).

²⁰ *Id.*

²¹ Andreas Merikas, Dimitrios Gounopoulos, Christos Nounis, *Global shipping IPOs performance*, 36 MARIT. POL. MGMT. 481, 481 (No. 6, 2009).

²² Tzavaras, at 18.

industry.”²³ To explain that, the main reasons include: reluctance of shipowners to dilute company control, nondisclosure of sensitive company information and unattractiveness of shipping stocks to institutional and private investors due to volatile cash flows.²⁴

Also, as stated by Stephenson Harwood, “[a] five year old Panamax bulk carrier, for example, could be purchased for U.S.\$13.5m and achieve freight rates of U.S.\$ 5,500 per day in 1999 while a similar profile vessel was worth U.S.\$46m and achieved freight rates in excess of U.S.\$46,000 per day in 2004/2005.”²⁵

The peak of shipping sector in late 2007 has generated strong earnings cash flows for shipping companies, which has also whetted investors’ appetites.²⁶ As of December 31, 2007, about 30 international shipping companies have raised capital on the New York Stock Exchange (NYSE), and nearly 25 companies on the NASDAQ National Market (NASDAQ).²⁷

²³ See Stephenson Harwood, *Shipping Finance* 109.

²⁴ Andreas Merikas, Dimitrios Gounopoulos, Christos Nounis, *Global shipping IPOs performance*, 36 MARIT. POL. MGMT. 481, 485 (No. 6, 2009).

²⁵ See Stephenson Harwood, *Shipping Finance* Foreword.

²⁶ Andreas Merikas, Dimitrios Gounopoulos, Christos Nounis, *Global shipping IPOs performance*, 36 MARIT. POL. MGMT. 481, 485 (No. 6, 2009).

²⁷ *Id.* at 486.

Table 1: Leading global shipping IPOs by market capitalization

Company	Country of listing	Market cap (USD billion)
A.P. Moller	Denmark	32.67
MISC	Malaysia	7.67
MOL	Japan	7.04
NYK	Japan	7.03
Bolloré	France	5.39
Teekay	US	3.05
Cosco	China	3.03
“K” Line	Japan	2.99
Frontline	Norway	2.84
Hyundai MM	South Korea	2.53
OSG	US	2.34
OOIL	Hong Kong	2.22
Evergreen	Taiwan	1.89
Kirby	US	1.85
Bergesen Gas	Norway	1.77
Hanjin	South Korea	1.67
China Shipping	China	1.61
Torm	Denmark	1.60
NOL	Singapore	1.60
W. Wilhelmsen	Norway	1.58
Safe Bulker	US	1.03

Source: Maritime Policy & Management

1.3.Private Equity Placements

Private equity is regarded as the most direct source of capital. Shipowners usually raise private equity through ship funds.

Many shipping funds are established within banks specializing in shipping, others are not, but they are all committed to widen the pool of capital and to structuring transactions that accommodate the capital needs of the shipping companies, like sale and leaseback structures, alternative debt, bridge loans, preferred equity, joint ventures and so forth.²⁸

²⁸ See generally <http://www.northernshippingfunds.com>.

1.4.KG/KS Structure

The German KG model is a successful instrument of project finance for various asset classes.²⁹ The KG financing system has provided one of the world's most significant sources of ship finance. Over 20% of investment in German closed end funds is estimated to be in shipping, generally in the form of KG financing. In 2007, an estimated US\$5.6 billion of equity was invested in shipping KG funds in Germany, contributing to a total KG investment volume in ships of US\$12.6 billion.³⁰

However, the global financial crisis hit the KG funds badly. For example, HCI Shipping Select 28, a KG fund issued by German financing house HCI Capital, was forced by the banks to sell one of its ships.³¹ The banking syndicate, which is led by Commerzbank, declined to grant a further deferral of loan repayment. In the meantime, the banks demanded that the fund recommence regular payments and catch up with the deferred payments. As a result, the fund will have to sell the vessel to avoid insolvency.³²

2. Debt Financing

2.1.Bonds and Credit Rating

High yield bonds have played an important role in the capital structure of a lot of shipping companies because they offer companies the ability to access a higher leverage than what is available in the commercial bank market. Also, high yield bonds tend to be longer in duration (approximately 10 years irrespective of vessel age) than traditional

²⁹ See Watson, Farley & Williams, *The German KG Model* (January 2009), available at [http://www.wfw.com/Publications/Publication392/\\$FILE/KG%20model%202009.pdf](http://www.wfw.com/Publications/Publication392/$FILE/KG%20model%202009.pdf). Initiators of the German KG model provide KG financing in the form of funds for several types of assets: ships, real estate, private equity, renewable energy, life insurance policies, films and other media rights etc.

³⁰ See generally *KG Finance & Shipping 2008*, Clarkson Research Services.

³¹ Patrick Hagen, Banks force HCI Capital fund to sell tanker, Sept. 5, 2011, available at: <http://www.lloydlist.com/ll/sector/finance/article379159.ece>.

³² HCI confirmed that the KG shipping fund HCI Shipping Select 28 will have to sell its 1999-built, 147,261 dwt crude oil tanker *Hellespont Trust*.

bank debt. In comparison, traditional commercial bank loans have an average duration of 7-10 years. Generally speaking, high yield bonds are non-amortizing, which means that issuers are responsible for paying interest only during the life of the bond. At the maturity of the bond comes the repayment of principal, namely, a “bullet”, at which time the entire principal balance must be repaid.

Moreover, high yield bonds typically have less stringent covenants than traditional bank loans. Covenants in high yield bond offerings are generally referred to as “incurrence covenants” which means the breach of covenants is the result of an action taken by the issuer as opposed to “occurrence” covenants which can be triggered by events in the marketplace and which are featured in commercial bank loans.³³

2.2.Commercial Bank Loans

Shipping finance is an indispensable link of the shipping industry. It is really hard to imagine that a shipowner can establish and manage a group of ocean-going ships without any help from the banks. Most shipowners would borrow money from commercial banks to build new ship(s) or buy second-hand ship(s). Sometimes the loan amount accounts for even 70% to 80% of the ship price.

For banks or financial institutions, it is attracting to conditionally lend out a large sum of money at one time. No wonder most sophisticated international commercial banks have set foot in shipping finance and hired popular “bankers” who have a good knowledge about shipping and a long history in dealing with shipowners to be responsible for the relevant departments. However, since the shipping industry became sluggish and banks now have better options for loan investments, they gradually lose interest in this

³³ See Report on ship financing, OECD Council Working Party on Shipbuilding (WP6), page 25, available at www.oecd.org/dataoecd/55/6/47128870.pdf.

sector. Still, shipowners will always need money from commercial banks, hence the reason the author further discuss about this issue.

Hypo of obtaining finance for the acquisition of the ship from commercial banks:

The following is to introduce an example about a relatively simple yet typical second-hand shipping loan. ABC, a Greek shipowner, plans to buy a three- or four-year-old bulk carrier of 30,000 tons from the ship market. In the need of the loan, ABC approaches a Bank that ABC is acquainted with in hopes of completing the loan and ship mortgage procedures as soon as possible, so that the deal can be concluded. To acquire that ship, ABC plans to form a single-ship Panamanian company - ABC Maritime S.A. as the owner of the ship and ABC will be the sole equity holder of the company.

The Bank already knew that ABC is managing another bulk ship which is going very well and generating earnings. The ship is named “EFG” and owned by a Panamanian company – EFG Maritime S.A.. That ship has been mortgaged to another U.S. bank, and the shares of EFG Maritime S.A. have also been pledged to that bank.

The Bank has some acquaintance and trusts with ABC, which is a condition precedent for doing business with ABC. For example, the President of ABC comes from a family, which owns a shipping business, understands the business and would not mess things up. The Bank is also aware of the fact that the President of ABC himself has money and current capital income since he has charter income from the ship “EFG” and the money owed to that bank has been almost paid off. Plus, he also owns a few valuable estate properties in London which have been leased out. Moreover, the President of ABC has managed to charter the ship, which he intends to purchase, to a top-ranking charterer XYZ for five years, which means he will have stable and sufficient charter income to repay the loan. As you may want to know, it is very hard to charter out a ship for even 3

to 4 years, especially for a bulk ship. Most oil companies prefer double hull tankers when it comes to a charter term of 3 to 5 years.

The Bank's trust in the President of ABC derives from their history, or the President's reputation in the shipping and/or financing market, or something else. Essentially the Bank must know the business itself and be smart enough to avoid losses resulting from its over-trust in him. For instance, the Bank must know that the well-known company XYZ is the charterer, which is an established fact, and it must also be constantly informed of the latest market price of a three- or four-year-old bulk ship of 30,000 tons or the like built in China, South Korea, or Japan.

Otherwise, there is a chance that the Bank gets fooled by a dishonest shipowner if it is unwilling to pay for a survey or valuation report. For example, if a survey report stated that "in a real estate sale, if the buyer/ borrower could get a mortgage loan in a larger amount from the bank, then the buyer could make a lesser down payment. Industry resource says that some real estate investors try to, through their real estate agents, convince house owners to raise the sale price so that buyers can get a larger amount of loan from the bank and then house owners can get a kickback from it. This largely reduces the housing investment cost. Some house owners are willing to cooperate with those investors since the current housing market is not as good as it was. Since both parties of such transaction, as well as the housing agent, have actually committed the crime of fraud and their behaviors have exposed the bank to a larger risk than usual. Thus it is suggested that house owners stay away from defying the law merely for the purpose of selling their properties sooner.

Similarly, the tricks have been used in the sale of second-hand ships on many occasions. Generally, a traditional loan is about 60% of the financing price for the acquisition of the ship, thus a loan facility of up to US\$3 Million can be granted for a ship

worth US\$5 Million.³⁴ However, if we raise the hypothetical ship price to US\$7 Million, then 60% will equal to US\$4.2 Million, which will largely reduce the amount to be paid by the shipowner from its own pocket. In practice, the ship price indicated in the “Memorandum of Agreement” (the “MOA”) would be US\$7 Million, and the seller and buyer would have a “confidential” side letter, which stipulates the “actual” ship price of US\$5 Million and the manner how the seller is to return the overcharged price. Undoubtedly, this kind of practice is risky as it is deceitful and illegal. Once any dispute arises, there is no way for the Bank to sue for remedy at the court or through arbitration proceedings.

Back to the original example, considering that the President of ABC and ABC Maritime S.A. could have a 5-year profitable charterparty with the reputable company XYZ, which is unlikely to default. After a round of relatively difficult but significant negotiations, the Bank made compromises by increasing the amount of the loan facility from the generally accepted 60% to 70% of the ship price, and waiving the “personal guarantee” from the President of ABC. The Bank made these compromises because it knew that the borrower is wealthy and in a good shape. A loan agreement, like any other agreement, is entered in the free will of both parties, and the law does not require certain collateral security as a “must” for its validity.

If the President of ABC finally reached a loan agreement with the Bank, the Bank will send the “borrower/shipowner” a “letter of offer” to confirm all major issues agreed by both parties. A “letter of offer” is subject to the execution of satisfactory

³⁴ The result for 2007 shipping banker survey indicates that over 2/3 commercial lenders to the shipping industry believe that 6-70% is a reasonable advance rate for a charter free newbuilding. Sixteen and ½ percent believe the percentage should be lower, while only 15.4% are comfortable with advance rates over 70%. These figures are considered as representative of the industry as a whole, where project finance deals or highly structured ones, where overall debt financing can reach 90%, are expectations rather than examples of the financings typically borne by the mainstream market.

documentation. To avoid future disputes, a “letter of offer” would also state that the loan agreement/guarantee agreement will supersede it as a final binding integrated agreement.

At the conclusion of this example, the author will move to the next stage of a ship finance deal, namely, the documentation process. Led by a loan agreement as the blueprint of a deal, various forms of finance and security will form the whole puzzle.

2.2.1. The structure of commercial bank loans

Shipping loan assessment is performed by humans based on personal judgments. In order to achieve a relatively unbiased stance, banks assemble the requirements regarding finance in a so-called “credit policy” booklet. In a ship finance risk management analysis, the lenders and investors must be persuaded that the return justifies the risk. However, the justification required by investors and lenders is very different. Investors take a risk in the hope of making a profit, but the lenders do not share the profits and just want to be repaid on time with accrued interest, so their focus is on strategies to ensure repayment.³⁵

In detail, a credit policy booklet includes extensively on the following key points³⁶:

“Tenor: the length of the loan. On types of loan such as balloon payment, not all installments have the same size. If all were equal then perhaps an 8-year loan would be fully repaid at, let’s say 10 years. It is said then that the 8-year loan has a 10-year profile. This is called ‘amortization’. The reference on the maximum acceptable period of the loan may be stated with any of the following expressions: maximum loan repayment, maximum age of ship at the end of the loan, maximum loan profile.

Gearing: is the ratio of the loan to the asset value. Varies from 40-80% depending on the ship type, employment, collateral, age, competition from other banks and general lending policy. One typical general intentions list, which is rather optimistic is displayed here:

- New buildings - 80%
- 2nd hand – 70%

³⁵ See Martin Stopford, *Maritime Economics* 310 (3rd ed. 2009).

³⁶ See <http://www.myyachtregistration.com/yacht-registration/marine-finance>.

- Special – 75%

Repayment schedule: equal installments over the period of the loan.

Currency: most commercial banks lend in U.S. dollars or other major currencies. This presents the borrower with currency risk. A prudent choice is that the loan be issued in the same currency with the expected cash flow.

Interest rates: most financing by commercial banks is done on a floating rate basis. They lend at a spread over the rate at which they borrow, six month LIBOR³⁷ being the most common.

Fees: where a standby period is involved, the bank will customarily charge the creditor a commitment fee; there is also arrangement for a front end fee.

Syndication of shipping loans: may be used to spread the risk of a large loan among several participating banks.

Security: the security sought against the loan may include the following: employment, first mortgage, second mortgage, assignment of income, assignment of the insurance, personal or corporate guarantees and security maintenance clauses. It should be noted that the greatest of all securities is the expected cash flow. If the ship brings money to the owners they will be able to repay the outstanding loan as fast as planned and the investment will have yielded a hundred per cent.

The commercial bank to enhance security on its risk management basis acquires information and monitors the following:

- Evaluation of the market prospects.
- Operational plan of the shipping company.
- Credit policy adjustments to better suit the current pursuits.
- Competition quality of services.
- Relationship banking.
- Portfolio distribution and allocation.
- Minimum acceptable yield.”

³⁷ Libor means the London Interbank Offered Rate. It is a daily reference rate based on the interest rates at which banks borrow unsecured funds from other banks in the London wholesale money market (or interbank lending market). The LIBOR rates are now internationally recognized indexes used for pricing many types of consumer and corporate loans, debt instruments and debt securities across the globe. For example, LIBOR is used as an index for the vast majority of interest-only loans in the United States.

Table 2: Top 20 bookrunners of global syndicated shipping loans – full year 2008

Pos	Bookrunner	Deal value (US\$m)	No.	% share
1	Nordea	12,481	42	14.9
2	DnB NOR	11,406	37	13.6
3	ING	3,462	11	4.1
4	Fortis	3,026	13	3.6
5	HSH Nordbank	2,681	11	3.2
6	BNP Paribas	2,475	12	3.0
7	Citi	2,232	7	2.7
8	Mitsubishi UFJ Financial Group	2,226	7	2.7
9	Deutsche Bank	1,872	6	2.2
10	Calyon	1,824	5	2.2
11	Mizuho	1,551	16	1.9
12	Dresdner Kleinwort	1,535	8	1.8
13	Sumitomo Mitsui Banking Corp	1,194	21	1.4
14	RBS	953	5	1.1
15	Natixis	830	2	1.0
16	SG CIB	818	2	1.0
17	Bank of America – Merrill Lynch	753	4	0.9
18	Standard Chartered Bank	587	4	0.7
19	Danske Bank	574	2	0.7
20	HSBC	554	3	0.7
	Total	83,620	294	100.0

Includes deals to finance vessels and deals secured on vessels

Source: Dealogic

In 2011, the UK's biggest banks (Barclays, HSBC, Lloyds Banking Group, RBS and Santander) have announced lending commitments, following negotiations with the Government known as Project Merlin.³⁸ In particular, the banks have stated their capacity and willingness to lend £190 billion of new credit to businesses in 2011.³⁹ They have also said they will lend more if demand exceeds this.

³⁸ Project Merlin is an agreement between the British Government of David Cameron and four of the major high street banks in the United Kingdom, Barclays, Lloyds Banking Group, the Royal Bank of Scotland and HSBC. The agreement covers aspects of banking activity, notably lending, pay and bonuses with the intention of promoting lending to businesses, particularly small businesses, curbing the size of bankers' bonuses and promoting transparency with regards to executive pay. The agreement was finalized on February 9 2011.

³⁹ See HM Treasury, February 9 2011; *see also* available at <http://www.hm-treasury.gov.uk>.

Whilst there are signs that new loan facilities are becoming more readily available, the ship finance banks remain circumspect about who they will lend to, indicating that we are still a long way from heady days of 2003-2007.⁴⁰

2.2.2. Debt finance for newbuildings

The high investment activity in new buildings takes place during periods of high freight markets.⁴¹ The shipping method to finance new buildings is a project financing, which is used to finance highly capital-intensive projects. These projects usually consist of two phases: the construction phase and the income-generating phase.⁴² The hope rests on the ship's earnings.

As mentioned above, there are two stages involving financing for newbuildings: pre-delivery financing and post-delivery financing. Because the vessel is being built at the shipyard, the borrower has not finished the sale with the builder and the ship mortgage has not been recorded in favor of the borrower's financing bank, at this stage, the borrower usually assigns its rights and interests under the shipbuilding contract, the refund guarantee from the builder's bank, and relevant novation agreement⁴³ to the financing bank as collateral. Since the vessel is under construction and there is no charter arrangement nor charter hire, this kind of financing bears very high risk.

⁴⁰ See Shari'a Compliant Methods for the Financing of Ships, Ince & Co Business & Finance Briefings, August 2011.

⁴¹ Volk, B., 1984, Shipping Investments in Recession (Bremen: Institute of Shipping Economics at Bremen).

⁴² See Shipping finance: time to follow a new track? MARIT. POL. MGMT., July 2006 Vol. 33, No.3 at 302.

⁴³ The Novation agreement is usually made among the shipyard, the borrower and the borrower's shareholding company. In the event that the shipyard failed to perform the shipbuilding contract, the profitable shareholding company will buy the shipbuilding contract and perform the borrower's obligations to repay the loan.

2.3.Private Placement of Debt (pension fund)

In addition to the commercial banks, non-bank lenders such as hedge funds and industrial finance companies⁴⁴ are also actively lending against vessels, though in terms of volume and magnitude, they play a much smaller role. They typically charge a higher interest rate than banks. They are mostly active in deals involving older vessels, financially inferior borrowers, smaller vessels and those registered in untraditional jurisdictions.⁴⁵

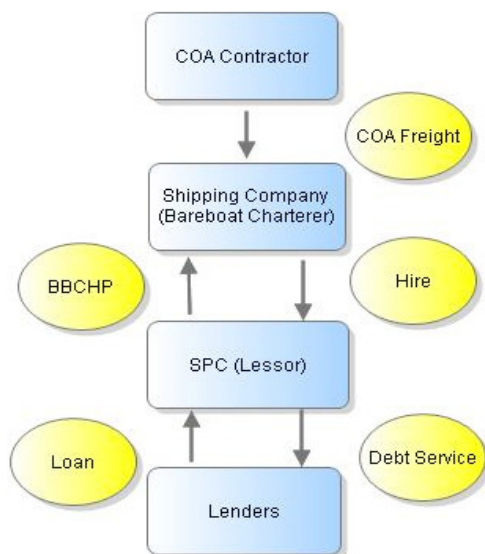
⁴⁴ The industrial finance companies include: Caterpillar Financial, GE Capital, GMAC, AIG, Merrill Lynch Capital, Evercore Partners, Northern Shipping Fund and so forth.

⁴⁵ See Report on ship financing, OECD Council Working Party on Shipbuilding (WP6), page 21, available at www.oecd.org/dataoecd/55/6/47128870.pdf.

3. Lease Financing

Leasing is a form of asset finance in which the financier – the lessor – acquires the asset and charters it out instead of lending to the owner against security given over the asset. The lessee, who in a loan financing would be the owner of the asset, is given possession by the lessor owner – a contract of bailment – and with its wide rights of use, control and responsibility. In these respects, the lessee is the owner for the time being. The lessor pays for the asset and recovers its investment, interest and costs through rentals – not as repayments of a loan.

Figure 2



As shown by Figure 2, the Lenders lend money to a special purpose company (lessor) who bareboat charters the vessel to Shipping Company (lessee), the latter in turn enters into a contract of affreightment (“COA”) with a contractor. The COA contractor pays the freight under the COA to the lessee, and the lessee uses the vessel earnings to pay the hire under the bareboat charter to the lessor. The lessor has opened a debt service reserve account with the lenders to ensure repayment of the loan.

The main parties involved in lease ship financing are set out below:

- Lessee: a lessee is a company who leases the ship from the lessor and who is responsible for operating the ship during the term of the lease. In Figure 2 above, the Shipping Company/Bareboat Charterer is the lessee. Other companies within the lessee's group may get involved in the transaction as well – granting guarantees to secure the lessee's obligations under the lease.
- Lessor: a lessor is the company who owns the ship and leases it to the lessee under the lease.
- In a financing lease structure, the lessor may be a wholly-owned subsidiary of a financial institution.

Sometimes, it is shipping companies' strategy to shift its decision to build its own vessels to control its freight towards a more traditional shipowning role whereby it would charter out its vessels to other shipowners and operators. For example, sources said that VALE Minerals, a Brazilian mining company, was in talks with Chinese shipowners to charter out its very large ore carriers on long-term contracts.⁴⁶ According to Macquarie Securities analyst Janet Lewis' opinion, given that China Shipping Group and Cosco group are the two most powerful vessel operators in China, it could mean that Vale would provide charters of some of its Valemax vessels to Cosco and possibly China Shipping Development to operate the vessels.⁴⁷ She said that, "This would likely be accompanied by a long-term contract for delivering the ore from Brazil, and it would likely be fairly low-margin but in the current environment profit is better than loss."⁴⁸

⁴⁶ Colum Murphy, Sale and leaseback suggestions signal strategy U-turn for Vale, Sept. 2, 2011, available at <http://www.lloydslist.com/ll/sector/dry-cargo/article378963.ece>.

⁴⁷ *Id.*

⁴⁸ *Id.*

There are usually two forms of lease used in ship finance: operating leases and finance leases. Both involve an owner of the ship leasing it to an operator.

In a pure operating lease structure, the owner will charter the ship to the operator, who will pay hire in return for the use of the ship. At the end of the charter term, the operator will return the ship to the owner, whose primary interest will be its ownership rights in the ship. The owner will retain substantially all of the risks and rewards relating to the ownership of the ship and so will be looking to preserve the future value of the ship and its earning potential. Operating leases allow operators to have use of ships without incurring the costs of financing or having to record the assets on their balance sheets and the leases can be short term. It differs from a hire-purchase agreement⁴⁹ in that the parties do not expect the lessee to acquire title to the ship at the end of the lease period. Also, unlike a finance lease, while the lessee possesses the ship, it does not bear the risks associated with owning it, which remain with the lessor.

In a finance lease the lessor (the lender) buys the ship from the shipyard and leases it to the lessee (the borrower). Under the terms of the lease the lessee pays regular (usually monthly) installments equivalent to the full value of the ship over the term of the lease plus a return on capital to the lessor, instead of interest on a loan. At the end of the lease, after the final payment has been made, the lessor will usually sell, scrap or otherwise dispose of the ship. It can provide an alternative, cheaper source of funding to conventional bank lending and is popular in jurisdictions that grant generous tax or capital allowances against the acquisition cost of the ship.⁵⁰ Title to the ship passes from the shipyard to the lessor bank, which retains title. This puts the lessor in a better position than a lender because the asset cannot be subject to any security granted by the lessee in

⁴⁹ A hire-purchase agreement is a type of lease agreement with an option (but not an obligation) for the lessee to acquire title to the asset for a nominal sum at the end of the hire period.

⁵⁰ See *Leasing as a financing technique: overview*, Practice Law Finance.

favor of an existing lender. On the other hand, there is no obligation to buy for the lessee at the end of the lease. It will be the lessee's responsibility to insure the ship and it will be liable for any loss or damage caused to the ship during the lease period.

In sum, speaking of the economic rewards and risks associated with owning the ship, the owner has the economic ownership to the ship in an operating lease, and the operator in a finance lease.

4. Shipbuilding Credit

Under the OECD shipbuilding understanding, export credit agencies are able to offer support at the commercial interest reference rate for periods of up to 12 years.⁵¹ The agreement is designed to make export credit finance more competitive, reducing the tendency for governments to assist their industries with direct subsidies, and the strategy appears successful with a busy pipeline of deals backed up. Therefore, with no surprise, it has become an increasingly attractive source of finance. Under the OECD guidelines, export credit agencies are able to support up to 80% of the contract cost of ship exports.⁵² The remaining 20% will be equity from the buyer, mezzanine debt or a separate debt facility. Terms vary, but of the eligible debt, a typical ECA will cover between 80% and 95%, leaving commercial lenders exposed only to a fraction of the contract amount.⁵³

The countries that dominate shipbuilding and/or equipment supply have ensured that strategic steps have been taken in order to support both of shipbuilding and shipping industries. For example, China Export-Import Bank (the “CEXIM”) had provided U.S.\$5 billion in newbuilding loans to support the Chinese shipbuilding industry in 2010.⁵⁴ Korean Export-Import Bank (the “KEXIM”) and Korea Export Insurance Corporation (the “KEIC”)⁵⁵ had provided U.S.\$7.6 billion to shipbuilders whilst the Korean

⁵¹ The Sector Understanding on Export Credits for Ships (SSU) sets common rules for government-supported export credits for ships, in particular concerning interest rates and the duration of credits. Available at: http://www.oecd.org/document/15/0,3343,en_2649_34211_40197967_1_1_1_1,00.html.

⁵² See the website of Asset Finance International, available at <http://asset-finance-international.com/81/Crediting%20shipping>.

⁵³ *Id.*

⁵⁴ See Shipbuilding contracts and related ship finance issues, London Shipping Law Center Maritime Business Forum, April 28th 2010.

⁵⁵ KEIC assumed the new name Korea Trade Insurance Corporation or K-sure on July 7, 2010, on its 18th anniversary, by amending the Export Insurance Act of Korea adopted in 1968, granting K-sure an increased scope of business to cover import transactions on top of export and overseas investment transactions.

government provided an extra U.S.\$9.2 billion for loans to domestic and foreign ship owners.⁵⁶ Korea Asset Management and Korean Development Bank (the “KDB”) also planned distress funds up to U.S.\$4.8 billion for ship acquisitions.⁵⁷

As we know, the Export Credit Agencies active in shipping are CEXIM/Sinosure⁵⁸, KEXIM/K-Sure, Japan Export-Import Bank (the “JEXIM”), the Norwegian Guarantee Institute for Export Credits (the “GIEK”) /Eksportfinans⁵⁹, Export Credits Guarantee Department (the “ECGD”)⁶⁰, SACE⁶¹, COFACE⁶² and Euler Hermes.⁶³

For China, only a couple of east-west deals – most notably 2009’s loan of U.S.\$389 million from CEXIM to New York listed OSG – have been reported in the trade media, and the assumption has been that Chinese banks were almost exclusively backing Chinese and overseas Chinese firms.⁶⁴

According to Marine Money Asia, in July 2010, CEXIM signed a massive RMB 50 billion (U.S.\$7.35 billion) long-term strategic agreement with Jiangsu Rongsheng Heavy

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ China Export & Credit Insurance Corporation (SINOSURE) is a state-funded policy-oriented insurance company with independent status of legal person, established for promoting China’s foreign trade and economic cooperation.

⁵⁹ Eksportfinans is the Norwegian Institution for Export Financing.

⁶⁰ The Export Credits Guarantee Department (ECGD) is the United Kingdom's Export Credit Agency.

⁶¹ SACE is known as the Italian Export Credit Agency.

⁶² The Compagnie Française d'Assurance pour le Commerce Extérieur (COFACE) was founded in 1946 as the French Export Credit Agency.

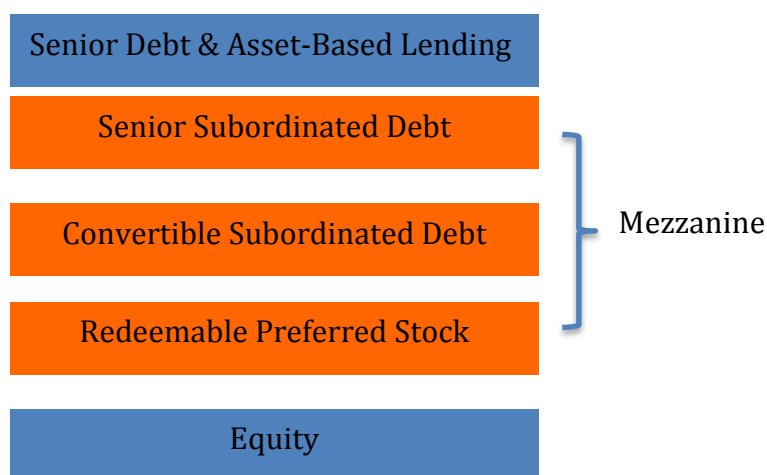
⁶³ Euler Hermes is a French credit insurance company majority-owned by Allianz France which is in turn owned by Germany's Allianz SE.

⁶⁴ See *The Actions Continues at China Exim*, available at <http://www.marine-money.com/archive/tag/china-exim-bank>.

Industries (“Jiangsu Rongsheng”).⁶⁵ The cooperation entailed the provision of different types of bank guarantees required in Jiangsu Rongsheng’s business which include refund guarantees, tender bonds, performance bonds, payment guarantees and seller’s credit.⁶⁶ Over RMB 10 billion (U.S.\$1.47 billion) was to be set aside for seller’s credit.

5. Mezzanine Financing

Mezzanine finance encompasses the broad spectrum of financing (e.g., preference shares and subordinated loans) that lies between equity and senior debt. It is a form of debt that will be subordinated to the owner’s senior debt.⁶⁷ As illustrated by the chart below, the mezzanine debt is subordinate in priority of payment to senior debt, but senior in rank to common stock or equity.



Source: FitchRatings

Mezzanine investors include pension funds, hedge funds, leveraged public funds,

⁶⁵ See The Action continues at China Exim, vol.5, issue 17, Marine Money Asia Edition, August 26, 2010. This was the largest agreement that China Exim has ever signed with a non-state owned shipbuilder.

⁶⁶ *Id.*

⁶⁷ Shipping Finance, 3d Edition, at 34-5, 76.

limited partnerships, insurance companies, as well as banks that have established stand-alone mezzanine efforts. When mezzanine debt is used in conjunction with senior debt it reduces the amount of equity required in the business. As equity is the most expensive form of capital, it is most cost effective to create a capital structure that secures the most funding, offers the lowest cost of capital, and maximizes return on equity. Also, as equity capital dilutes existing shareholders, mezzanine debt can be an attractive alternative way to obtain much needed capital. On the other hand, mezzanine investors' goal is not to be a long-term shareholder, but rather to achieve a target return rate at the appropriate time.

III. The Two Shipping Markets

Shipping finance is, as the name suggests, finance for ships. It is a complex and constantly developing area. Shipping finance is a form of asset finance and may be used to: finance the building of a new ship, finance the purchase of an existing ship, and refinance indebtedness incurred in relation to the above. The shipping industry is made up of many different markets for different types of ship. Stopford has summarized that, "Today sea transport services are provided by four closely related markets, each trading in a different commodity: The freight market trades in sea transport; the sale and purchase market trades second-hand ships; the newbuilding market trades new ships; and the demolition market deals in ships for scrapping."⁶⁸ Shipowners' activities in the four markets are closely correlated, because they are trading in all these markets.⁶⁹

1. The Sale and Purchase (S & P) Market

⁶⁸ See Martin Stopford, *Maritime Economics* 177 (3rd ed. 2009).

⁶⁹ *Id.* at 178.

As stated by Stopford, the sale and purchase procedure can be summarized into the following five stages⁷⁰:

- i. “Putting the ship on the market. The first step is for the buyer and seller to appoint a broker [or the party may decide to handle the transaction on his own].
- ii. Negotiation of price and conditions. In a buoyant market the buyer may have to make a quick decision on very limited information. In a weak market he can take his time, inspecting large numbers of ships and seeking detailed information from the owners. When agreement has been reached in principle, the brokers may draw up a ‘recap’ summarizing the key details about the ship and the transaction, before proceeding to the formal stage of preparing a sale contract.
- iii. Memorandum of Agreement. Once an offer has been accepted a Memorandum of Agreement is drawn up setting out the terms on which the sale will take place. At this stage, the memorandum is not generally legally binding, since it will include a phrase to the effect that it is ‘subject to...’
- iv. Inspections. The buyer, or his surveyor, makes any inspections, which are permitted in the sales contract. This will generally include a physical inspection of the ship, possibly with a dry docking or an underwater inspection by divers to ensure that when delivered it complies with the requirements of its classification society. The buyer, with the seller’s permission, will also inspect the classification society records for information about the mechanical and structural history of the ship.
- v. Closing. Finally, the ship is delivered to its new owners who simultaneously transfer the balance of funds to the seller’s bank.”

2. The Newbuilding Market

The vast majority of the capital committed for newbuilding contracts is not paid up front. Payment is made in installments based on percentages of the contract price and certain milestones achieved in the contracting for and construction of each vessel.⁷¹ Sometimes, contract for newbuilding requires a first installment to be paid at contract signing, a second payable 12 months after contract signing, a third due at the cutting of

⁷⁰ *Id.* at 199.

⁷¹ The production stages in ship construction: 1) Gathering, mobilization and sorting of materials; 2.) Cutting of materials; 3) Fabrication will start from the basic component of the Ship; 4) Assembly; 5) Laying Ship’s keel; and 6) Sub-assembly of large segments of the Ship.

the first steel plate of a vessel, a fourth payable at the keel-laying of the first section of the vessel, and a fifth at the launching of the vessel. The remainder of the contract price would be due upon delivery of the vessel to the buyer.

IV. SHIP FINANCING

1. Characteristics and Advantages of leasing and secured lending transactions

Financing of a ship can be made available by way of one of the followings: (i) leasing and (ii) secured lending.

Lease financing denotes procurement of assets through lease. Nowadays, modern lease financing has been the financing vehicle second only to bank loans. The main forms include: direct lease, leaseback, sublease, lease on commission and leveraged lease.⁷² In recent years, as the shipping market has boomed, the funds sought by shipping companies to renew and enlarge their fleets grew. Ship lease financing is a method comparatively more cost saving than the traditional ship procurement through bank loans. For a ship newbuilding, lease financing is a combined service that involves at least two contracts and three parties – lessor, lessee, and the shipyard. These two contracts, sale contract and lease contract, make a triangular transaction. This has often been compared to “borrow chickens to lay eggs and then sell eggs to buy chickens.” Ship lease financing causes a real breakthrough to the traditional mode of debt financing under which the debtor repays the principal sum, plus interest.

Originally devised as a financing alternative, finance lease’s transaction system is different from that of a normal lease, such as letting, rent, or hire. Under the finance lease

⁷² A leveraged lease is a lease in which the lessor puts up some of the money required to purchase the asset and borrows the rest from a lender. The lender is given a senior secured interest on the asset and an assignment of the lease and lease payments. The lessee makes payments to the lessor, who makes payments to the lender. *See available at* http://en.wikipedia.org/wiki/Leveraged_lease. A leveraged lease typically involves at least three significant parties: the lessor, lessee or the charterer and a long-term lender or lenders.

scheme, a lessor purchases the ship at lessee's selection, and then time/ bareboat charters the ship, which has already become his property, to lessee to operate the vessel and manage the business. It aims at resolving the conflict between the insufficient funds and shipping companies' cry for transportation availability. Through this method, the right to use the ship is long separated from the ownership right. That said, the lessor is entitled to the ownership right and the lessee has the right to use.

With respect to the lease period, generally speaking, it approximately equals to the estimated operational life of a vessel. When the lease expires, the lessee has a few of options: firstly, re-letting, but the hire of the lease will reduce a lot; secondly, hold and purchase the vessel according to the agreed price; thirdly, off hire. It is worth mentioning that, because the hire standard is highly related to the options, which choice the lessee makes is of great importance. Furthermore, because of the fact that the ship for lease is selected at lessee's own need, the lessee could not terminate the contract in advance. By the same token, the lessor could not increase the hire due to the market rise, because the ship has already been purchased. In brief, during the agreed lease period, neither lessor nor lessee can terminate the contract unilaterally.

By leasing the ships, the business of the shipping companies has expanded, as these companies can pay the hire after obtaining earnings, and then eventually acquire the ship. The financing risks can be better controlled and reduced to a much lower range. Moreover, in some cases, since lessee pays the hire annually, and the payment computed on the basis of annuity remains the same for the entire lease period, at a fixed interest, lessee can manage to budget and evaluate the costs and profits properly. As it turns out, the financing risk becomes comparatively low. In order to increase the transportation availability, shipping companies also consider the issues of flag of convenience. Today, more than half of the world's merchant ships (measured by tonnage) are registered under

so-called flags of convenience, formally referred to as "open registries" (to be discussed in Chapter VI of this article).⁷³ If the lease financing is operated under the flag of convenience, the policies of these related open registration countries should be a factor for consideration. To encourage benefiting from the investment, many countries require the lessee to be a citizen and the vessel to be registered domestically, thereby making the ship leasing become restricted across different boundaries.

In a pure secured loan structure, a lender or lenders will lend money to the prospective owner of the ship to finance its construction or acquisition and take security over the ship and its earnings and insurances. Loans may be bilateral, a term loan or a revolving credit facility. A term loan is a committed facility allowing a borrower to draw a lump sum (or in several portions or tranches) for a set period with an agreed schedule for repayment. Once repaid, an amount cannot then be re-borrowed. In contrast, a revolving credit facility is a committed facility allowing a borrower to draw down and repay amounts (up to a limit) for short periods throughout the life of the facility. Amounts repaid can be re-borrowed, thereby combining some of the flexibility of the overdraft facility with the certainty of a term loan.

The conclusion of the loan agreement is of significance for the ship financing transaction. In connection therewith, security is an important item that the lender requires. Usually, the lending banks advance a large sum of money to one or more shipping companies as borrower(s), requiring security to secure the obligations of the borrower(s) under the loan facility. The bank will take a mortgage as security on the ship which is to be financed by the loan disbursement. Sometimes, it may take other mortgages on other ships (sister ships) for the same security purpose to cross collateralize the loan facility with other loan facilities involving the same borrowing group. If the ship

⁷³ *ISL: Shipping Statistics Yearbook 2008*, at 27 (Institute of Shipping Economics and Logistics, 2009).

is to be time chartered, the bank will then demand an assignment of the time charter, in order to benefit from the charterparty as an assignee, which also has the effect of reducing the mortgage debt. In addition, banks will almost invariably take an assignment of the insurance policies and the P & I club covers, to assure that banks as lenders are suitably secured, especially in the event of total or partial loss of the ships.⁷⁴

In some degree, security may decide the financing scale, which in turn determines the scale of the shipbuilding industry. While security is the outcome of the loan agreement, mortgage is known as one form of the security interests. A mortgage is a method of using property as security for the payment of a debt. Once a mortgage contract is reached between both parties, the mortgage is created as well. Subsequently, the ship mortgage is required to be registered with the relevant authority. If the mortgage is recorded, a bona fide purchase is deemed to have constructive notice. Otherwise, the mortgage is only good between the parties to the contract, and can neither survive a third party nor the right of an in rem action.

There is not a great deal of laws regarding ship mortgages, but it is broadly true that the general law relating to mortgages is equally applicable to ship mortgages.⁷⁵ Ship mortgage issues will be dealt with more in conjunction with different rights and responsibilities of creditors, banks or shipyards (in the face of shipowners and other third parties, such as cargo interests, lessee and appurtenant mortgagee, etc.) Meanwhile, shipowners, as debtors, have certain rights under the mortgage, most importantly, the right of redemption. More discussions about mortgage and security will follow in the following Chapters of this article.

⁷⁴ See Judge Goff, speech in *The "Lancaster"*, 2 Lloyd's Rep. 497 (1980).

⁷⁵ See *Fletcher & Campbell v. City Marine Finance Ltd.*, 2 Lloyd's Rep. 520 (1968).

2. Loan Agreement

Ship financing is a distinctive field intertwined with laws relating to both financing and commercial contracts generally.⁷⁶ As mentioned above, simply because the ships (assets) move internationally, ship finance brings a different approach to the documentation than one would ordinarily see in an asset-based financing transaction.⁷⁷ Vessel acquisition can be a very complex transaction.

The issues involved are many, including but not limited to, shipbuilding contracts, ship purchase and sale contracts, marine surveys, mortgages, leases (or charters), liens, assignments, guarantees and so forth. Mostly due to the tax provisions and balance sheet reasons, many owners of large commercial vessels choose to hold the property as charterers.⁷⁸ As the ship finance practitioner described⁷⁹:

“[W]hile a general security agreement is a common feature of asset-based financings, collateralization instruments for ship financings are far more specific: there are assignments for insurances, charter parties, and earnings, and if it is construction financing, there is a pre-delivery security assignment that assigns the borrower’s rights in the shipbuilding contract and associate refund guarantee.”

It is the infinite variety of risks that attach to the bank’s interest in the vessel that it has financed, which give rise to the greatest concern on the part of the bank. The risks emerge essentially from the mobility of the vessel, the vessel’s exposure to various national laws and jurisdictions, the peculiarities of maritime law and the wide range of maritime perils⁸⁰ that may affect a vessel.

⁷⁶ See Edward H. Mahla, *Some Problems in Vessel Financing – A Lender’s Lawyer’s View*, 47 TUL. L. REV. 629, 652 (1972-73).

⁷⁷ See Daniel C. Rodgers, *Banking and Finance Law Client Strategies* 71 (1st ed. 2009).

⁷⁸ See *Purchase and Sale of Vessels*, available at <http://www.marlegal.com/mlpur.html>.

⁷⁹ See Daniel C. Rodgers, *Banking and Finance Law Client Strategies* 71 (1st ed. 2009).

⁸⁰ See *Marine Insurance Act 1906*, s.3. (maritime perils will include perils of the sea, fire, war, political risks, piracy and the like.)

The bank will seek to manage the risks by a combination of contractual, insurance and security mechanisms. In particular, the bank will wish to ensure that it has considered a combination of some of the following:

- i. an adequate loan agreement which sets out the shipowning borrower's covenants with a view to reduce the risk of loss;
- ii. a mortgage over the vessel which will create a security interest in favor of the bank;
- iii. an assignment of the vessel's earnings, receivables, charter interests as security for the loan;
- iv. personal guarantees from the shipowners;
- v. participation in or assignment of the shipowner's insurance policies covering the vessel; and
- vi. insurance products designed for the mortgagee.⁸¹

2.1. Introduction

A loan agreement (the “**Loan Agreement**”) is an important link between the lender(s) and the borrower/shipowner on the transaction from the starting point till closing. The Loan Agreement is converted from a term sheet of the deal between the lender(s) and the borrower, and therefore is the fundamental basis of the whole transaction and all other finance documents and security documents.⁸² Sometimes it is a difficult task to come into an agreement which is satisfactory to both the lender(s) and the borrower(s), as both parties have different standpoints and varied interests (or opposite interests).

⁸² See Preparing a Term Sheet, by Stephen M. Goodman & Steven M. Cohen, Layman's Guide to the Legal Aspects of Venture Investments, Fifth Edition 1996-1997, p21. A term sheet is a bullet-point document outlining the material terms and conditions of a business agreement. After a Term Sheet has been "executed", it guides legal counsel in the preparation of a proposed "final agreement".

A loan agreement is normally a thick document prepared by the lender's counsel. It contains standard terms and/or small variations thereof. The commercial bank lending market for shipping deals is highly competitive with many lenders offering standard or similar terms including loan pricing, leverage, amortization profile, repayment schedule and fees. The terms featured in ship finance loans vary according to the credit quality of the borrower and the charterer, the amount of recourse made available to the lender and the age and type of the asset being financed.⁸³

The essence lies in the freedom of contract between parties. Most contracts, as we have seen, favor the lenders, as the lenders have more bargaining power and speaking authority to control the document. Few lenders would make compromises in the contract terms, which are usually not open to debate. Even though it seems unfair, shipowners are not consumers, so they do not get the same protection as the consumers would have. However, it is not necessarily true that lenders would make no compromises to shipowners such as COSCO, Maersk, or Petrobras.⁸⁴ Also, due to competition and other factors, the lenders would cope with the borrower's needs. Commonly seen, shipowners also engage their own counsel to negotiate the forms of finance and security documents with the lender's counsel.

2.2. Principal Clauses and Appendices

The principal terms of an English/New York law governed loan agreement in the context of shipping finance include:

■ Heading, stating that it is a “Loan Agreement”, and the name and address of both

⁸³ See Report on ship financing, OECD Council Working Party on Shipbuilding (WP6), page 7, available at www.oecd.org/dataoecd/55/6/47128870.pdf.

⁸⁴ China Ocean Shipping (Group) Company, known as COSCO, is one of the largest liner shipping companies worldwide. It is a government owned company of the People's Republic of China. Maersk is the largest container ship operator and supply vessel operator in the world since 1996. Petróleo Brasileiro S.A. or Petrobras is a semi-public Brazilian multinational energy corporation headquartered in Rio de Janeiro, Brazil.

parties, and the basic information of the purpose of the loan facility.

■ **Clauses**

1. “Definitions and Interpretations”
2. “The Facility and its Purpose”
3. “Drawdown”
4. “Interest”
5. “Repayment and Prepayment”
6. “Conditions Precedent and Subsequent”
7. “Representations and Warranties”
8. “Covenants”
9. “Guarantee”
10. “Payments”
11. “Event of Default”
12. “Indemnities”
13. “Fees”
14. “Set-off and Lien”
15. “Security documents”
16. “Notices”
17. “Miscellaneous”
18. “Law and jurisdiction”
19. “Patriot Act Notice”

SCHEDULES**APPENDIX A FORM OF CHARTER [AND CHARTER GUARANTEE] ASSIGNMENT****APPENDIX B FORM OF COMPLIANCE CERTIFICATE****APPENDIX C FORM OF EARNINGS ACCOUNT PLEDGE****APPENDIX D FORM OF EARNINGS ASSIGNMENT****APPENDIX E FORM OF GUARANTOR ACCESSION AGREEMENT****APPENDIX F FORM OF INSURANCE ASSIGNMENT****APPENDIX G FORM OF MANAGER'S UNDERTAKING****APPENDIX H FORM OF MASTER AGREEMENT ASSIGNMENT****APPENDIX I FORM OF MORTGAGE [AND DEED OF COVENANT]****APPENDIX J FORM OF PROMISSORY NOTE****APPENDIX K FORM OF PERSONAL GUARANTY****APPENDIX L FORM OF RETENTION ACCOUNT PLEDGE****APPENDIX M FORM OF SHARES PLEDGE**

For these Clauses, the author will firstly give a brief introduction of their roles, and choose some important ones to elaborate the standard terms thereof.

2.3. Clauses

2.3.1. “Definitions and Interpretations”

Some agreements, especially loan agreements (including but not limited to loan agreements for shipping finance deals) always have a section to define or interpret the terms or phrases used in the agreement, such as the definition of “drawdown”, “encumbrances”, “events of default”, “memorandum of agreement (or MOA)”, “vessel”, “vessels earnings” and so forth.

As reasonable as this Clause can be pursuant to the fundamental principle of “freedom of contract”, it sometimes can become very complex, lengthy and controversial for a number of reasons, such as:

a. Most terms or phrases have precedent or customary usage and meanings. Defining or interpreting them with express clauses works when they are completely accurate and compliant with laws, but on the other hand, repeating the implied meanings is time consuming.

b. Once the definition or interpretation varies even slightly from the implied meaning, has any omission, or differs from the one given by the law, many disputes would arise. Even if it has been expressly stated that such definition or interpretation prevails over the implied meaning, the implied meaning is always a better option since it has been negotiated and customary and acceptable to many good lawyers and deliberated by many good judges.

c. An agreement involves uncountable terms or phrases, this Clause only lists those important or repeatedly mentioned ones in alphabetical order to make it for easy reference, but it is not perfect and would always miss something.

2.3.2. “The Facility and its purpose”

Under this clause, it is introduced to the reader that the lender makes a commitment on the loan and often declares that the loan is used for the (part) financing of the ship.

2.3.3. “Conditions Precedent and Subsequent”

In a Loan Agreement, the provisions specifying the requirements that must be satisfied before a party thereto is obliged to perform under the Loan Agreement or before a closing occurs are known as conditions precedent. Conditions are heavily negotiated because they potentially give one or both parties the ability to get out of the deal.

Generally, an owner would like to see from the side of the bank a maximum loan period to match the life of the asset, moratoriums, balloon and bullet terms and a minimum collateral recourse to the borrower itself, which minimizes losses if the project goes wrong, and of course, low interest.⁸⁵ On the other side, the lender would like to get all conditions precedent (the “CPs”) (the author will explain later) prior to the drawdown of the loan facility to be made available to the borrower. In summary, the lender would like to get maximum collateral and recourse to beneficial owners, a minimum loan period and expensive bank finance.

The borrower has to make sure that, on or before the service of the first Drawdown Notice⁸⁶ of the loan, the lender receives the following CPs, which have the purpose of forming a loan:

Part A

1. *A duly executed original of the Loan Agreement, a Drawdown Notice, and if the borrower has elected to enter into a designated transaction, a Master Agreement, a swap between the lenders;*

⁸⁵ See Orfanidis Alex, Shipping Finance, Approach to the Hellenic market, Athens 2004.

⁸⁶ Drawdown Notice is the notice issued by a debtor to a creditor informing the creditor that the debtor wishes to use the facility, e.g. by the creditor making a loan or issuing a letter of credit, also referred to as a utilization request.

“Drawdown Notice” is a voucher for the borrower to draw the loan from the lender. A Drawdown Notice has no specific form, but must specify the amount to be drawn, currency, interest period, date of use, account to which it is transferred, etc. Although there is no specific formatting requirement, it is usually prepared in the form or wording agreed by both parties of the Loan Agreement and constitutes a schedule to the Agreement.

Generally, a “Drawdown Notice” is irrevocable. It requires a lot of work to prepare when it comes to a syndicated loan provided by two or more banks. The Agent for the lenders, upon receiving a drawdown notice from the shipowning borrower, will forward it to all syndicated banks and specify the amount of the commitment that should be paid by each bank based on its proportion in the loan. Sometimes when the total sum is more or less than a special amount requested by the shipowning borrower, the Agent may properly adjust the amount that should be paid by each bank to meet the shipowning borrower’s special request.

Moreover, ISDA Master Agreement is “fundamental to, and provides a template for, the derivatives market”.⁸⁷ The ISDA Master Agreement was first published in 1992, and a second edition was published in 2002. It is the most commonly used master contract for over-the-counter (finance) derivative transactions internationally to reduce the financial system risk.⁸⁸

⁸⁷ See Stacy-Marie Ishmael, Lehman, Metavante and the ISDA Master agreement, Financial Times Alphaville (September 30, 2009).

⁸⁸ The ISDA master agreement is published by the International Swaps and Derivatives Association. See also at <http://www2.isda.org>. The most updated edition is known as the 2002 ISDA master agreement. There are two forms of the ISDA Master Agreement: a general multicurrency agreement and a simpler version for use in transactions where there is no international element.

2. *A certified copy of the Memorandum of Agreement⁸⁹ (the “MOA”), acceptable to the lender as of a date reasonably near the date of the Drawdown Notice⁹⁰;*
3. *A certified copy of the charter⁹¹ and charter guarantee⁹² (if applicable), acceptable to the lender as of a date reasonably near the date of the Drawdown Notice;*
4. *Copies of the board of directors resolutions and, where applicable, the shareholders resolutions of the borrower authorizing the execution of each of the finance documents, the MOA⁹³, charter and charter guarantee to which the borrower is a party.*

The forms for the resolutions are: Minutes of meetings of the Board of Directors and/or the assembly of shareholders of the shipowner and the guarantor, as well as written consent of the shareholder or certified extract of the shareholders of the company. The essential requirements are related to the above-mentioned documents including the Memorandum of Association. Since different countries adopt different practices, it is important that we know beforehand what the exact requirements are. For example, under the laws of the U.K., the Board of Directors does not need the approval of shareholders on the purchase or sale of ships unless it has been specifically stipulated in the

⁸⁹ Memorandum of Agreement (MOA) is a formal contract for the sale of ship. There are some standard forms contracts for the MOA like Norwegian Sale Form (NSF). The forms of NSF 1993 and NSF 1987 can be found on the BIMCO website – www.bimco.org.

⁹⁰ In the case of a newbuilding, a certified copy of the Shipbuilding Contract acceptable to the lender as of a date reasonably near the date of the Drawdown Notice.

⁹¹ The charterer takes over the vessel for either a certain amount of time (a time charter) or for a certain point-to-point voyage (a voyage charter). There is a subtype of time charter called bareboat charter.

⁹² BIMCO has drafted a standard charter guarantee form for the time charterer's performance. It is designed to cover all payments due by the charterers under a time charter party – primarily hire, but also other payments such as unpaid bunkers, port disbursements and legal and other costs.

⁹³ In the case of a newbuilding, the Shipbuilding Contract.

memorandum. Under Liberian or Marshall Islands laws, however, generally it needs the approval of shareholders if the company intends to sell any major property or provide guarantee. Moreover, there is no need for shareholder resolutions at the borrower level if the borrower is granting security over its own assets as it is in furtherance of its own business interest. Shareholder resolutions are needed only where a corporation is granting an upstream or cross-stream guarantee or collateral security.⁹⁴ Therefore, the safest way is to keep records of all specific approvals granted at the shareholders' meeting.

5. ***“Constitutional documents” of the corporate shipowner (borrower/debtor) and the corporate guarantor (parent/group company).***

The documentation includes Articles of Incorporation, Certificate of Incorporation⁹⁵ or Certificate of Formation⁹⁶, and the Memorandum, Articles of Association and LLC operating agreement. The Memorandum shall indicate the objects, share equity and other detailed information about the company. Articles will further detail the internal operations of the company such as the appointment and removal of directors. Based on such information, the lender may confirm whether the borrower has the capacity to own a ship (e.g. if the ship in question is Danish flagged, under the laws of Denmark, at least 2/3 of Directors in the Board of Directors of the company must be citizens residing inside

⁹⁴ See Marshall Islands Associations Law, Division 2 §16 “Guarantee authorized by shareholders” at p6 (A guarantee may be given by a corporation, although not in furtherance of its corporate purposes, when authorized at a meeting of shareholders by vote of the holders of a majority of all outstanding shares entitled to vote thereon. If authorized by a like vote, such guarantee may be secured by a mortgage or pledge of, or the creation of a security interest in, all or any part of the corporate property, or any interest therein, wherever situated.) See also Liberian Codes of Laws, Title 5 Association Law, Chapter 2 “Corporate Purposes and Powers” §2.3 “Guarantee authorized by shareholders.”

⁹⁵ For Liberian corporations, it is called “Certificate of Incorporation”.

⁹⁶ For Marshall Islands Limited Liability Company, it is called “Certificate of Formation”.

Denmark if the company wants to own the ship), to borrow money and/or to provide guarantee and grant security.

For Liberian or Marshall Islands corporations, foreign maritime entities can apply to be registered with the Liberian Registry⁹⁷ or the Marshall Islands Registry⁹⁸ as a foreign maritime entity (the “**FME**”). Under Liberian laws, a registered FME has the powers “[t]o own and operate vessels registered under the Laws of the Republic of Liberia provided all requirements of the Maritime Law met, [and] to do all things necessary to the conduct of the business of ownership and operation of Liberian-flag vessels and, for that purpose, to have one or more offices in Liberia and to hold, purchase, lease, mortgage and convey real and personal property, subject to the organic law of the Republic of Liberia.”⁹⁹

Moreover, other constitutional documents are By-laws, incumbency certificate, certificate of goodstanding¹⁰⁰ and power of attorney under which any finance document is executed on behalf of a security party. The certificate of goodstanding is used to prove that the company (shipowner or guarantor) in question is not in liquidation and that it has paid up all payables and annual corporation fees.

⁹⁷ The Liberian Registry – the second largest in the world – includes over 3500 ships of more than 112 million gross tons, which represents 11 percent of the world’s ocean going fleet. The Liberian Registry, is administered by the Liberian International Ship & Corporate Registry (LISCR, LLC), a U.S. owned and operated company that provides the day-to-day management for the Republic of Liberia’s (ROL) ship and corporate registry.

⁹⁸ International Registries, Inc. (IRI) and its affiliates are the Maritime and Corporate Administrators of the Republic of the Marshall Islands (RMI) and have been administering maritime and corporate programs for over 60 years.

⁹⁹ See Liberian Codes of Laws, Title 5 Association Law, Chapter 13 “Foreign Maritime Entities” §13.1-13.2.

¹⁰⁰ “Certificate of Goodstanding”, if the state where the company was formed so requires (such as in Panama, Marshall Islands and Liberia).

It is provided in Section 39 (1) of the Companies Act (2006)¹⁰¹ of the UK that “[t]he validity of an act done by a company shall not be called into question on the ground of lack of capacity by reason of anything in the company’s constitution.”

Section 39 is for disputes arising from “ultra vires” and to prevent a company from refusing to, on the ground of lack of capacity by reason of anything in the company’s Memorandum, assume responsibility or pay for certain actions (such as the purchase of goods or services) done by its employees beyond their powers. Therefore, lenders and their lawyers, if cautious enough, would check the limitations on powers described in the company’s Memorandum beforehand. As a company’s Memorandum generally covers extensive aspects, it is not hard to use some standard terms or phrases. There are also some rare examples, such as, a company was originally formed for a certain specific business or objective, and it then extended to other businesses later but failed to alter or enlarge its Memorandum accordingly.

Regarding the “company search” on the borrower/shipowner and the corporate guarantor, most countries would require the registration of limited companies and may disclose some information about these companies.¹⁰² The scope of the disclosed information varies from country to country. In some countries like those of flag of convenience, information about companies is even not open to their directors.

Some countries (like the U.K.) insist on information disclosure so that small shareholders and third parties who need to do business with these companies have a way to know their significant moves, especially, financial moves.¹⁰³ All versions of the

¹⁰¹See Companies Act (2006) §39(1); *see also* available at <http://www.legislation.gov.uk>.

¹⁰² See website of British Virgin Islands (BVI) Registry of Corporate Affairs at <http://www.bvifsc.vg/AreaofSupervision/RegistryofCorporateAffairs/tabid/182/Default.aspx>.

¹⁰³ The requirement for a company to disclose specific company information including the company name and company address is set out in the Companies Act 1985 (as amended) and Business Names Act 1985.

Companies Act of the U.K. have required the directors of each company to file annual reports and accounts to the Companies House for reference. To make sure that the accounts are as accurate as possible, the law also requires them to have their accounts audited by independent accountants.

Another example for instance, as to GmbH Co. Ltd¹⁰⁴ in Germany, the law requires the managers of the company to file with the Commercial Register the operating statement, profit or loss status and development report of the last year to the assembly of shareholders within 3 to 6 months upon the end of each business year and to convene a meeting of shareholders with a prescribed time limit to decide on the reports, evaluate their performance, investigate their responsibilities, and etc.¹⁰⁵

“Power of Attorney” is required for persons signing or executing the Loan Agreement and other relevant documents in connection therewith.

Lenders usually also request the so-called “Know Your Customer” (“KYC”) documents from the borrower/shipowner. It is the due diligence that financial institutions and other regulated companies must perform to identify their clients and ascertain relevant information in connection with doing financial business with them. In the U.S., KYC is typically a policy implemented to conform to a customer identification program mandated under the Bank Secrecy Act and USA PATRIOT Act.¹⁰⁶ The constitutional documents and corporate authorities usually suffice this requirement.

As a result of the implementation of the Companies Act 2006 giving effect to The Company Law Amendment Directive, companies in the UK are now required to include specific regulatory information on their websites and email footers. The law is effective from the January 1, 2007 with further developments in company law to take effect throughout the rest of the year.

¹⁰⁴ Gesellschaft mit beschränkter Haftung (GmbH) (English: company with limited liability) is a type of legal entity very common in Germany.

¹⁰⁵ See *Doing business in Germany*, Edition 2010, PKF.

¹⁰⁶ See Patriot Act, the Customer’s View of “Know Your Customer” – Section 326 of the USA Patriot Act, by Mark E. Plotkin and B.J. Sanford. Available at <http://www.cov.com/files/Publication/8991ab01-87ff->

6. *Certified copies of all consents which a security party requires to enter into, or make any payment under any finance document and certified copies of any mandates required in connection with the opening or operation of the Earnings Account;*
7. *Documentary evidence that the capital structure of the borrower, the charterer and the charter guarantor, if applicable.*

After the Loan Agreement is formed, the following are the documents needed to execute the Loan Agreement. The borrower will make sure that, on each Drawdown Date but prior to the making of an advance of the loan commitment for a vessel, the following are provided to the lender:

Part B

1. *A duly executed original of each finance document and of each document required to be delivered in connection with each finance document;*
2. *If the Drawdown Date is more than five business days after the date of the Drawdown Notice, a bringdown certificate of the Borrower certifying as of the Drawdown Date as to the absence of any amendments to the documents of such party referred to in paragraphs 4, 5 and 6 of Part A since the date of the Drawdown Notice;*
3. *Certification by the Borrower as of the Drawdown Date for the Loan advance that no event of default or potential event of default has occurred or would*

result from the borrowing of the advance; the representations and warranties in the Loan Agreement and those of the borrower or any other security party which are set out in the other finance documents would be true and not misleading if repeated on each of those dates with reference to the circumstances then existing; none of the circumstances of the market disruption has occurred and is continuing; and there has been no material change in the consolidated financial condition, operations or business prospects of the borrower since the date on which the borrower provided information concerning those topics to the lender;

4. Documentary evidence that:

- *the Ship has been unconditionally delivered by the seller to, and accepted by, the borrower under the MOA, and the full purchase price payable under the MOA has been duly paid¹⁰⁷;*
- *the Ship is provisionally registered in the name of the borrower under an approved flag by the lender(s);*
- *the Mortgage has been registered against the Ship as a valid first priority ship mortgage in accordance with the laws of the approved flag on which the Ship is registered;*
- *the security interests intended to be created by each of the finance documents have been duly perfected under applicable law¹⁰⁸;*

¹⁰⁷ In the case of a newbuilding, the Ship has been unconditionally delivered by the shipyard to, and accepted by, the borrower under the shipbuilding contract, and the full purchase price payable under the shipbuilding contract has been duly paid.

- *the Ship is in the absolute and unencumbered ownership of the borrower save as contemplated by the finance documents;*

“Search” on whether the seller has ownership over the ship and has no “encumbrances”. The search here is to dig information from the seller’s “Ship’s Registry” instead of the Registrar of Companies. Since the seller’s status (e.g. whether it has encumbrances) is easily changing, the closer the search is to the “drawdown of the loan”, the more reliable the result is. When trading second-hand ships, the seller would try to get a certificate from its flag country to prove that the ship has no “encumbrances” any longer.

In Panama, instead of requiring a certificate of ownership and encumbrances or a similar document issued by the former registry of a ship, the Panamanian authorities rely on (a) the statements made by a notary public in the notarial certificate attached to the ship’s bill of sale and (b) the deletion certificate issued by the former registry of the ship attesting to the fact that the seller was the last owner there.¹⁰⁹

After completing the mortgage registration formalities at the bank, the borrower shall provide its company registration certificate (if necessary) and the ship registration certificate to the bank as soon as possible.

- the Ship is insured in accordance with the provisions of the Loan Agreement and all requirements therein in respect of insurances have been complied with.

¹⁰⁸ This involves UCC-1 filing in the location of debtor under Uniform Commercial Code. If the company is registered in UK or Singapore where there is a system for registering non-possessory security interests, then security interests are also filed with Companies House in UK or Singapore corporate regulatory authorities.

¹⁰⁹ See the website of Consulate General of Panama in New York at <http://www.nyconsul.com>.

The lender may also request a “letter of undertaking” from both the insurer and the P& I club to confirm that they have received the shipowner’s “notice of assignment” and are willing to pay any indemnity that may occur to the lender.

- the Ship maintains the highest class for vessels of its type with the classification society¹¹⁰ free of any recommendations and qualifications affecting class (which status shall be established by a confirmation of class certificate issued by the classification society¹¹¹).

5. *Valuations of the fair market value of the Ship;*

A “valuation” certificate is made by an independent “surveyor” and an independent “valuer”. Valuer is usually a full-time “shipbroker”.

6. *A survey report from an independent marine surveyor selected by the lender in respect of the physical condition of the Ship, which report shall confirm the condition of the Ship to the satisfaction of the lender(s);*

7. *Copies of all ship delivery documents signed or issued by the borrower and the seller under or in connection with the delivery of the Ship under the terms of the MOA¹¹²;*

Various “current/valid” safety certificates about the Ship such as “safety construction”, “safety radio”, “safety equipment”, “loadline certificates” and other

¹¹⁰ A classification society is a non-governmental organization that establishes and maintains technical standards for the construction and operation of ships and offshore structures. The most well-known classification societies are: Lloyd's Register of Shipping, Bureau Veritas, American Bureau of Shipping, Det Norske Veritas, Nippon Kaiji Kyokai and China Classification Society.

¹¹¹ In the case of a newbuilding, an interim class certificate.

¹¹² In the case of a newbuilding, under the terms of a Shipbuilding Contract.

certificates required for different types of ships (e.g. refrigerator ships, chemical carriers, etc.)¹¹³ Also, the delivery documents include commercial invoice, protocol of sea trial, protocol of inventories, protocol of drawings, plans and documents, protocol of fuel, lubricant and greases, protocol of spare parts, builder's certificate, declaration of warranty and so forth.

In July 2011, the Marine Environment Protection Committee (the "MEPC") under the International Maritime Organization adopted Mandatory Energy Efficient Measures for International Shipping to come into force January 1, 2013.¹¹⁴ Some believe that various certificates and approvals will be issued by Flag State which will include an "International Energy Efficiency Certificate" issued to each vessel.¹¹⁵

8. *A duplicate of the "Bill of Sale (or MOA)" on the seller's assignment of the ship's ownership to the buyer (borrower);*
9. *Borrower's instruction letter to the classification society so as to maintain the highest class for that Ship with the classification society, free of overdue recommendations and conditions;*
10. *Ship's Manager's Undertaking, together with a certified copy of the Ship Management Agreement;*

¹¹³ Normally vessel safety certificates include Safety Construction Certificate, Safety Equipment Certificate, Safety Radio Certificate, Load Line Certificate, Certificate of Financial Responsibility, Safety Management Certificate, International Tonnage Certificate, and so forth.

¹¹⁴ See IMO website, available at: <http://www.imo.org/MediaCentre/PressBriefings/Pages/42-mepc-ghg.aspx>.

¹¹⁵ *Id.* (The amendments to MARPOL Annex VI Regulations for the prevention of air pollution from ships, add a new chapter 4 to Annex VI on Regulations on energy efficiency for ships to make mandatory the Energy Efficiency Design Index (EEDI), for new ships, and the Ship Energy Efficiency Management Plan (SEEMP) for all ships. The SEEMP is a management plan which applies to all vessels and will try to create a mechanism for operators to continually improve the energy efficiency of all types of vessels.)

11. *Certified copies of the Ship Manager's Document of Compliance¹¹⁶ and of the Ship's ISSC and Safety Management Certificate¹¹⁷;*
12. *A favorable opinion from an independent insurance consultant acceptable to the lender on such matters relating to the insurances for the Ship¹¹⁸;*
13. *Other documents/materials;*

Based on the actual needs, the lender has the liberty to add other documents/materials into this Article and to set specific requirements. For example, for a charterparty, especially a long-term charterparty, the bank may ask the borrower to repay the loan with its income from the charter and/or “assign” the charter to it. This aspect is not concerned in the lending for a fishing boat or tourist ship;

14. *Whether the loan can be recovered mainly relies on adequate and reliable “security”, the most important one of which is the ship mortgage.*

Since the ship is constantly facing multiple maritime risks, security from the mortgage would easily disappear.¹¹⁹ This is the last thing that the lender wants to see. The countermeasure is to pass the risk to the insurer as much as possible. To provide documents to meet the lender's requirements in this aspect, the shipowner would ask the

¹¹⁶ See 33 CFR 96.330 (in sub-section (d), “[a]ll U.S. and foreign vessels that carry more than 12 passengers or a tanker, bulk freight vessel, freight vessel, or a self-propelled mobile offshore drilling unit of 500 gross tons or more, must carry a valid copy of the company's Document of Compliance certificate onboard when on a foreign voyage.”)

¹¹⁷ Flag states (countries of registry of ships) are responsible for approving Ship Security Plans, compliance with SOLAS and the ISPS Code through verification audit, issuing an International Ship Security Certificate (ISSC) and continuous monitoring of ownership, classification and operator information. Every Ship Managing Company, as well its ships, are subject to verification and control by the Flag Administration or by Organizations authorized by it, for the proper functioning of the Safety Management System and its conformity with the provisions of the ISM Code.

¹¹⁸ Aon's BankAssure team is one of the independent insurance consultant acceptable to the lenders.

¹¹⁹ See Yang, *supra* note 9, at 145.

“insurance broker” or “insurer” to directly send documents to the lender to confirm the risks (marine risk, war risk, hull and machinery risk, liability of the Mutual Assurance Association and etc) are covered by the insurances, amount of insurances, amount of deductible and etc., because the lender will not approve the borrower’s “drawdown” request until after it receives adequate security to secure the borrower’s obligations under the loan.

15. To change the ship’s country of registration, the borrower/shipowner must also provide a “deletion certificate” issued by the existing ship registration authority (usually the country of registration of the ship when it is still owned by the seller).

The “deletion certificate” is a “must” for the shipowner to make permanent registration at the new ship registry. In practice, it would take a comparatively long period of time to get this document (for instance, the existing ship registration authority requests the seller to return the original ship registration certificate, but the certificate must be carried on the ship just like individuals must carry their identity certificates along with them, so it means that the original ship registration certificate cannot be surrendered for deletion until the ship is delivered to the buyer). Therefore, a general practice would be that the seller adds an additional clause to the “Memorandum of Agreement (MOA)”, undertaking the buyer that it will provide a “deletion certificate” within a certain time limit (e.g. one month) after the delivery of the ship.

In Panama, there is no requirement at the time of provisional registration of a ship for evidence of deletion from the former registry to be produced to the Panamanian authorities. Before the ship is permanently registered there, the original deletion certificate must be submitted by the buyer to the Directorate General of Merchant Marine

(DIGEMAR), and normally this document is submitted before the date of expiry of the Provisional Patente.¹²⁰

16. The borrower/shipowner has to pay off the “commitment fee” and other financial charges before drawdown.

Financial charges refer to loan costs to be paid by the borrower/shipowner in addition to the loan interest. Different “Loan Agreements” involve different items of financial charges, including “management fee”, “front-end fee”, “participating fee”, “commitment fee”, “agent fee”, “arrangement fee” and so on so forth.

Among all financial charges, the front-end fee is paid once and for all when the loan agreement is signed. The front-end fee includes participating fee and management fee, which generally account for 0.5% to 1% of the total lending. In particular, the participating fee is distributed among lenders based on their respective proportions in the lending, while the management fee is always distributed between the manager bank and the leading bank based on their underwriting amount. The front-end fee is closely related to the lending rate. If the interest margin or profit is lower than the market price, front-end fee would be higher, and vice versa. The commitment fee is charged by the lender for assuring the availability of the loan at any time when the borrower needs it. The commitment fee is about 0.25% to 0.5% of the loan that has not been drawn by the borrower and is calculated on an annual basis. If the borrower exercises its right to reduce or cancel any part of the loan under the loan agreement, the commitment fee would be reduced accordingly. The arrangement fee and agency fee are charged only in syndicated loans which are provided by a group of lenders. In particular, the arrangement

¹²⁰ Article 14 of Law 57 of the Panamanian Code of Laws provides a term of up to 30 days for the presentation of those documents not submitted at the time of a ship’s flagging and which the applicant undertakes to deliver.

fee is paid to the arranging bank, while agency fee is paid to the agent bank. Apparently, it is okay that neither “agency fee” nor “arrangement fee” is included in the loan agreement since neither of them has anything to do with the borrower/shipowner, but eventually they are paid by the borrower/shipowner since banks are always good bargainers.

17. Favorable legal opinions of the legal counsel for the Creditor Parties and from legal counsel appointed by the borrower on such matters concerning the laws of such relevant jurisdictions as the lender may require.

The ship loan is always an international issue. Here is a typical example. Bank of America grants a loan to a Liberian ship company to own an oil tanker flying the Panama flag under the personal guarantee of a Hong Kong shipowner. It is expressly stated in the “Loan Agreement” that the applicable law is the English law, which is a generally accepted practice. However, it is not enough to know about the English law, and the bank also needs to find out whether the Liberian law permits Liberian companies to borrow money from foreign banks or to provide guarantees with their property.

It is also necessary for the bank to know whether Panama allows ship mortgage and whether personal guarantee is legal in Hong Kong. In another word, the bank must confirm the legality and feasibility of the Loan Agreement in different places. The legal opinion would also involve “exchange control”, “withholding tax”, guarantee registration, format requirements on documents (e.g. which documents need to be notarized and/or validated at the embassy) and etc.

Generally, the bank/shipowner would designate a sophisticated lawyer to make a “Loan Agreement” and to get a legal opinion from a lawyer of the country concerned. The bank’s needs and the wording of the document will be deliberated later.

Summary

In summary, with the documents/materials provided by the shipowner, the bank may also oversee the shipowner's performance. If it has any violation under the loan facility, it constitutes an "event of default".¹²¹ As is well known, a violation of "conditions precedent" would cause serious consequences as the damaged party can terminate the agreement in addition to seeking indemnity.¹²² On the other hand, for a "minor" violation of the "warranties", the damaged party can only claim for indemnity but cannot terminate the agreement.

The line between "condition precedent" and "condition subsequent" is "drawdown". It means that the lender will allow the shipowner to draw the loan only after it meets all "conditions precedent" in the loan agreement, unless the lender consents to give a temporary "waiver". For example, sometimes the lender does not receive the duplicates of the incorporation documents of the shipowner and/or the guarantor or the ship purchase agreement or commercial invoice; it does not matter as long as it does not involve any significant issue. As to "conditions subsequent", the consequences of any violation thereof can also be serious even though they are conditions to be met after drawdown.

Sometimes it is hard to decide whether a certain document/material is a condition precedent or subsequent, such as the "legal opinion" mentioned previously. In theory, banks should review and accept the legal opinion before approving a drawdown which means that the legal opinion is a "condition precedent", but in practice banks always ask for foreign lawyers' legal opinions after approving the borrowers' drawdown requests.

The reasons are listed below:

¹²¹ It refers to the occurrence of an event which allows the lender to demand repayment of the loan in advance of its normal due date (also known as accelerating the loan).

¹²² See Yang, *supra* note 9, at 146.

(i) Under normal conditions, the legal opinion of a foreign lawyer is available only after the loan and guarantee documents are done because foreign lawyers always need to check through the executed and dated documents before issuing a legal opinion.

(ii) The lender ignores the risk in this regard and deems it a “formality”, although some lenders may have asked their lawyers about the generally acceptable form of a legal opinion of the same type of transaction.

Sometimes certain documents are deemed as “condition concurrent.”¹²³ In a ship auction, the bid-winning bank will preposition funds with its oversea branch where the ship delivery is taken place. The funds will be released to the court concurrently with the registration of each auctioned ship and each mortgage over such ship and, of course, the fulfillment of other CPs.

A good example here is that Nordea Bank had two ships, *Blue Coral* and *Blue Diamond*, arrested in Singapore to enforce outstanding debts with Korea Line Corp, which ordered the ships from South Korean builder STX.¹²⁴ The ships were pledged by Korea Line Corp. to Nordea Bank as collateral for an \$82 million loan in October 2006.¹²⁵ With the court’s approval, Scorpio Tankers Inc. signed a deal to acquire the ships. Nordea Bank prepositioned money (Scorpio’s equity and the bank’s loan to Scorpio) with its Singapore branch, which would be released to the Singapore High

¹²³ It is a condition that is to be fulfilled by one party at the same time that a mutual condition is to be fulfilled by another party. It is the timing of performance under the terms of the contract whereby two events must occur simultaneously.

¹²⁴ See “*Scorpio confirms Korea Line tanker purchases*”, by Lloyd's List, last modified Apr 29, 2011.

¹²⁵ Andrea Tan & Kyunghye Park, *Nordea Bank Seizes Korea Line Singapore Vessels to Recoup Debt*, available at <http://www.bloomberg.com/news/2011-03-25/nordea-bank-seizes-korea-line-singapore-vessels-to-recoup-debt.html>.

Court¹²⁶ simultaneously with the vessels being registered and mortgages being granted and recorded.

2.3.4. “Representations and Warranties”

Representations and warranties are statements of fact made in the contract by one party to the other party as of a particular point in time. Their purpose is to create a snapshots of facts that are important to the recipient’s business decision to enter into the transaction. As such, the failure of a party’s representations to be true will result in the other party having rights and remedies under the contract. In practice, this Clause is combined with the “conditions precedent” into one since they have similar functions.

The major purpose of this Clause is to get written representations and warranties from the borrower/shipowner every time it makes a drawdown so that the lender is able to rescind the agreement once any event of default occurs in the same way as it violates the “conditions”. After all, “misrepresentation” itself constitutes a ground for terminating the loan agreement. “Warranties” provide a basis for deciding which facts exist, which acts are allowed, and so forth.

For the lender, it is always better to have more representations and warranties from the shipowner so that it can better protect its own interest. Generally, a Loan Agreement contains 10 to 20 representations and warranties, sometimes even 50 or 60. Mainly they include the following¹²⁷:

- a) The borrower/shipowner has the capacity to borrow money from the bank;
- b) The borrower/shipowner is a company duly organized, validly existing and in goodstanding and is capable to own property, operate business, etc.;

¹²⁶ The case is *Nordea Bank Finland Plc, Singapore Branch v Korea Line (Singapore) Pte* OS220/2011 in the Singapore High Court.

¹²⁷ See Yang, *supra* note 9, at 147.

- c) The borrower/shipowner and the guarantor have the capacity to fulfill the obligations stipulated in the Loan Agreement and the guarantee agreement;
- d) The borrower/shipowner's obligations stipulated in the Loan Agreement are legitimate, valid, binding and enforceable at the locality of the borrower/shipowner;
- e) The borrower/shipowner is not or unlikely to be involved in any pending lawsuit;
- f) The borrower/shipowner is not or unlikely to be in any event of default; and
- g) The latest audited financial statement of the borrower/shipowner is a truthful report on its financial and operating status.

Representations and warranties regarding the subject ship, e.g. the maintenance, repair, classification and insurance of the ship, can be stipulated in the "ship mortgage" or "deed of covenant"¹²⁸, but it is also fine to include them under this Clause. The wording of representations and warranties in connection with the ship is usually seen as follows:

"Ships. As of the Drawdown Date, the Ship will be:

- a) in the sole and absolute ownership of the Borrower/Guarantor and duly registered in such Borrower/Guarantor's name under the law of an approved flag, unencumbered save and except for the Mortgage thereon in favor of the Security Trustee recorded against it and as permitted thereby;
- b) seaworthy for hull and machinery insurance warranty purposes and in every way fit for its intended service;
- c) as of the relevant Drawdown Date insured in accordance with the provisions of this Agreement and the requirements hereof in respect of such insurances will have been complied with;

¹²⁸ It is usual for the mortgagor and the mortgagee to enter into "Deed of Covenant" collateral to the statutory ship mortgage, setting out in detail the legal relation between them and the terms and conditions under which the mortgagee may enforce its rights under the mortgage.

d) in class in accordance with the provisions of the Loan Agreement and the requirements thereof in respect of such classification will have been complied with; and

e) managed by an approved manager pursuant to an approved management agreement.”¹²⁹

The lender also has big concerns on environmental law compliance. The wording in standard ship finance Loan Agreement is as follow:

“Except to the extent the following could not reasonably be expected to have a material adverse effect on the business, assets or financial condition of any Security Party, or affect the legality, validity, binding effect or enforceability of the Finance Documents:

a) the operations and properties of each of the Security Parties comply with all applicable laws and regulations, including without limitation Environmental Laws, all necessary Environmental Permits have been obtained and are in effect for the operations and properties of each of the Security Parties and each of the Security Parties is in compliance in all material respects with all such Environmental Permits; and

b) none of the Security Parties has been notified in writing by any person that it or any of its subsidiaries or affiliates is potentially liable for the remedial or other costs with respect to treatment, storage, disposal, release, arrangement for disposal or transportation of any Environmentally Sensitive Material, except for costs incurred in the ordinary course of business with respect to treatment, storage, disposal or transportation of such Environmentally Sensitive Material.”¹³⁰

The author now would like to analyze a British High Court case of *Essentially Different Limited v Bank of Scotland plc* [2011] EWHC 475 (Comm) in which the defendant bank unsuccessfully sought to rectify the terms of a Facility Letter.¹³¹ The

¹²⁹ It is summarized on the basis of the author’s practice experience.

¹³⁰ See Yang, *supra* note 9, at 150.

¹³¹ *Essentially Different Limited v Bank of Scotland plc* [2011] EWHC 475 (Comm) (U.K.), available at <http://www.bailii.org/ew/cases/EWHC/Comm/2011/475.html>.

bank was held liable for breach of contract, in failing to advance the second tranche of a loan.

Essentially Different Limited (E) was a start-up company which had a license to exploit intellectual property in software called “Smartblobz”.¹³² On February 11, 2004, E and Bank of Scotland plc (B) entered into a Facility Letter.¹³³ Under the facility arrangements, B was to advance the loan in two tranches.¹³⁴ The first lump sum of £100,000 was paid over to E on February 25, 2004.¹³⁵ The second tranche of £145,000 was to be advanced on May 25, 2004, but B refused to make payment.¹³⁶ Clause 6.1 of the Facility Letter read as follows:

“The Borrower represents and warrants that:

(e) the information given by the Borrower in the Application was and remains true, complete and accurate in all respects and the Borrower is not aware of any such facts or circumstances that have not been disclosed to the Lender which might if disclosed adversely affect the decision of the person considering whether or not to provide finance to the Borrower”.¹³⁷

Under Clause 10.1 of the Facility Letter, it provides that “[i]f any of the following events occur, the Lender shall be under no obligation to advance monies hereunder and may by notice to the Borrower require repayment. . . .of all sums outstanding hereunder

¹³² *Id.* para. 1.

¹³³ *Id.* para. 2.

¹³⁴ *Id.*

¹³⁵ *Id.*

¹³⁶ *Id.*

¹³⁷ *Id.* para. 3.

together with accrued interest thereon and/or cancel any portion of the Facility then undrawn, that is to say, if: (b) any statement or representation or warranty made by the Borrower in or in connection with the Application... proves to have been incorrect or inaccurate when made or would be incorrect or inaccurate if made at any time during the continuation of this agreement”.¹³⁸

E eventually commenced proceedings, alleging that B’s refusal to pay over the second tranche of the loan was in breach of contract. B, by way of defense, argued that a condition precedent was agreed between the parties that E was to put forward evidence of contracts sufficient to service the full £245,000 debt.¹³⁹ As E did not do this, B’s non-payment was justified. B sought rectification of the Facility Letter, to incorporate the alleged condition precedent E made misrepresentations which entitled B to withhold payment of the second tranche.¹⁴⁰

The Judge quoted the principles set out by Gibson LJ in *Swainland Builders Limited v Freehold Properties Limited*¹⁴¹ – “The parties seeking rectification must show that:

- (1) the parties had a common continuing intention, whether or not amounting to an agreement, in respect of a particular matter in the instrument to be rectified;
- (2) there was an outward expression of accord;
- (3) the intention continued at the time of the execution of the instrument sought to be rectified;

¹³⁸ *Id.*

¹³⁹ *Id.* para. 6.

¹⁴⁰ *Id.* para. 7.

¹⁴¹ See *id.* para. 22 quoting *Swainland Builders Limited v Freehold Properties Limited* [2002] EWCA Civ 560.

(4) by mistake, the instrument did not reflect that common intention;

(5) The standard of proof required if the Court is to order rectification is the ordinary standard of the balance of probabilities.”

However, as it is unusual to question and “look behind” a written document, convincing proof is required.¹⁴²

On the facts, the Judge was not persuaded that rectification was appropriate. The parties did not have a common intention that E would provide evidence of contracts to service the full debt by way of a condition precedent.¹⁴³

Regarding “Misrepresentation”, B alleged that a number of misrepresentations were made in E’s business plans, as supplied to the Bank before the Facility Letter was entered into.¹⁴⁴ Inter alia, B highlighted E’s statement in an Executive Summary of July 2003 that E was “now in a position to take a significant market share”.¹⁴⁵ The Judge took the view that this was not a misrepresentation, given that “Smartblobz” would have been a unique product at that time.¹⁴⁶ B also alleged that E’s statement that it was “far down the path to significant contracts” was a misrepresentation.¹⁴⁷

¹⁴² See *id.* para. 22 quoting *Thomas Bates & Sons Limited v Wyndham’s (Lingerie) Limited* [1981] 1 WLR 505.

¹⁴³ *Essentially Different*, para. 43.

¹⁴⁴ *Id.* para. 45.

¹⁴⁵ *Id.* para. 49.

¹⁴⁶ *Id.*

¹⁴⁷ *Id.* para. 46.

On the facts, E made sufficient disclosure to show that it had indeed made progress in relation to securing significant contracts.¹⁴⁸ Furthermore, publicity material submitted to the Bank prior to February 2004 clearly stated that those contracts were a year away from signing.¹⁴⁹ The Judge dismissed B's counterclaim for rectification and misrepresentation, and concluded that the Bank had not been entitled to withhold the second tranche of the loan.¹⁵⁰

2.3.5. "Repayment and Prepayment"

In the Loan Agreement, usually the date of the repayment will be provided in details. It will be deemed as a default if the shipowner did not make repayments under the Loan Agreement. The majority of loan agreement will provide that the shipowner can make repayments of the total loan facility amount by installments, and the number of the installments and time intervals will vary depending on detailed situation. The first installment shall usually be repaid on the date falling three months after the first Drawdown Date and the last installment on the maturity date of the loan facility. However, it also depends on when the earnings (charter hire or freight earnings) are available to the shipowner in order to repay the loan.

The Loan Agreement also has clauses that regulate the borrower/shipowner's prepayment of the loan. Sometimes, the borrower is not allowed to make prepayment for the loan facility. But after all, the option to repay a loan does not rest with the borrower. Sometimes as a preventive measure against collateral threat, banks are likely to resort to prepayment notices. If the borrower had money to make prepayment, it would undoubtedly save borrower's interest and add more flexibility. Sometimes, due to the

¹⁴⁸ *Id.* para. 49.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* para. 51.

market change, a restructure of the loan facility by getting a new loan and paying off the old loan can benefit the borrower with a better interest rate and financing options. For the lenders, restrictions and regulations are provided in the Loan Agreement regarding the borrower's involuntary prepayment, such as:

- (a) partial prepayment shall be \$[●] or a multiple of \$[●];
- (b) the Agent of the Lenders (the "Agent") has received from the Borrower at least [30] days' prior written notice specifying the amount to be prepaid and the date on which the prepayment is to be made; and
- (c) the Borrower has provided evidence satisfactory to the Agent that any consent required by the Borrower or any other Security Party in connection with the prepayment has been obtained and remains in force, and that any regulation relevant to this Agreement which affects the Borrower or any other Security Party has been complied with (which may be satisfied by the Borrower certifying that no consents are required and that no regulations need to be complied with).

Subject to the above conditions, the Borrower may prepay the whole or any part of the Loan on the last day of an Interest Period. Moreover, the amount of the prepayment is restricted to a minimum amount, usually an integral number or multiple of an integral number. In contrast, in a mandatory prepayment situation, the Borrower must prepay the relevant proportion of the loan if a ship is sold or becomes a total loss:

- (a) in the case of a sale, on or before the date on which the sale is completed by delivery of the ship to the buyer; or
- (b) in the case of a total loss, on the earlier of the date falling [90] days after the total loss date and the date of receipt by the Security Trustee of the proceeds of insurance relating to such total loss.

2.3.6. "Covenants"

Covenants are designed to ensure that a party receives the benefits that it bargained for in the operative provisions of the Loan Agreement. Representations are statements of fact as of a specific point in time. In contrast, covenants are ongoing promises by one party to take or not to take certain actions.

Lenders usually feature covenants, including covenants requiring borrowers to maintain adequate insurance coverage, provide the facility agent with copies of financial statements, notify the lenders of any event of default, obtain and comply with any necessary authorizations, comply with all applicable laws where the failure to comply is reasonably likely to have a material adverse effect, maintain the classification and repair of the fleet in accordance with industry practice, lawfully and safely operate the fleet, discharge any liabilities and arrest of any containerships in the fleet within 30 days, provide the lender with information in respect of any total loss, class recommendation and environmental claims and comply with ISM Code and ISPS Code.¹⁵¹

2.3.6.1 Financial Covenants

There are different types of financial covenants, some of which are tailored to a specific company. Below are some of the most frequently recurring financial covenants¹⁵²:

- Minimum EBITDA¹⁵³

It is popular because many lenders base their investment decisions on EBITDA figures. EBITDA is a pro-forma accounting figure that measures the operating efficiency of a company, taking into consideration vessel operating expenses and administrative overhead. It also measures a company's capacity to service its debt obligations, and is frequently used in loan covenants.¹⁵⁴

- Interest Coverage Ratio

¹⁵¹ See Report on ship financing, OECD Council Working Party on Shipbuilding (WP6), page 11, available at www.oecd.org/dataoecd/55/6/47128870.pdf.

¹⁵² Charles M. Fox, *Working with Contracts* (2d Edition) 217-8.

¹⁵³ EBITDA is an acronym for “earnings before interest, taxes, depreciation and amortization.”

¹⁵⁴ See How To Make Sense Of EBITDA In The Shipping Industry, available at <http://seekingalpha.com/article/919401-how-to-make-sense-of-ebitda-in-the-shipping-industry>.

Borrowing comes with a cost: the interest that is payable month after month, year after year. These interest payments directly affect the company's profitability. For this reason, a company's ability to meet its interest obligations is one of the most important factors in the return to lenders. This ratio measures the ratio of the debtor's EBITDA to its interest expense, over specified period of time. It determines the sufficiency of the debtor's cash flow. It is simple to calculate from the financial statements but lacks the impact of debt repayment, which variants sometimes include.¹⁵⁵

- Fix Charge Coverage Ratio

It is a ratio that indicates a company's ability to satisfy fixed financing expenses, such as interest and leases. It indicates the risk involved in ability to pay fixed costs when business activity falls.

- Leverage Ratio

Leverage is a measure of the percentage of a company's capital provided by debt. Leverage ratio covenants are usually express as "Total Liabilities" or "Net Debt" divided by "Total Assets".

- Net Worth

Net worth is what is left over after liabilities have been subtracted from the assets of the business. In a sole proprietorship, it is also known as owner's equity. This equity is the investment by the owner plus any profits or minus any losses that have accumulated in the business.¹⁵⁶

¹⁵⁵ Shipping Finance, 3d Edition, at 84.

¹⁵⁶ See *generally* Understanding Financial Statements, available at <http://www.dnb.com/customer-service/understanding-financial-statements.html#megamenu.html>.

These financial covenants allow the bank to closely monitor the borrower's financial performance. Once certain ratio falls below the required percentage, the covenant is thus breached and the bank is entitled to exercise remedies in the event of default.

2.3.6.2 Marine Insurance Covenants

The financing bank's first priority is to ensure that adequate insurance policies have been arranged, are in place and maintained, which is the shipowner's responsibility.

Hull and Machinery insurance (H&M) typically insures against physical loss or damage to the ship, against general average contribution payments and against a proportion of third party liability for collisions caused by perils of the sea.¹⁵⁷ War Risks insurance covers damage caused not only by war, but also by strikes. Risks such as liabilities to cargo and to crew, and collision liabilities which are excluded under the H&M policy, together with other third party liabilities, should be covered by the P&I Club entry.¹⁵⁸ The shipowner will also keep the ship insured against risks covered by mortgagee's interest insurance (M.I.I.), which will be discussed later. From the bank's perspective, it is not enough for the shipowner just to arrange such insurance cover, the shipowner must also covenant not to jeopardise the insurance.

The shipowner will also further covenant to obtain from the underwriters and/or P&I Clubs and/or all approved brokers a letter of undertaking in a pro forma copy acceptable to the bank confirming the status of the insurance and that the bank will be informed in the event the insurance is compromised. The letter of undertaking of the Club and/or Insurer confirms that they will have endorsed on each policy, a loss payable clause and a notice of assignment in accordance with the Insurance Assignment for the ship. The

¹⁵⁷ See Hull and Machinery, www.willis.com.

¹⁵⁸ See the website of North of England P&I Club, <http://www.nepia.com/home/>.

bank's interest is thus recognized either as an Assignee, or as a Co-assured, or as a Loss payee. These concepts will be discussed below.

Also, the shipowner will renew the obligatory insurances and will advise the bank immediately of any material change to the terms of the obligatory insurances or if the insurance broker cease to act as a broker.

2.3.6.3 Ship Covenants

a. Registration and classification of the ship

The loss of the ship's registration or classification probably will render any insurance over the ship void or discharged.¹⁵⁹ It may also render the trading of the ship illegal. Securities granted by the shipowner to the bank may become severely compromised by having the ship's classification or registration affected. As such, the shipowner is required to covenant to maintain both.¹⁶⁰

b. Repair

The poor condition of the ship has a number of consequences: firstly, the value of the ship will depreciate, which increases the likelihood that in the event of a sale enforced by the bank, it will not recoup its investment; secondly, the possibility of an accident to the ship will increase; thirdly, it will put the ship in breach of the ISM Code;¹⁶¹ and fourthly, it may prejudice the insurance cover. Due to the above, the bank requires the shipowner to maintain the vessel in a good shape and sufficient state of repair to counter the risks.

c. Release from arrest and liens

¹⁵⁹ See generally Classification Societies – What, Why and How?
Available at http://www.iacs.org.uk/document/public/explained/class_whatwhy&how.pdf.

¹⁶⁰ Usually speaking, the shipowner is required to maintain the highest class for the ship with the Classification Society, free of overdue recommendations and conditions.

¹⁶¹ See generally International Safety Management (ISM) Code 2010.

The shipowner must promptly discharge all liabilities which give rise to maritime or possessory liens on or claims enforceable against the ship owned by it, the earnings or the insurances.

The bank will require the shipowner to discharge and pay all debts, damages and liabilities which may give rise to a maritime or possessory lien which could be enforced against the ship. Such liens may attach either before or after the mortgage execution, including liens which arise through breaches of contract of affreightment, collisions caused by the vessel, incidents of pollution or through debts in connection with vessel supplies. All of these liens may pose risk to the bank.

d. Inspection

The shipowner shall permit the bank's representative to board the ship to inspect its condition or to satisfy themselves by proposed or executed repairs.

e. Notification

For various reasons, either geographical distance or business focus, the bank may not have access to information which could affect the bank's security over the vessel. The shipowner must covenant to notify the bank of any occurrence which may adversely affect the security. For example, should the ship call a war zone, the shipowner must notify the bank every time it calls unless this requirement is waived by the bank.

f. Sale

Unless otherwise agreed with the lender, the shipowner will covenant not to sell, charge or encumber the ship during the existence of the mortgage because these may embroil the bank in disputes about priority of security interests. In the worst scenario, the interests of a bona fide purchaser or further mortgagee may take precedence over those of the bank. A bona fide purchaser, such as a subsequent mortgagee, only loses priority if it has notice of the prior encumbrance. Therefore, a prior mortgage will only rank above a

subsequent mortgage if the subsequent mortgagee has notice of the prior security interest. It is important to register the mortgage to prevent a subsequent creditor taking a higher-ranking security interest without notice.

g. Charter

It is common for the bank to require the shipowner not to enter into charterparty terms over a specified period of time. Such charters may prevent the bank/mortgagee from exercising proprietary rights over the ship in the event of default.

2.3.7. “Interest”

This Clause is self-explanatory. It stipulates that the lenders could increase the interest upon the borrower’s default.¹⁶² If the interest is increased to an unreasonable rate, it will be void because it is a penalty clause.¹⁶³

The wording of this Clause has been seen as follows¹⁶⁴:

“Interest

- The rate of interest on US\$ Advance for any Interest Period shall be aggregate of LIBOR¹⁶⁵ (London Inter-bank offered rate) plus 1% of margin.
- Interest under [the Loan Agreement] shall accrue from date to date, be calculated on the Daily Basis and be paid by the Borrower to the Lender in arrears on each Interest Payment Date.

¹⁶² The increased interest usually is between 1% and 2%.

¹⁶³ See *Lordsvale Finance plc v. Bank of Zambia* (1996) QB 752 (U.K.).

¹⁶⁴ See Yang, *supra* note 9, at 153-54.

¹⁶⁵ LIBOR is the average interest rate estimated by leading banks in London that they would be charged if borrowing from other banks.

- The Lender shall certify to the Borrower each rate of interest as soon as it is determined under [the Loan Agreement] and any such certificate of the Lender shall, in the absence of manifest error, be conclusive and binding upon the parties hereto.
- Interest on an Advance shall be payable in US\$, unless otherwise agreed by the Lender.
- If the Borrower fails to pay interest in accordance with [the Loan Agreement] and so long as such interest shall remain unpaid, the interest rate shall be 1% over the interest rate charged on the principal sum from the due date of such payment to the date of actual payment which shall be compounded and be consolidated with the interest payment owing and unpaid.”

The interest rates for ship financing loans may be swapped and fixed for the duration of the loan, remain floating or involve other interest rate management products. Although LIBOR represents the base rate in the majority of ship financing transactions, it is important to note this does not necessarily reflect the cost of funds for the lending bank.¹⁶⁶

¹⁶⁶ See Report on ship financing, OECD Council Working Party on Shipbuilding (WP6), page 7, available at www.oecd.org/dataoecd/55/6/47128870.pdf.

2.3.8. “Event of Default”

Most term loan agreements contain a comprehensive list of events of default whose occurrence will entitle the bank to declare the outstanding balance of the loan, accrued interest and any other sums due under the loan agreement to be immediately repayable.¹⁶⁷

Generally speaking, the following examples will constitute events of default¹⁶⁸:

- Non-payment of amounts due under the credit facility unless due to administrative delay and cured within 3 business days.
- Default by borrower, other than payment default, under any material provision of the loan agreement or security document, except, in the case of a default capable of remedy in accordance with the facility, a default remedied within 30 days of the earlier of notice to us and discovery.
- Breach of a material representation or warranty not remedied within 30 days of the earlier of notice to Borrower and discovery.
- Cross-default of other indebtedness of said amount.
- Event of insolvency or bankruptcy.
- Failure to pay a final judgment or court order.
- Cessation of business.
- Any attachment, sequestration, distress, execution or analogous event affecting Borrower’s assets having an aggregate value pre-agreed value that is not discharged within 30 days.
- Unlawfulness, non-effectiveness or repudiation of any material provision of the credit facility or a related finance document.

¹⁶⁷ Shipping Finance, 3d Edition, at 27.

¹⁶⁸ See Report on ship financing, OECD Council Working Party on Shipbuilding (WP6), page 12, available at www.oecd.org/dataoecd/55/6/47128870.pdf.

- Invalidity of a security document in any material respect or if any of those security documents ceases to provide a perfected first priority security interest; and
- If an event of default is outstanding, the lenders may cancel the credit facility and/or declare the outstanding amounts due and payable.

There is heavy negotiation between the borrower and the bank when it comes to the total loss of the ship because if the bank ultimately receives the insurance proceeds, there is no point in accelerating the loan and putting the borrower in default. It is possible to made arrangement that the total loss of the ship will not trigger the acceleration of loan repayment if the insurance proceeds are paid to the bank in full within a reasonable period of time acceptable to the bank.

The author will discuss a significant British High Court case¹⁶⁹ concerning, inter alia, the interpretation of equity cure provisions, events of default, notices of acceleration and powers to withdraw such notices.

The Ideal Standard Group sold and manufactured bathroom furnishings and fittings.¹⁷⁰ In 2007, the company was bought out by private equity funds advised by Bain Capital Limited.¹⁷¹ The acquisition vehicle was Ideal Standard International Acquisition SARL (IS), which was specifically incorporated for that purpose.¹⁷² On October 3, 2007, and in connection with funding arrangements for the acquisition, IS and various group

¹⁶⁹ Strategic Value Master Fund Limited v Ideal Standard International Acquisition S.A.R.L. & ORS [2011] EWHC 171(Ch) (U.K.), *available* at <http://www.bailii.org/ew/cases/EWHC/Ch/2011/171.html>.

¹⁷⁰ *Id.* para. 1.

¹⁷¹ *Id.* para. 2.

¹⁷² *Id.*

companies entered into a Senior Facilities Agreement (SFA).¹⁷³ In the original lending syndicate, Strategic Master Fund Limited (S) held a 10% participation.¹⁷⁴ Credit Suisse and Bank of America held approximately 66% of the loan, making them Majority Lenders.¹⁷⁵ Under the SFA, the following clauses were relevant:

Clause 22.2 – this contained a debt to EBITDA ratio; and an interest to EBITDA ratio.¹⁷⁶ The financial covenants, if met, would ensure that IS would become progressively less leveraged over time; and that its interest cover would increase.¹⁷⁷

Clause 22.5 – “If the requirements of any financial undertaking set out in Clause 22.2. . . . are not met in respect of a Relevant Period, the cash proceeds (“Cure Amount”) received by the Company pursuant to any New Equity (“Cure Subscription”) or additional Subordinated Debt (“Cure Loan”) invested in [IS] for the purpose of curing such breach shall be included in a recalculation of such financial undertaking by making a pro forma adjustment to EBITDA ...”¹⁷⁸ Where the recalculation had the effect that the financial undertakings were met, they were deemed to have been satisfied on the relevant test date.¹⁷⁹

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.* para. 9.

¹⁷⁷ *Id.*

¹⁷⁸ *Id.* para. 11.

¹⁷⁹ *Id.*

Clause 23.13 – “The Company shall not declare, make or pay dividends or pay any management, advisory or other fee to or to the order of any of the shareholders of the Company”.¹⁸⁰

Clause 23.18 – “The Company shall not trade, undertake commercial activities, own any assets or incur any liabilities except for:

(a) business as a holding company

(b) normal treasury and holding company activities”¹⁸¹

Clause 24.6 – “[It shall be an Event of Default if a Material Company] is, or is deemed for the purposes of any applicable law to be, unable to pay its debts as they fall due or insolvent”.¹⁸²

Clause 24.18 - “On and at any time after the occurrence of an Event of Default which is continuing the Facility Agent may, and shall if directed by the Majority Lenders by notice to the Company:

(a) cancel the Total Commitments ... and/or

(b) declare that all or part of the Utilizations, together with accrued interest, and all other amounts accrued or outstanding under the Finance Documents be immediately due and payable, at which time they shall become immediately due and payable; and/or

¹⁸⁰ *Id.* para. 13.

¹⁸¹ *Id.* para. 14.

¹⁸² *Id.* para. 16.

(c) declare that all or part of the Utilizations be payable on demand, at which time they shall immediately become payable on demand by the Facility Agent on the instructions of the Majority Lenders ...”¹⁸³

Clause 30.1 – “(a) ...any term of the Finance Documents may be amended or waived with the agreement of the Company and the Majority Lenders. The Facility Agent may effect, on behalf of any Finance Party, an amendment or waiver under this Clause 30.1(b). The Facility Agent must promptly notify the other Parties of any amendment or waiver effected by it under paragraph (a) above. Any such amendment or waiver is binding on all parties”.¹⁸⁴

Clause 30.2(b) – this set out exceptions to Clause 30.1, specifying certain amendments or waivers which required the consent of every lender directly affected by the amendment/waiver. It included “... any extension of the availability period of, maturity of or redenomination into another currency [of] any commitment of any Lender”.¹⁸⁵

Clause 30.4 – “The rights and remedies of each Finance Party under the Finance Documents:

(a) may be exercised as often as necessary;

(b) are cumulative and not exclusive of its rights under the general law; and

¹⁸³ *Id.* para. 17.

¹⁸⁴ *Id.* para. 19.

¹⁸⁵ *Id.* para. 20.

(c) may be waived only in writing and specifically”.¹⁸⁶

IS breached its financial covenants as to interest cover on September 30, 2009.¹⁸⁷ In order to effect an equity cure, a series of intra-group loans and prepayments took place all on the same day – October 29, 2009.¹⁸⁸ One of the transactions involved the redemption of PPPE Certificates (financial instruments with a capital and income element) which one of the group companies had issued to IS.¹⁸⁹

In practical terms, IS did not receive a fresh capital injection; €75 million was transferred out of the Group’s cash pool and returned to that pool later on the same day.¹⁹⁰ The parties agreed that, absent a valid equity cure, the Company had breached its financial obligations under Clause 22.2.¹⁹¹ The parties also agreed that IS’s liabilities exceeded its assets, as shown on its balance sheet; but that an excess of liabilities over assets are not grounds on which a company incorporated in Luxembourg can be wound up.¹⁹²

On February 2, 2010, the Majority Lenders instructed the Agent to serve notice of two Events of Default.¹⁹³ Credit Suisse and Bank of America subsequently sold their interests to the second and third defendants (two Bain entities), who purported to withdraw the

¹⁸⁶ *Id.* para. 21.

¹⁸⁷ *Id.* para. 23.

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ *Id.*

¹⁹¹ *Id.*

¹⁹² *Id.* para. 25.

¹⁹³ *Id.* para. 26.

notice and waive the Events of Default by way of a waiver letter dated June 30, 2010.¹⁹⁴ S commenced proceedings. The Judge said that there were four issues for him to decide as follows¹⁹⁵:

- a) Was the equity cure ineffective?
- b) Was the company “insolvent” within the meaning of the SFA?
- c) If the answer to either of those questions was “yes”, were the Majority Lenders entitled (a) to waive breaches of the SFA and/or (b) to withdraw the Default and Acceleration Letter and/or (c) to enter into a binding agreement not to make a demand for payment based on the Events of Default specified in it?
- d) Did the Majority Lenders in fact enter into an agreement not to make a demand based on those Events of Default?

The Judge held for the defendants:

Equity Cure

The Court quoted Lord Mance’s opinion on the interpretation of commercial contracts from the recent decision of the Supreme Court in *Re Sigma Finance Corp* [2010] BCC 40:¹⁹⁶

“In my opinion, the conclusion reached below attaches too much weight to what the courts perceived as the natural meaning of the words of the third sentence of cl.7.6, and too little weight to the context in which that sentence appears and to the scheme of the security trust deed as a whole...Of much greater importance in my view, in the ascertainment of the meaning that the deed would convey to a reasonable person with the relevant background knowledge, is an understanding of its overall scheme and a reading of its

¹⁹⁴ *Id.* para. 28.

¹⁹⁵ *Id.* para. 31.

¹⁹⁶ *Id.* para. 32.

individual sentences and phrases which places them in the context of the overall scheme.”¹⁹⁷

In Re Sigma Finance Corp, Lord Collins stated that “[a]n over-literal interpretation of one provision without regard to the whole may distort or frustrate the commercial purpose.”¹⁹⁸

In *Barclays Bank PLC v HHY Luxembourg SARL* [2010] EWCA Civ 1248, Longmore LJ said:

“If a clause is capable of two meanings, as on any view this clause is, it is quite possible that neither meaning will flout common sense. In such circumstances, it is much more appropriate to adopt the more, rather than the less, commercial construction.”¹⁹⁹

In this case, the Judge said that, “I entirely accept this as a principle of interpretation. Nevertheless I must also bear in mind the important warning of the Court of Appeal in *Bank of Nova Scotia v Hellenic Mutual War Risks Association (Bermuda) Ltd* [1990] QB 818, 890:

“It is nonetheless important, in attributing a purpose to a commercial transaction, to be sure that it is the purpose of both parties and not just one. If the purpose of the transaction is seen through the eyes of one party only an unbalanced view of the transaction may result. Many contracts represent a

¹⁹⁷ See *id.* para. 32. quoting *Re Sigma Finance Corp* [2010] BCC 40.

¹⁹⁸ *Id.* para. 33.

¹⁹⁹ *Id.* para. 34.

compromise between what one party wishes to obtain and the other is willing to give.”²⁰⁰

S’s arguments concerning the commercial purposes of the equity cure provisions concentrated on them entirely from the Lender’s perspective.²⁰¹ The usual or general accepted meaning of an equity cure is a right to inject fresh equity to cure a breach of financial covenant, and the claimant claimed much the same thing (“if there was no new money it could not be said that the commercial purpose of the financial obligations and the safety valve contained in the equity cure had been met”).²⁰² However, in the current case, this was not the point:

“As a matter of generality, there is considerable force in this submission. However, the commercial purpose of the clause must be found in the SFA itself, interpreted with the help of any admissible background. There are a number of features of the equity cure that need to be examined.”²⁰³

It was not appropriate to approach the construction of the equity cure provision with preconceptions about its commercial purpose.²⁰⁴ For example, under the SFA, IS was entitled to cure a breach of a financial covenant by borrowing more money.²⁰⁵ A fresh injection of capital was not mandatory.²⁰⁶ S argued that the “round-tripping” was a breach of

²⁰⁰ *Id.* para. 35.

²⁰¹ *Id.* para. 37.

²⁰² *Id.* para. 37.

²⁰³ *Id.*

²⁰⁴ *Id.*

²⁰⁵ *Id.* para. 38.

²⁰⁶ *Id.*

Clause 23.18.²⁰⁷ The Judge disagreed.²⁰⁸ There was nothing to indicate that the money transfers on October 29 were above and beyond “normal treasury and holding company activities”.²⁰⁹ Furthermore, the SFA contemplated IS receiving short-term loans on a revolving credit basis.²¹⁰

S also claimed that the redemption of the PPPE Certificates was a breach of Clause 23.13, arguing that the Certificates included an income element, and interest payable in respect of that was in effect a dividend.²¹¹ The Judge did not accept this, and gave the example of buying shares when the acquisition took place near the time of the declaration of a dividend.²¹² The price paid for such shares would be regarded as a capital sum, even though the purchase price would reflect the right to a dividend.²¹³ The Judge stated that, “The fact that income is (or may be) treated as a dividend when paid does not, in my judgment, alter the nature of the transaction of redemption”.²¹⁴

Insolvency

The claimants argued that under Clause 24.6 (Insolvency Event of Default), English law would always be the applicable law, since this was the governing law of the SPA.²¹⁵ However, the Court held that the phrase “applicable law” did not refer to the governing

²⁰⁷ *Id.* para. 43.

²⁰⁸ *Id.*

²⁰⁹ *Id.*

²¹⁰ *Id.*

²¹¹ *Id.* para. 42.

²¹² *Id.*

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.* para. 46.

law of the SFA; the law of Luxembourg was the applicable law, being the place where IS had been incorporated, and in addition, the law of any other jurisdiction which had the power to initiate winding-up proceedings (or any equivalent insolvency process).²¹⁶

The Court disagreed with the claimants' interpretation that the commercial purpose of the clause should be ascertained in the light of the lenders' needs to have certainty; and secondly, since all lenders at the inception of the SFA were English, they would naturally have been concerned to apply the English test of insolvency.²¹⁷ This appreciation of the commercial purpose of the clause looked at it only from the perspective of the lenders. Furthermore, lenders' interests in the loans were transferable. There was nothing in the SFA to prevent those interests from being transferred to assignees with no connection to England and Wales.²¹⁸ The English law "balance sheet" insolvency test therefore did not apply; and IS was not insolvent.²¹⁹

Notice of acceleration

The Judge pointed out that although the terms of Clause 24.18 permitted the Facility Agent to give a notice of acceleration, "in practice it is the Majority Lenders alone who will decide whether or not to give notice".²²⁰ The parties accepted that an acceleration notice could be withdrawn with the consent of all Lenders. Were the Majority Lenders entitled (a) to waive the breaches of the SFA and/or (b) to withdraw the Default and

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ *Id.* para. 45.

²²⁰ *Id.* para. 48.

Acceleration Letter and/or (c) to enter into a binding agreement not to make a demand for payment based on the Events of Default specified in it?²²¹

The SFA distinguished between the waiver of breaches; events of default; rights and remedies; and terms.²²² It did indeed provide that a party might give up its own rights, but not the rights of others.²²³

The claimants argued that the supposed dichotomy between waiver of a right and waiver of a term was a distinction without a difference.²²⁴ Before the Notice of Acceleration was withdrawn (assuming it was validly withdrawn) the loans were repayable on demand; after the Notice was withdrawn they were not repayable on demand.²²⁵ This must be either because the contractual rights and obligations of the parties had been amended by agreement, or because some part of them had been waived.²²⁶ On either view, the terms of the Finance Documents had been either “amended” or “waived”.²²⁷ Therefore, Clause 30 applied and the consent of all lenders would be required in the circumstances specified in that clause as requiring all lender consent.

The defendants argued that it was clear that Clause 30.1, which dealt with waiver of a “term”, and Clause 30.4, which dealt with waiver of a “right of remedy” belonging to an

²²¹ *Id.* para. 31.

²²² *Id.* para. 53.

²²³ *Id.* para. 54.

²²⁴ *Id.* para. 55.

²²⁵ *Id.* para. 66.

²²⁶ *Id.*

²²⁷ *Id.*

individual lender, were intended to deal with distinct matters.²²⁸ The parties had drawn a distinction between waiver of a “term” (30.1 and 30.2) and waiver of a “right or remedy” (30.4).²²⁹ The Court decided that as a matter of construction, Clause 30.1 applied where the waiver extended beyond the rights of the waiving party.²³⁰ Thus, if a lender (whether a Majority Lender or not) waived its own rights, then Clause 30.4 applied.²³¹ However, if the Majority Lenders wished to waive the rights of all relevant lenders on an issue, then Clause 30.1 and 30.2 applied.²³²

The Court concluded that the defendant’s interpretation was correct.²³³ A party could give up his own rights but not other people’s.²³⁴ The Majority Lenders were merely “giving up the right to rely on a particular invocation of the rights afforded to the Majority Lenders by Clause 24.18 [which was] not a waiver of that term”.²³⁵ That term remained in being and was available to be used on future occasions. Clauses 30.1 and 30.2 were not, therefore, engaged.²³⁶ Therefore, the notice had been validly withdrawn.²³⁷

²²⁸ *Id.* para. 67.

²²⁹ *Id.*

²³⁰ *Id.*

²³¹ *Id.*

²³² *Id.*

²³³ *Id.* para. 70.

²³⁴ *Id.* para. 69.

²³⁵ *Id.* para. 69.

²³⁶ *Id.*

²³⁷ *Id.* para. 70.

In order to minimize the risks and be prepared to deal with a default, a lender shall monitor the performance of the borrower to give early warning that the risk of a potential event of default is increasing and have a well-thought strategy for handling any defaults which might occur. It is good practice for the banks to routinely check the financial strength of the borrowers by periodic reviews of the company's financial statements.

Also, the assignments of all freights, earnings and insurances and an enforceable ship mortgage to the lender can provide basic protection. The author will discuss more in the next section of this Chapter.

Once an event of default has occurred, the lender need to know promptly the location of the ship, the conditions of the ship, the cargo aboard the ship and the claims by other creditors. The location of the ship determines the jurisdiction for arresting the ship. If the ship is in a poor condition, it cannot be moved until repairs have been made. Other claims need to be dealt with promptly, such as crew wages, rank ahead of the mortgage.

Different situations will give the bank different choices, such as, foreclose and sell the ship privately, foreclose and sell the ship through admiralty sale, foreclose and trade on with a new company or provide the owner with the financial support to trade on.²³⁸

2.3.9. "Indemnities"

Under the loan facility, the borrower undertakes to fully indemnify the bank on its demand in respect of all claims, expenses, liabilities and losses which are made or brought against or incurred by the bank, or which the bank reasonably and with due diligence estimates that it will incur, in connection with any actions specified under the Loan Agreement.

²³⁸ See Martin Stopford, *Maritime Economics* 315 (3rd ed. 2009).

A 2010 English High Court case²³⁹ considered the efficacy of an indemnity clause. In the 1990s, Eagle One Limited (E) and Rockeagle Festival Shopping Limited (EF) were property development companies, appointed to construct a shopping village in Ebbw Vale, Gwent.²⁴⁰ The development site had formerly been used for the dumping of steel waste products from the old Ebbw Vale steel works.²⁴¹ In 1995, E retained Rust Consulting Limited (R), a geotechnical engineering consultancy, to advise on the stability of the site and its suitability for development.²⁴² In February 1996, R provided E with an Interpretative Geotechnical and Environmental Report.²⁴³ On November 8, 1996, R entered into a Deed of Warranty for the benefit of EF.²⁴⁴ Under the Deed, R warranted that it had exercised reasonable skill and care in the performance of its duties; and promised to maintain professional indemnity insurance of at least £2 million for twelve years following the issuance of its Report.²⁴⁵ By way of an Asset Purchase Agreement dated September 15, 1997, the business of R was acquired by PB Limited (P).²⁴⁶ Under the Agreement, the following provisions were relevant:

Definition of “Liabilities” – “the book debts and other liabilities ... owing
by the Vendor (i.e. R) at Completion insofar as they are attributable to the

²³⁹ Rust Consulting Limited (in Creditors’ Voluntary Liquidation) v. PB Limited (formerly Kennedy & Donkin Limited) [2010] EWHC 3243 (TCC) (U.K.), *see also* available at <http://www.bailii.org/ew/cases/EWHC/TCC/2010/3243.html>.

²⁴⁰ *Id.* para. 1.

²⁴¹ *Id.*

²⁴² *Id.* para. 2.

²⁴³ *Id.*

²⁴⁴ *Id.* para. 3.

²⁴⁵ *Id.*

²⁴⁶ *Id.* para. 6.

Business, the Assets, the Subsidiaries or the Contracts and insofar as they are reflected in the accounts of the Vendor ... as at [31 December 1996]...”²⁴⁷

Definition of “Contracts” – “all contracts, orders and commitments of the Vendor ... under which the obligations of all the parties thereto had not at [31 December 1996] been fully performed”²⁴⁸

Clause 3.1 – “The consideration for the sale and transfer by the Vendor is (i) the sum of £1,000 and (ii) the Purchaser assuming responsibility for the satisfaction, fulfilment and discharge of all the Liabilities and the Contracts of the Business outstanding at [31 December 1996] and the Purchaser hereby indemnifies and covenants to keep indemnified the Vendor against all proceedings, claims and demands in respect thereof....”²⁴⁹

On November 13, 2007, E and EF commenced proceedings against R.²⁵⁰ They alleged that the buildings on the Ebbw Vale site were suffering structural damage due to the steel slag waste in the soil rendering the foundations unstable; and that R had been negligent in its advice.²⁵¹ On April 24, 2008, R went into creditors’ voluntary liquidation.²⁵² R’s liquidators consented to judgment being entered against R in favor of

²⁴⁷ *Id.* para. 15.

²⁴⁸ *Id.*

²⁴⁹ *Id.* para. 7.

²⁵⁰ *Id.* para. 2.

²⁵¹ *Id.*

²⁵² *Id.*

E for damages of approximately £8 million.²⁵³ R's liquidators were pressed by EF and E to claim against P under the indemnities contained in the Asset Purchase Agreement.²⁵⁴ The liquidators commenced proceedings to determine as to whether P was obliged to indemnify R against its liability to E.²⁵⁵

The Judge held in favor of the defendant because “[p]arties can use the words ‘indemnity’, ‘guarantee’ or ‘warranty’ but whatever such words they use, one needs by way of contractual interpretation to determine what is being indemnified, guaranteed or warranted.”²⁵⁶ If the indemnifier had agreed to pay any relevant judgment sum (or whatever might be awarded by an expert/arbitrator), then the sum could be recovered.²⁵⁷ Clear words were required to establish such an agreement.²⁵⁸ However, if the indemnity only covered “liabilities” (as was the case in Clause 3.1) then those liabilities had to be established against the indemnifier.²⁵⁹

The fact that proceedings were issued against R, or even that judgment (whether by consent or contested) had been entered against R, did not mean that P was automatically liable to indemnify it.²⁶⁰ There might be circumstances where an indemnifier could be estopped from arguing that the amount agreed or awarded was more than the amount due.²⁶¹ Relevant factors might include: whether the indemnifier had notice of the

²⁵³ *Id.* para. 5.

²⁵⁴ *Id.* para. 8.

²⁵⁵ *Id.* para. 10.

²⁵⁶ *Id.* para. 42.

²⁵⁷ *Id.* para. 45.

²⁵⁸ *Id.* para. 45.

²⁵⁹ *Id.*

²⁶⁰ *Id.*

²⁶¹ *Id.*

proceedings, if the indemnifier had actively participated in proceedings (this might “go much further” to establishing an estoppel against it), and whether it had been involved in any settlement. Concurring with any judgment would “go further still” in establishing an estoppel.²⁶²

R would have to prove that P was liable for any particular sum; and, as a matter of fact, whether P was estopped from challenging the judgment.²⁶³ It seems that in drafting the project finance facility agreement and any related guarantee or security, it might be prudent to include express language in the indemnity clause that allows the banks, their agent or security trustee (the “beneficiary”) to be paid an indemnity by the borrower or security party where the beneficiary has settled, compromised or consented to a claim against the beneficiary by a third party where the borrower or security party is contractually obliged to indemnify the beneficiary for that payment (absent any restrictive or exclusionary language – the wilful misconduct or gross negligence of the beneficiary, for example).

3. Security Documents in connection with the Loan Agreement

3.1 Introduction

From the lending perspective, three components are mostly concerned by the credit institutions: the asset, the cash flow and corporate recourse. With ship financing as a form of asset financing, the credit analysis focus on the asset itself along with other securities granted by the borrower²⁶⁴:

- Ship Mortgage

²⁶² *Id.*

²⁶³ *Id.* para. 49.

²⁶⁴ See Lloyds Maritime Academy Amitlaw Maritime Finance Workshop, Michael Kenny & Sandra Sinclair-Hughes, Ghana, September 27, 2010.

- Other Security
 - Guarantee (personal/corporate)
 - Earnings
 - Charters
 - Insurances
 - Requisition Compensation
 - Share Charge/Pledge
 - Accounts/Cash Security

An extract of Judge Goff's opinion in a precedent illustrates the significance of the securities granted by the borrower in favor of the lenders, securing its obligations and liabilities under the Loan Agreement.

“For at least a quarter of a century, if not more, the method of obtaining finance for building ships (which was adopted in this case by finance obtained from the First National City Bank – now called Citibank) was widely adopted on both sides of the Atlantic. It may be summarized in these words. The bank advances to one or more owning companies a large sum of money. It of course requires security. It will take a mortgage on the ship for that security. It may take other mortgages, on other ships for the same security. If the ship, as often happens, is about to be time chartered, then the bank will take an assignment of the time charter in order that the bank as assignee can benefit from the time charter in order to reduce the mortgage debt. In addition it will almost invariably in my experience take an assignment of insurance policies and P. and I. Club cover in order that in the event of total or partial loss of the ship the bank as the lender may be suitably secured. As a result, over the last quarter of a century when many ships similarly built and financed have been totally lost banks have found themselves completely protected in the events which have happened. The effect of all this is to ensure that the lending bank is completely secured against the insolvency of the borrower who intends that the bank shall obtain complete priority over the claims of other creditors against the borrower.”²⁶⁵

Generally speaking, the definition of “Security Interest” and “Security Party” in a Loan Agreement is as follow:

²⁶⁵ See The “Lancaster” (1980) 2 Lloyd’s Rep. 497.

“Security Interest” means:

- (a) A mortgage, encumbrance, charge (whether fixed or floating) or pledge, any maritime or other lien or privilege or any other security interest of any kind;
- (b) The security rights of a plaintiff under an action in rem; and
- (c) Any arrangement entered into by a person (A) the effect of which is to place another person (B) in a position which is similar, in economic terms, to the position in which B would have been had he held a security interest over an asset of A; but this paragraph (c) does not apply to a right of set off or combination of accounts conferred by the standard terms of business of a bank or financial institution.

“Security Party” means: the Borrowers, the Guarantors and any other person who, as a surety, guarantor, mortgagor, assignor or pledgor, as a party to any subordination or priorities arrangement, or in any similar capacity, executes a Finance Document.

3.2 Assignments of charter, earnings, insurances and charter guarantee

In a shipping finance transaction, the lender will take collateral as security to secure the obligation of the borrower to repay a loan. Literally, an invariable part of a financing bank’s security package is an assignment of the earnings and the assignment of insurances of a mortgage vessel.²⁶⁶ If the vessel is to be time chartered or bareboat chartered, an assignment of time charter/bareboat charter is also required by the lender. In a mortgage on the vessel, a shipowner (or mortgagor) gives a lender (or mortgagee) an interest in the vessel as security for a loan. A ship mortgage legally consists of three parts:

²⁶⁶ See Stephenson Harwood, *Shipping Finance* 225 (3d ed. 2006).

the mortgage loan, the mortgage document (deed) and the rights derived from the mortgage deed onto the lender.

The underlying reason for the bank to take the assignments is not hard to understand. Most often as we have seen, the bank will perhaps be lending to a one-ship company or a special purpose vehicle (the “SPV”) set up by the borrower. The SPV will be the owner of the vessel and thus will be the assignor to assign earnings, charter and insurances interests derived from the vessel operation to the lender. In the context of the ship mortgage, the SPV will be the mortgagor. The lender is assured by no other source of income but the income from the operation of the vessel.²⁶⁷ Therefore, the lender will want to exercise control over the money flow from the vessel.

The assignments are assignment of rights but not liabilities. Under the contract law doctrine, assignment of rights under a contract is a complete transfer of the rights to receive the benefits accruing to one of the parties to that contract. The obligations remain with the owner (or assignor). Such an assignment is contractually exchanged for consideration, namely, the borrower’s promise to assign all rights and interests under the charter, earnings and insurances of the operation of the vessel, in exchange of the lender’s loan facility made available to the borrower.

After getting the collateral security from the borrower, it is the most important to the lender that the rights and interests assigned to it remain valid and existing. Otherwise, the assignments are meaningless. If the charterer defaults or becomes bankrupt, the assignment will be of no value to the lender.

For example, a New York listed dry bulk shipowner Eagle Bulk Shipping renegotiated the time charters of 12 dry bulk carriers it had on long-term charter to bankrupt Korea Line Corporation (“KLC”), one of the largest operators of dry bulk

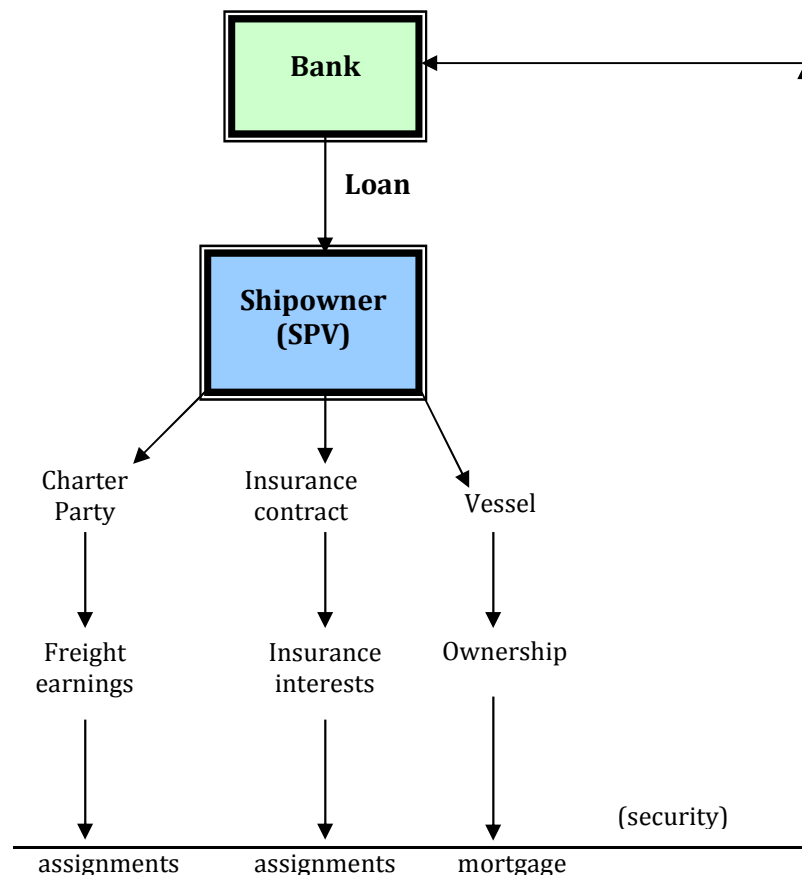
²⁶⁷ *Id.*

tonnage in Asia.²⁶⁸ KLC's fall is a prime example that, under such circumstances, lenders will exercise control over the ship to secure the repayment of the loan. Nordea Bank AB (NDA)'s Singapore branch seized two vessels from KLC's local subsidiary in a bid to recoup \$64.9 million in debt.²⁶⁹ The ships were pledged as collateral for an \$82 million loan in October 2006, NDA said in a March 17, 2011 lawsuit with the Singapore High Court.²⁷⁰

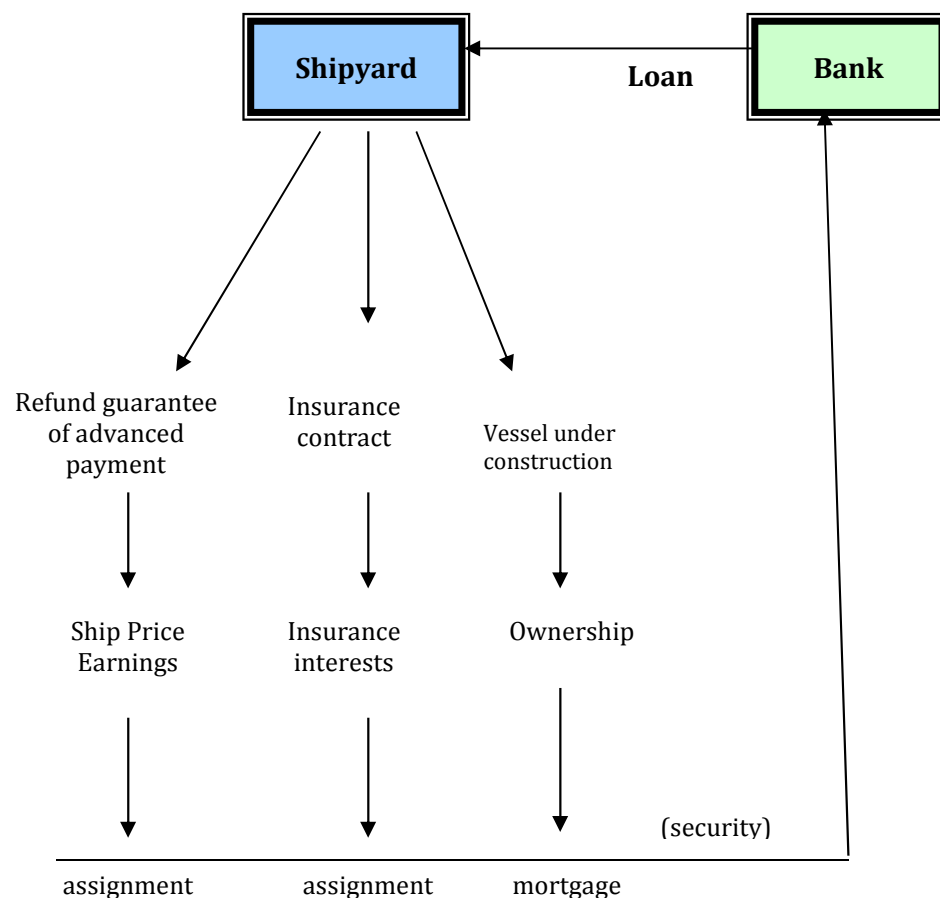
²⁶⁸ See available at <http://www.platts.com/RSSFeedDetailedNews/RSSFeed/Shipping/8715355>.

²⁶⁹ See available at <http://www.bloomberg.com/news/2011-03-25/nordea-bank-seizes-korea-line-singapore-vessels-to-recoup-debt.html>.

²⁷⁰ Nordea Bank Finland Plc, Singapore Branch v Korea Line (Singapore) Pte OS220/2011.



As shown by the diagram above, for post-delivery financing, when the borrower is also the shipowner, the lender will want to ensure that the borrower is able to meet the repayment installments. The money to service and repay the debt is likely to come from the income generated by the ship. The security package agreed with the borrower should reflect these concerns, such as; the lender takes assignments of earning, insurances, and will be granted a mortgage over the ship as security.



As illustrated by the diagram above, for pre-delivery security for newbuildings, the lender usually take an assignment over the buyer's rights under the shipbuilding contract, any refund guarantees, the buyer's interest in the construction risk insurance and any other security given to the buyer for the shipbuilding's performance and obligations of the shipbuilding contract.

▪ Charter Assignment

In asset-based financing for vessels, most lenders rely upon the earnings generated by the vessels to provide additional security.²⁷¹ The SPV as the owner/assignor, as the case

²⁷¹ See gen., E. Mahla, Some Problems In Vessel Financing—A Lender's Lawyer's View, 47 Tul.L.Rev. 629, 634–38 (1973).

may be, charters the Ship to the Charterer, pursuant to the terms of a bareboat or time charter agreement. It is one of the conditions precedent to the availability of the loan facility under the Loan Agreement that the assignor executes and delivers the assignment in favor of the security trustee as assignee, for the benefit of the lenders, as security for the secured liabilities and the performance and observance of and compliance with the covenants, terms and conditions contained in the Loan Agreement.

The assignor will grant to the lenders security interest in and to all of the assignor's right, title and interest in the following property, whether now owned or existing or hereafter from time to time acquired: (1) the charter; (2) all claims, rights, remedies, powers and privileges for moneys due and to become due to the assignor pursuant to the charter; (3) all claims, rights, remedies, powers and privileges for failure of the charterer to meet any of its obligations under the charter; (4) the right to make all waivers, consents and agreements under the charter; (5) the right to give and receive all notices and other instruments or communications under the charter; (6) the right to take such action, including the commencement, conduct and consummation of legal, administrative or other proceedings, as shall be permitted by the charter, or by law; (7) the right to do any and all other things whatsoever which assignor may be entitled to do under the charter including, without limitation, termination of the charter; and (8) any proceeds of the foregoing.²⁷²

The lenders want to make sure that, in the event of default, the charterers can be called on to pay earnings to the lenders free of any claim from the borrower or its liquidator.²⁷³ The lenders, as assignee under the assignment, shall have no liability under the charter arising out of the assignment nor shall the assignee be obligated to fulfill any of

²⁷² It is summarized on the basis of the author's practical experience.

²⁷³ See Stephenson Harwood, *Shipping Finance* 225.

the duties of the assignor under the charter or to make any payment as to the nature or sufficiency of any payment received by the assignee or to file any claim to enforce the payment of any amounts which may have been assigned to it.

Also, it is hardly surprising that the lender will insist on bareboat charters being on a “hell and high water” basis in order for the hire to continue to be payable to the lender.²⁷⁴

▪ **Earnings Assignment**

Although certain earnings are treated as a legal extension of the vessel itself, the U.S. Ship Mortgage Act does not automatically extend a mortgage to a vessel’s earnings.²⁷⁵ Therefore, earnings of the vessel will not be covered by a ship mortgage unless expressly mentioned in the granting clause. That’s why lenders also will require earnings assignments.

The main source of the vessel earnings for the ship-owning borrower will be freights/charter hire from the charterers. These earnings will normally be used as repayment of the loan and interest. There are three kinds of charterparties: the time charter, the voyage charter and the bareboat charter.

The definition of earnings, as we have seen in transactions, means all moneys whatsoever which are now, or later become, payable (actually or contingently) to the debtor and which arise out of the use or operation of the Ship, including (but not limited to):

- (a) all freight, hire and passage moneys;

²⁷⁴ The Hell and High Water (HHW) Clause provides that the charterer is obliged to pay the agreed hire daily rate under all circumstances including fatal accidents, stoppages of all sorts, Seizures, strikes etc. It compels the Charterer to make Payments regardless of what happens to the Shipowner or to the Collateral vessel.

²⁷⁵ See Vessel Financing Issues, by Francis X. Nolan, III, American Law Institute - American Bar Association Continuing Legal Education, ALI-ABA Course of Study (March 25, 1993) citing *In Re Levy-Mellon Marine*, 61 B.R. 331 (Bkcty.W.D.La.1986).

- (b) compensation payable to the owner or the bank in the event of requisition of the Ship for hire;
- (c) remuneration for salvage and towage services;
- (d) demurrage and detention moneys;
- (e) damages for breach (or payments for variation or termination) of any charterparty or other contract for the employment of the Ship;
- (f) all moneys which are at any time payable under Insurances in respect of loss of hire; and
- if and whenever the Ship is employed on terms whereby any moneys falling within paragraphs (a) to (f) are pooled or shared with any other person, that proportion of the net receipts of the relevant pooling or sharing arrangement which is attributable to the Ship.

The bank usually requires the earnings to be paid to an account held with the bank, for the ease of monitoring the vessel's income. In the case of the bareboat charter, given the fact that the demise charterer has the management, control and crew of the vessel in the duration of the charterparty, a bank will run credit checks with the bareboat charter very closely, and that's why sometimes the bank also requires a guarantee from the charterer's guarantor.

The owner will give notice of assignment to the charterer and in return the charterer will acknowledge and consent to the assignment in undertaking to pay the hire/freight to the bank free of set-off or counterclaims.

▪ **Insurance Assignment**

In the event of a major accident involving the vessel, the proceeds of any insurance claim will be paid directly to the lender towards payment of the outstanding debt.²⁷⁶ The precedent²⁷⁷ of United States District Court for the Southern District of New York noted

²⁷⁶ See Stephenson Harwood, *Shipping Finance* 225.

²⁷⁷ *Marine Insurance Survey, A Comparison of United States Law to the Marine Insurance Act of 1906*, by Robert Bocko et al., 20 Tul. Mar. L.J. 5 citing *Caribe Carriers v. C.E. Heath & Co.*, 784 F. Supp. 1119,

that “marine insurance policies are not incidents of ownership and do not pass automatically with the sale of the insured property.”²⁷⁸ Where a marine insurance policy has been assigned so as to transfer the beneficial interest therein, “the assignee is entitled to sue in his own name; and the defendant is entitled to make any defense arising out of the contract which he would have been entitled to make if the action had been brought in the name of the person by or on behalf of whom the policy was effected”.²⁷⁹

By the insurance assignment, the bank participated in the owner’s insurance policies either as (i) loss payee or (ii) assignee or (iii) co-assured.

As loss payee, the bank may be paid only in circumstances where the owner himself might be paid because the loss payee is not a party to the insurance contract and therefore enjoys no greater rights or entitlement to the insurance money than the owner would. If the loss payable clause in the notice of assignment provides that “in the event of an actual or constructive total loss or a compromised or arranged total loss or requisition of title, all insurance payments shall be paid to the bank/mortgagee for distribution by it in accordance with the terms of the Mortgage on the ship”, it constitutes an assignment of insurance proceeds.

As assignee, the bank will have an enforceable right to payment under the policy against the insurer. However, if the insurer could defend a claim on the grounds of owner’s breach of duty of good faith or of its willful misconduct, the bank would have to be subject to the defects. There are various risks of non-payment by the insurers of the hull and machinery insurance and/or the war risks insurance and/or the P&I club coverage (collectively, “Owner’s Policies and Club Entries”), namely that: (i) misrepresentation or

1992 AMC 1382 (S.D.N.Y. 1992).

²⁷⁸ *Id.* FN 69.

²⁷⁹ *Id.* at 17.

non-disclosure of any material circumstance from the shipowner or manager or any of the assured's insurance agents or insurance brokers; (ii) breach of any express or implied warranty or condition; (iii) any fraudulent damage to the vessel, such as arson; (iv) failure of the assured, the shipowner, the manager or agent to exercise due diligence in respect of any loss or damage to the vessel; and so forth.²⁸⁰ The security interests of the mortgagee (as assignee and loss payee of the insurance claims recoveries) will be impaired if a marine insurance claim is legitimately declined by insurers.

As co-assured, there are different theories: one, the interests insured are identical so that a loss or gain affects all the co-assureds to the same extent²⁸¹; the other, a bank as a co-assured will have a severable interest to that of the owner.²⁸²

²⁸⁰ See *Shipping Finance 3d Edition*, at 521-522.

²⁸¹ See *General Accident Fire & Life Assurance Corp Limited v. Midland Bank Limited* [1940] 2 KB 388.

²⁸² *Id.*

▪ **Charter and Charter Guarantee Assignment**

This is identical mechanism as that of the Charter Assignment, adding only rights and interests under the Charter Guarantee as assigned collateral to the bank. The assignment include: all claims, rights, remedies for moneys due and to become due to the assignor pursuant to the Charter Guarantee.

3.3 General Assignment

General Assignment is usually used in English law governed loan facility, by which the ship's earnings, insurances and requisition compensations are assigned by the owner to the bank. "Requisition Compensation" includes all compensation or other moneys payable by reason of expropriation, confiscation, requisition or acquisition of the ship, whether for full consideration, a consideration less than its proper value or without any consideration, which is effected by any government or by any person claiming to be or to represent a government. Each security interest is a separate security interest and if any one of them is a floating charge, it shall not result in any of the others being a floating charge.

3.4 Earnings Account Pledge

Pledge is a form of bailment in which possession of the asset is transferred to the creditor by way of security. The creditor is considered to acquire a special property in the asset, and has an implied power of sale on default.²⁸³ A company might pledge a bill of lading; that would be equivalent to a pledge of the goods. A pledge may also be given of a bill of exchange or a bearer bond; but an attempted pledge of share certificates not in

²⁸³ See Commercial Law (2nd edn 1995) at 643-4.

bearer form will take effect as an equitable mortgage, that is, an agreement to execute a transfer of the shares by way of mortgage.²⁸⁴

As to pledging a bill of lading, practically speaking, a so called “trust receipt” is always used. For example, P, in London, is importing goods from Brazil, intending to sell them shortly after they arrive in England. P borrows from his bank to pay for the goods, intending to repay when he sells them. As security, P pledges the bills of lading, equivalent to a pledge of the goods themselves. There is only one problem. The bank’s pledge depends on its retaining possession of the bills of lading; but P needs the bills of lading in order to obtain delivery of the goods when the ship arrives in England. The trust receipt solves this problem. The bank hands P the bills of lading against a receipt signed by P stating that P has received the bills of lading on trust for the bank’s account, and that P undertakes to hold the goods and their net proceeds on trust for the bank and to remit the net proceeds as realized. If the original pledge was valid, the trust receipt creates no charge; neither on the goods nor their proceeds. Its sole effect is to ensure that the bank’s pre-existing security, created by the original pledge, remains in effect and continues into the proceeds of sale.²⁸⁵

There are different forms of pledge. In the asset-based lending, pledge on earnings account is often used. “Earnings Account Pledge” means the pledge executed or, as the context may require, to be executed by the borrower in favor of the lender/creditor parties, in respect of the earnings account, in such form as the lender/creditor parties may require in its/their sole discretion.

²⁸⁴ Harrold v. Plenty [1901] 2 Ch 314.

²⁸⁵ In re David Allester Ltd [1922] Ch 211.

3.5 Share Pledge and Share Charge

The main advantage in taking security over the shares of the borrower is that the bank will be readily able, in the event of default, to sell the vessel owning borrower, rather than just the vessel itself. However, there is some concern that taking physical possession of the share certificates by way of security will increase the bank's risk being considered and liable as an operator of the vessel for the purpose of the OPA 1990.

"Share pledge" is different from "Share charge". A pledge is the form of security where shares are in bearer form, whereas a charge where shares are in registered form. The bearer of the shares owns the shares and, as such, the title to bearer shares passes on delivery of the share certificates to the bank. In contrast, title to registered shares does not, depending on express transfer. The chargor will execute undated forms of transfer of the shares with transferee's names left blank; in the event of default the bank will be able to perfect its title to the shares and to sell the shares.

For both pledge and charge, the pledgee and charge will required the pledgor and chargor to execute undated resignations of all the directors of the pledger and chargor in order for the bank to easily replace the directors with its own people to manage the company in the event of default.

Share pledges and share charges contain very similar provisions, as summarized by Sheila Obhrai, as follows²⁸⁶:

- "a warranty by the shareholder that the pledged or charged shares represent the whole of the authorized and issued share capital of the company and that the shares are fully paid;

²⁸⁶ Shipping Finance 3d Edition, at 249.

- a warranty that the shares are free from encumbrances, options and so on, and a covenant not to create any encumbrances, grant any options and so on;
- usual warranties as to title;
- an undertaking to procure that the borrower issues no further shares;
- either an undertaking not to exercise voting rights in a manner inconsistent with the rights of the bank or [] a transfer of the voting rights to the bank;
- a Power of Attorney enabling the bank on default to exercise all rights relating to the shares, to put into effect the directors' resignations and to sell the shares; and
- other standard provisions of charging documents.”

More recently, lenders have experienced the greatest returns from an enforcement of their security to be from the sale of the shares of the borrower company rather than from the sale of individual assets. However, enforcement of share security, unlike enforcement of ship mortgages, does not discharge maritime liens. Such liens would remain in place and will need to be satisfied. Also, taking share security may expose the lender to possibility of lender liability, such as liability for certain environmental issues.

It is highly unlikely that under English law lenders can be held liable for pollution caused by a vessel if such vessel is in the mortgagor's possession. The same position exists in the European Union and similar provisions apply in the U.S. A lender can, however, be liable if it takes possession of a vessel and that vessel causes pollution.²⁸⁷ Therefore, lenders should carry out full due diligence, insist that insurance is in place

²⁸⁷ Andrew Evans and Hannah Salton, *Potential Lender Liability When Taking Security Over An Asset* (Last Updated: January 25, 2013).

sufficiently covering borrower and itself from third party environmental liability and carefully consider how they enforce their security so they avoid potential liability.

3.6 Floating Charges

It is of the essence of a charge that a particular asset or class of assets is appropriated to the satisfaction of a debt or other obligation of the chargor or a third party, so that the chargee is entitled to look to the asset and its proceeds for the discharge of the liability.²⁸⁸

Since legal title is not transferred, a charge must necessarily be equitable. A charge has been described as “merely an encumbrance, a weight hanging on the asset which travels with it into the hands of third parties other than a bona fide purchaser of the legal title for value and without notice.”²⁸⁹

There is distinction between a fixed and a floating charge:

“The essence of a floating charge is that it is a charge, not on any particular asset, but on a fluctuating body of assets which remain under the management and control of the chargor, and which the chargor has the right to withdraw from the security despite the existence of the charge. The essence of a fixed charge is that the charge is on a particular asset or class of assets which the chargor cannot deal with free from the charge without the consent of the chargee. The question is not whether the chargor has complete freedom to carry on his business as he chooses, but whether the chargee is in control of the charged assets.”²⁹⁰

The typical negative pledge clause in a financing transaction is to be found in the standard form of floating charge, by which the debtor undertakes that it will not, without the prior written consent of the debenture holder, grant any subsequent security ranking in priority to or *pari passu* with the floating charge. In international loan finance, the

²⁸⁸ See *In re Cosslett (Contractors) Ltd* [1998] Ch. 495, 508.

²⁸⁹ See *Legal Problems of Credit and Security* (2nd edn 1988, p. 14).

²⁹⁰ See *Smith (Administrator of Cosslett (Contractors) Ltd v. Bridgend County Borough Council* [2002] 1 AC 336 at 41.

negative pledge is commonly taken by an unsecured lender and is often designed to secure equality rather than priority.²⁹¹

In consideration of the bank agreeing to make the loan available to the borrower, the guarantor undertakes that, during the facility period, it shall not, without the written consent of the bank, create, or permit to subsist, any encumbrance over the accounts or account balances it has with the bank. The accounts usually refer to the earnings account, the money market accounts, dealer deposit accounts or other subsidiary accounts of the guarantor.

The lender holds “a contractual guarantee that property in which the debtor has equity will remain unencumbered and unconveyed, and thus available for levy and execution should the creditor reduce his debt to judgment”.²⁹² However, if a lender is required to show that enforcement of an instrument is necessary to protect its security interest in order to validate the instrument, is a negative pledge agreement enforceable given that it creates no security interest? Some courts render unenforceable any agreement that unreasonably restricts the right to transfer property. While many types of restraints have been found to be reasonable, some freely agreed to by the parties have also been held to be unenforceable. Lenders should consider securing the loan with a typical deed of trust instead of a negative pledge agreement.²⁹³

By way of update, the UK Overseas Companies (Execution of Documents and Registration of Charges) (Amendment) Regulations 2011 was passed to come into effect on October 1, 2011. Overseas companies that have a registered establishment in the UK are required to register any charges they create over property *in the UK at the time the*

²⁹¹ See Goode on *Legal Problems of Credit and Security*, 4th ed., 2008 at 51-52.

²⁹² See *Tahoe National Bank v. Phillips* in 1971.

²⁹³ See David Harris, *Negative Pledge Agreements: Are They Enforceable?* (BankNews Publications).

charge is created. This may present some difficulties to a lender wishing to protect its security. In particular:

- the location of intangible property may be uncertain
- it may be challenging for a lender to discover whether an overseas company has a registered UK establishment, because the name under which it registers such an establishment may be very different to its incorporated name. For example, a Chinese company could have a UK trading name which is entirely different to its incorporated name in China.

However, despite these problems, if a registerable charge is not registered within 21 days of its creation, the security becomes void against a liquidator, administrator or creditor company. Current law also requires overseas companies to keep a charges register giving brief details of their registerable charges. The register and copies of the relevant instruments can be kept at any location in the UK that has been notified to the Registrar of Companies.

Under these amending Regulations: overseas companies will no longer be required to register charges created over UK property, and the requirements for an overseas company to keep details of its registerable charges have also been revised:

- an overseas company will be required to keep a register of charges granted over land in the UK; charges over ships; aircraft and intellectual property registered in the UK; and floating charges (except any whose terms expressly exclude property in the UK);
- an overseas company will be required to make available for inspection copies of the instruments noted on its own register of charges and of any charge over assets in the UK, subject to notice requirements;
- the Regulations also provide for electronic inspection as an alternative.

3.7 Guarantee and Indemnity

There are different types of guarantees, for example, performance guarantee and on-demand guarantee.

In the context of the performance guarantee, for example, the builder agrees to build a vessel for a buyer. The contract states that if the builder builds the vessel with defects it shall be liable in damages for up to \$35million, the maximum liability. As security for the maximum liability, the builder procures a guarantee from X on terms that if the builder is found liable for a defect, including after a court judgment or arbitration award, X will pay the due amount on demand. The buyer claims that the vessel is defective and that it is owed \$20million in damages. The builder disputes this and a court finds in favor of the builder. Nothing is due from the builder to the buyer and the builder cannot make any demand under X's guarantee.

In the context of on demand guarantee, assuming the same facts as above, except that the builder has received an on demand guarantee from X that states simply that X shall pay the builder up to \$35million on receipt of a demand from the buyer stating that this amount is due from the builder. X pays the buyer. The builder disputes the claim and wins. The buyer has in the meantime become insolvent and either the builder or X, claiming back the \$35million that the buyer received after it made its demand under the demand guarantee. X's payment may be irrecoverable from the insolvent buyer, and, if the builder agreed to indemnify X for any payments X made under its guarantee, the builder will be liable for payments that were never due to the buyer under the construction contract.

In ship financing transactions, usually the borrowers are special purpose vehicles and, the parent company will give a guarantee to the bank and guarantee the borrower's obligations under the Loan Agreement and other finance documents to which the

borrower is or will become a party in connection with the loan facility. In consideration of the bank to make loan to the borrower, the guarantor irrevocably and unconditionally guarantees to the bank to discharge the indebtedness from time to time on first demand, and as a separate and independent obligation, agrees that if any of the indebtedness is not recoverable from the guarantor for any reason, the guarantor will be liable to the bank as a principal debtor by way of indemnity for the same amount as that for which the guarantor would have been liable had that indebtedness been recoverable.

In the particular guarantee agreement, the guarantor will give representations and warranties regarding its financial condition, solvency, no material defaults, no undisclosed liabilities, no money laundering, no breach of laws and so forth. Also, the guarantor will make general undertaking of its financial statements, environmental compliance, chartering, insurance and so on, along with covenants to maintain certain financial ratios on an on-going basis.

It is very important to specify what the guarantee covers. The bank may agree the ultimate amount recoverable from the guarantor will be capped, but should never limit the scope of the guarantor's liabilities. The guarantor should, at least ideally, be contingently liable for everything for which the borrower could be liable under the loan facility: principal, indemnity liabilities, costs and so on.²⁹⁴ It is also important the guarantor's board of directors passed resolutions authorizing or ratifying the entering into certain transactions and why they considered those in furtherance of the company's commercial interest. Otherwise, the bank probably cannot enforce the guarantee if the bank cannot rely on the director's authority.²⁹⁵

²⁹⁴ Shipping Finance 3d Edition, at 243.

²⁹⁵ *Id.* at 245.

In the context of second-hand ship financing, on certain occasions a seller will deliver the ship to a buyer without being paid in full and, the seller will need some comfort from the buyer's parent company, or usually, a bank.²⁹⁶ The bank will agree to issue its guarantee if the buyer agrees to counter-indemnify the bank for any sums that the bank is called on to pay under the guarantee and to pay the bank commission. The buyer will secure the counter-indemnity by granting some other securities to the bank, such as, ship mortgage, charge of deposit with the bank, and so on.

3.8 Mortgage

A mortgage of a ship essentially involves the transfer of the security interest in the vessel to the mortgagee. However, the transfer is not absolute and operates only by way of security.

Among various security and finance documents in a ship financing transaction, the principal documents are the loan agreement, the mortgage itself, and the deed of covenants attached thereto, in the case of a statutory mortgage. The deed of covenants sets out the obligations of the shipowner, which are designed to protect the security of the Bank and to reduce the risk of loss. Being the most principal security for the loan, the mortgage will grant a security interest in the vessel to the Bank, which will rank above other proprietary interests (some privileged claims could have a higher ranking over that of mortgagee against the ship), if it is registered in accordance with the requirements of the flag State.

Given the high risk of the vessel being financed, the Bank seeks to force the shipowner to protect the vessel by the following covenants²⁹⁷:

²⁹⁶ Shipping Finance, 3d Edition, at 17.

²⁹⁷ See generally Nigel K. Meeson Q.C., *Ship and Aircraft Mortgages*, (1989), ch.4.

- (a) Insurance
- (b) Registration and classification of the vessel
- (c) Maintenance and repair
- (d) Liens
- (e) Legality
- (f) Notification
- (g) Sale or further charge
- (h) Limitation of charter term
- (i) Avoiding ship repair liens

As set out above, the borrower/owner will covenant that:

- That the borrower will undertake to repay the loan in accordance with the terms specified in the Loan Agreement;
- That the borrower has an obligation to insure the vessel. The Mortgage will often refer to the insurance covenants set out detailed in the Loan Agreement;
- That the borrower will grant an assignment of insurances and earnings to the lender. Such assignments will be granted to secure the performance obligations, the most important being repayment of the loan. In some circumstances, the lender may prefer to include these in a separate general assignment document instead; and
- The obligations and restrictions on the borrower including maintaining registration of the vessel, classification and safety requirements.

The mortgagor mortgages the ship by execution of a simple mortgage deed and registering the same at the offices of the Ship Registry, where the existence of the

mortgage is then recorded in the ship's records in the Registry Book. The priority of the mortgage is determined by the date and time of its registration in the Registry Book.²⁹⁸

The mortgage (in the case of statutory mortgage, the deed of covenants) typically provides that the mortgagee may take whatever action it deems necessary to protect its security. In the case of event of default, the mortgagee may enforce the mortgage by taking possession of the ship and selling it by private sale or at auction.²⁹⁹

Mortgage Registration, Transfer and Discharge procedure

- Registration of Mortgages³⁰⁰:

Registration of Mortgages is allowed as soon as a vessel is provisionally registered. For a vessel that is Provisionally Registered, the mortgagee (bank, shipyard, finance house etc.) is to confirm that they have sighted the original evidence of ownership of title in the ship i.e. bill of sale, sale contract etc. Completed Application Form "Mortgage Registration, Transfer & Discharge" is to be submitted. Moreover, an original or certified true copy of Covenant or similar document may also be submitted. Payment of Mortgage Registration fees is to be confirmed. An entry will be made in the Registry Book, recording the registration of the mortgage. If requested, a Transcript of Registry will be issued by the Ship Registrar.³⁰¹

Furthermore, the banks should be aware that, as well as registration of mortgagees at the ship's registry, some jurisdictions will require certain security documents created by

²⁹⁸ See *Information relating to the registration, transfer and discharge of a mortgage*, available at <http://www.stkittsnevisregistry.net/Mortgage.htm>.

²⁹⁹ Dr. Doran Magri Demajo and Dr. Andrew J. Zammit, *The Enforcement of Malta-registered Mortgages, 'In Rem' Actions Against Vessels Sailing in Maltese Waters, and the Recognition of Foreign-Registered Mortgages*

³⁰⁰ The example is used for the Panamanian mortgages.

³⁰¹ Ismael Gerli, *A Guide to Ship Registration in Panama*, available at <http://www.diazreus.com/publications-ship-registry-panama-maritime.html>.

companies incorporated in them to be registered in companies' registry or other public registries. The counties are mostly common law jurisdictions, like Hong Kong, Singapore, BVI, Malta and so forth.

- **Transfer of Mortgage:**

Transfer of a Registered Mortgage is allowed on any ship, whether provisionally or permanently registered.³⁰² For a vessel that is Provisionally Registered, the new mortgagee (bank, shipyard, finance house etc.) is to confirm that they have sighted the original evidence of ownership of title in the ship i.e. bill of sale, sale contract etc. Completed Application Form showing the original Mortgage Registration and new Mortgage is to be submitted. An original or certified true copy of any new accompanying Mortgage Deed of Covenant or similar document may also be submitted. An entry will be made in the Registry Book, recording the transfer of the mortgage. If requested, a Transcript of Registry will be issued by the Ship Registry.

- **Discharge of Mortgage:**

A shipowner may enter into a new facility to refinance an existing loan facility, or has repaid the existing loan facility. Therefore, existing mortgages will have to be discharged and, in the case of refinancing, new mortgages granted and registered over the refinanced ship/ships. To discharge a mortgage, an instrument of discharge should be executed by the mortgagee. The registry involved may require a specific discharge document to carry out the mortgage discharge.

³⁰² The example is used for Panamanian mortgages. The enrollment consists of two stages: provisional and permanent. In order to facilitate shipping operations, Panamanian titles and mortgages may be filed for preliminary registration at certain Panamanian Consulate with maritime jurisdiction. The aforementioned preliminary registration has the effect of a permanent registration during six (6) months, starting from the date and hour of the annotation or entry in the Diary of the Public Registry Office (this will be certified by the respective Consulate). Within this six month period, the interested party must have the title and/or mortgage protocolised and filed for permanent registration at the Public Registry Office in Panama through a lawyer or law firm in Panama. *See also* at <http://www.nyconsul.com/registration1.htm>.

For instance, to discharge a Panamanian ship mortgage, there are no express requirements other than (a) the name and domicile of the party granting the mortgage, (b) details of the ship and details concerning the date of the mortgage and registration details thereof and (c) an express declaration that the mortgagee discharges and release the owner from the obligations secured by the ship mortgage.³⁰³

The signature of the parties to the discharge of mortgage must be authenticated by a notary public or by a Panamanian Consul in exercise of notarial functions, both as to identity of the signatories and as to their authority to act. The signature of such notary public must be legalized by a Panamanian Consul, or by way of apostille to the extent that the discharge is executed abroad.³⁰⁴

Same with the mortgage registration procedures, a discharge may be preliminarily registered through a notary public in Panama or a Panama Consulate. The discharge must also be filed for permanent registration at the Public Registry in Panama.

³⁰³ Shipping Finance, 3d Edition, at 212.

³⁰⁴ *Id.*

- Mortgage Interest Insurance (MII)

The Mortgagees Interest Insurance (MII) covers the bank/lenders interest in the mortgaged vessel. The cover is secondary to the vessel's actual primary insurance, such as Hull & Machinery, Hull Interest, War and P&I insurance.³⁰⁵ As an alternative to an innocent owners endorsement³⁰⁶ for the borrower/insured's policy, MII aims to protect the mortgagee from the shipowner's breaches of the duty of good faith, willful misconduct and breaches of warranty and where underwriters avoid the policy, or where the policy is void, or in certain cases where there is no cover.³⁰⁷

The need for a separate additional insurance to cover the mortgagee's interest arises because the mortgagee has no involvement in the running of the vessel and is therefore unable to act in the event of any negligence or breach on the part of the owner. Under a hull policy, any defense available to the hull insurer against a claim by the owner is also valid against the mortgagee.

The implementation of the ISM code may signal an increase in the demands made upon MII insurers, where H&M underwriters reject claims, in particular where there are potential breaches by the shipowner relating to unseaworthiness. MII payments were made within a specified period of the H&M underwriters refusing a claim. However, MII does not provide absolute security for the bank: there are a number of circumstances in which the MII policy will not pay out. For example, where there are express exclusions in the H&M or P&I cover, the MII insurance will not pay.

A mortgagee's right to recover is not unconditional and can be limited in certain

³⁰⁵ MII is dependent on the lack of indemnity under the H&M insurance, plus, where the relevant policies are endorsed, the Increased Value policy, the War Risks insurance and the P&I Club coverage.

³⁰⁶ The lender would want a special endorsement protecting the lender which states that, if any acts of the borrower/named insured results in a loss of coverage, the insurer still will pay the lender/additional insured to the extent of its interest, i.e. the loan balance. Sometimes this is called an innocent owner endorsement. See *Additioanl Insured and Marine Finance*, by Edward F. LeBreton, III, Fowler, Rodriguez, and Chalos.

³⁰⁷ See generally <http://www.swedishclub.com/upload/174/27.mortgagees-interest.pdf>.

circumstances. For example: the mortgagee's knowing participation in a fraudulent transaction; the mortgagee's knowledge of an increase of hazard/change of risk; or where the mortgagee has prejudiced the insurer's right to subrogation.³⁰⁸

Additionally, the lender needs to require the right kind of coverage in order to be protected. If not, the MII will provide no relief, such as, the lender was only a loss payee when it should have been an additional insured.³⁰⁹

- Mortgagee's additional perils (pollution) insurance

The "EXXON VALDEZ" oil spill in Alaska resulted in immediate liabilities of more than U.S.\$3bn and, the banks/mortgagees realized that they faced the U.S. tort action risk of maritime liens attaching to a mortgaged vessel in favor of the plaintiffs. The need for a new insurance arose from the realization that a broad range of third party plaintiffs are allowed under U.S. tort law to acquire a priority maritime lien on a vessel – the tortfeasor – that is responsible for the damages.³¹⁰ Consequently, Mortgagee's Additional Perils (Pollution) Insurance was introduced in early 1990, which was designed to indemnify ship mortgagees to the extent of their loss under a loan caused by a mortgaged vessel being held responsible for a pollution incident where the liabilities against the owners exceed the liability limit insured by owners.

3.9 UCC-1 Filings

The UCC-1 filing has been for many years a primary method for recording vessel liens and lenders file these as an extra precaution, or perhaps to cover accessories that are not essential to the vessel. For consideration, borrower grants the bank a continuing

³⁰⁸ Charles R. Franklin, *Mortgagee's Rights & Obligations Under Insurance Policies with a Standard Mortgage Clause*.

³⁰⁹ See *Additioanl Insured and Marine Finance*, by Edward F. LeBreton, III, Fowler, Rodriguez, and Chalos.

³¹⁰ <http://www.nyconsul.com/registration1.htm>

security interest in the Collateral to secure the present and future obligations.³¹¹ The UCC filings are usually periodic and must be renewed from time to time.

Assuming the applicable law in a ship finance transaction is New York Law, New York Uniform Commercial Code provides that, “[e]xcept as otherwise provided, including with respect to deposit accounts, investment property and letter-of-credit rights, the local law where a debtor is located governs perfection, the effect of perfection or non-perfection, and the priority of a security interest in collateral.”³¹² There are several exceptions to the general rule, as follows:

- (a) the local law of the jurisdiction where collateral is located governs perfection, the effect of perfection and non-perfection, and the priority of a possessory security interest in collateral;
- (b) the local law of the jurisdiction in which negotiable documents, goods, instruments, money or tangible chattel paper is located governs, among other things, the effect of perfection or non-perfection and the priority of a non-possessory security interest in the collateral;

So even if one perfects a security interest in negotiable documents, goods, instruments or tangible chattel paper by filing under the UCC, one must look to the jurisdiction where this collateral is located to see if one really has anything;

- (c) Other exceptions, including, without limitation, as to deposit accounts, investment property and letter-of-credit rights.³¹³

³¹¹ Neal Kling, *Admiralty: Vessel Documentation and Finance*, at 141.

³¹² See New York Uniform Commercial Code, §9-301(a).

³¹³ See New York UCC §9-301(b), §9-301(c)(3), §9-304, §9-305, and §9-306.

It is very important in a ship finance deal to make sure where a debtor is “located” for purposes of the UCC. The general rule is provided in §9-307(b):

Except as otherwise provided in §9-307, including as to registered organizations organized under state law as noted below³¹⁴:

- (i) individuals are located at the individual’s principal residence;
- (ii) a debtor that is an organization with only one place of business is located at that place of business; and
- (iii) a debtor with more than one place of business is located at its chief executive office;

However, this general rule applies only if the debtor’s residence, place of business or chief executive office is located in a jurisdiction whose law generally requires that information regarding the existence of a non-possessory security interest to be made generally available in a filing, recording, or registration system as a condition or result of the security interest’s obtaining priority over the rights of a lien creditor with respect to the collateral, and if the general rule does not apply, the debtor is located in Washington, D.C.

This is why so frequently, UCC-1 financing statements are filed in Washington, D.C. for debtors organized outside of the United States. One might want to treat a company organized outside of the United States as being located in Washington, D.C. and in each jurisdiction in which it maintains a place of business in the United States absent strong evidence that it is located in a specific jurisdiction for purposes of the UCC.

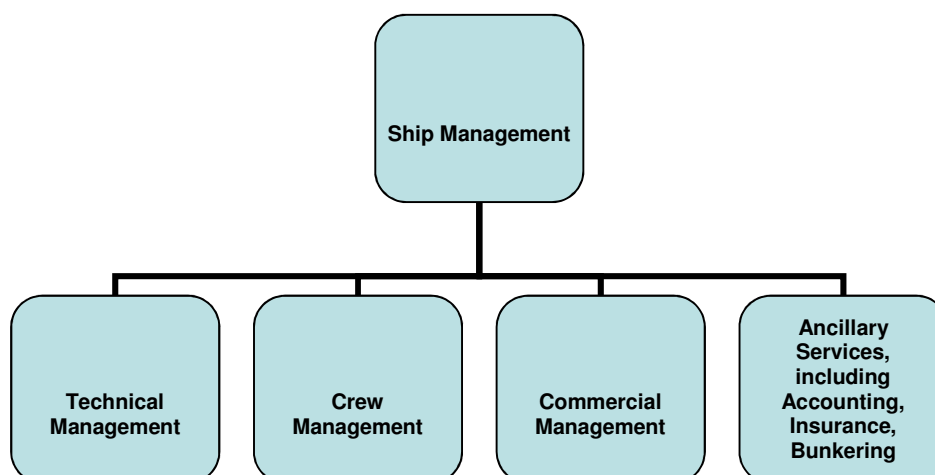
³¹⁴ See New York UCC §9-307(b).

Moreover, according to §9-203(b)(2), a security interest is enforceable against the debtor and third parties with respect to the collateral only if “the debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party.”³¹⁵

4. Vessel Documents in connection with the Loan Agreement

- Manager’s undertaking

Most shipowners appoint ship manager to undertake management of the ship. Usually for large fleet owners, they have in-house service department to handle this matter, whilst most shipowners have external ship managers - the professional ship management company. Such ship manager can fulfill all of the management services for a ship or fleet or only a few services as required by the shipowner. The agreed ship managements, as shown in the diagram below, are always attached to the Manager’s Undertaking.



Source: Lloyds Maritime Academy Amitlaw Maritime Finance Workshop, Michael Kenny & Sandra Sinclair-Hughes, Ghana, September 27, 2010

³¹⁵ See New York UCC §9-203(b)(2).

BIMCO “SHIPMAN 98” is widely used and highly successful standard form of ship management agreement. A Revised edition, BIMCO “SHIPMAN 2009” was launched to reflect the latest ship management practice and legal developments.³¹⁶

The most commonly seen agreements are Technical Management Agreement and Commercial Management Agreement. Usually the following services are documented in the Technical Management: maintenance of the ship, arrangement and supervision of dry-dockings, repairs and alterations of the ship in compliance with Class; supply of necessary stores, spares and consumables; compliance with ISM Code (Chapter IX of SOLAS) and maintenance of a Safety Management System, and ISPS Code (Chapter XI-2 of SOLAS) and maintenance of Ship Security Plan.³¹⁷

In a commercial management agreement, the following services³¹⁸ are required by the shipowners: commercial operation of the ship, chartering services, collection of hire and /or freight revenues earned by the ship, providing voyage estimates and accounts and calculating hire, freight, demurrage and/or dispatch moneys due from or to charterers of the ship, issuing voyage instruments, and appointing agents and stevedores. Moreover,

³¹⁶ See <https://www.bimco.org/en/Products/Publications/SHIPMAN.aspx>.

³¹⁷ See International Maritime Organization official website. [http://www.imo.org/About/Conventions/ListOfConventions/Pages/International-Convention-for-the-Safety-of-Life-at-Sea-\(SOLAS\),-1974.aspx](http://www.imo.org/About/Conventions/ListOfConventions/Pages/International-Convention-for-the-Safety-of-Life-at-Sea-(SOLAS),-1974.aspx). The International Convention for the Safety of Life at Sea (SOLAS) is an international maritime safety treaty. Chapter IX – Management for the Safe Operation of Ships, requires every shipowner and any person or company that has assumed responsibility for a ship to comply with the International Safety Management Code (ISM). http://en.wikipedia.org/wiki/International_Convention_for_the_Safety_of_Life_at_Sea_-_cite_note-IMO-1974-0#cite_note-IMO-1974-0 Chapter XI-2 – Special measures to enhance maritime security, includes the International Ship and Port Facility Security Code (ISPS Code), confirms that the role of the Master in maintaining the security of the ship is not, and cannot be, constrained by the Company, the charterer or any other person. Port facilities must carry out security assessments and develop, implement and review port facility security plans, and controls the delay, detention, restriction, or expulsion of a ship from a port. It requires that ships must have a ship security alert system, as well as detailing other measures and requirements. http://en.wikipedia.org/wiki/International_Convention_for_the_Safety_of_Life_at_Sea_-_cite_note-IMO-1974-0#cite_note-IMO-1974-0

³¹⁸ See Lloyds Maritime Academy Amitlaw Maritime Finance Workshop, Michael Kenny & Sandra Sinclair-Hughes, Ghana, September 27, 2010.

chartering services includes: seeking and negotiating employment for the ship, and concluding charter parties and other contracts of employment for the ship.

- Ship Certificates

A lot of vessel related documents will tabled and signed at the closing meeting at the ship delivery. All certificates and documents required under the Shipbuilding Contract including but not limited to:

- (i) Protocol of Trials (Hull/Machinery)
- (ii) Protocol of Inventory
- (iii) Protocol of Stores of Consumable Nature
- (iv) All Classification Society and Statutory Certificates
- (v) Finished Drawings, Plans and Instruction Books
- (vi) Declaration of Warranty
- (vii) Builder's Certificate
- (viii) Bill of Sale
- (ix) Commercial Invoice
- (x) Protocol of Deadweight and Inclining Experiment

Other certificates are pertinent to the vessel:

- (i) Class Certificate
- (ii) Tonnage Certificate
- (iii) ISSC
- (iv) Safety Management Certificate
- (v) Document of Compliance
- (vi) Free of Encumbrance Certificate

5. International Legal Background

The statutes and regulations concerning lease financing around the world are highly divergent. The development of finance lease requires international harmony and unification. *Unidroit Convention on International Financial Leasing*, made in 1988, is regarded as the international custom and usage, though still yet to become effective.³¹⁹ It

³¹⁹ UNIDROIT Convention in International Financial Leasing (May 28, 1988), available at <http://www.unidroit.org/english/conventions/1988leasing/1988leasing-e.htm> (last visited Mar. 31, 2010). As at early 2007, this convention had been ratified by Belarus, France, Hungary, Italy, Latvia, Nigeria, Panama, Russia, the Ukraine and Uzbekistan. See Philip R. Wood, *Comparative law of security interests and title finance* 38-029 (2d ed. 2007).

sought to create uniform rules regarding the civil and commercial law areas of international financial leasing.³²⁰ The *Convention* applies to financial leases, a term generally referred to “a particular type of tripartite financing transaction that takes the form of a purchase and ‘lease’ of the equipment.”³²¹

A lot of factors have also influenced the international ship lease financing, such as, the development of regulations on banking supervision issued by the Basel Committee, The General Agreement on Trade in Services (GATS)³²² and Understanding on Commitments in Financial Services reached by the WTO, the rise of the negotiable securities in international loaning business, the appearance of loan transfer market, along with the startup of Euro.

6. Ship Financing in China

China is the third-largest trading nation after the US and Germany, controls the world’s fourth-largest fleet and is the second-largest shipbuilder just inferior to Korea, according to 2008 United Nations statistics.³²³ Since 2009, statistics have reflected that China's shipbuilding has overtaken South Korea's in terms of order volume already received and new orders.³²⁴ China Association of the National Shipbuilding Industry

³²⁰ See Sandeep Gopalan, *Transnational Commercial Law: The Way Forward*, 18 AM. U. INT’L L. REV. 803 n. 74.

³²¹ See Ronald Cuming, *Legal Regulation of International Financial Leasing: The 1988 Ottawa Convention*, 7 ARIZ. J. INT’L & COMP. L. 39, 46 (1998-1990).

³²² The General Agreement on Trade in Services (GATS) is a treaty of the World Trade Organization (WTO) that entered into force in January 1995 as a result of the Uruguay Round negotiations. The treaty was created to extend the multilateral trading system to service sector, in the same way the General Agreement on Tariffs and Trade (GATT) provides such a system for merchandise trade. *See available at* http://en.wikipedia.org/wiki/General_Agreement_on_Trade_in_Services.

³²³ Michelle Wiese Bockmann, *China to increase ship finance role*, Lloyd’s List (29 Mar. 2010).

³²⁴ According to statistical results released by Clarkson, as of early November 2009, China's shipbuilding orders reached 54.96 million Compensated Gross Ton (CGT), 34.7% of the world market share, while the

says the volume of new orders China's shipyards bagged in the first two months of 2010 soared 770% year on year to 5.7m dwt from 660,000 dwt in the same period last year.³²⁵ China's rise and its maritime dominance has become a central discussion point in the shipping industry, for example, at the Connecticut Maritime Association Shipping 2010 conference in late March.

China Merchants Bank ("CMB") Leasing has signed a RMB 800 million (USD 124 million) leasing agreement with Hunan Ocean Shipping for the financing of four 76,000 dwt panamax bulk carriers to be built at CSSC Guangzhou Huangpu Shipbuilding.³²⁶ The transaction is said to be groundbreaking, as this is the very first time that a bank affiliated ship leasing company has agreed to acquire ships directly from shipbuilder.³²⁷ The ships will subsequently bareboat chartered to its lessee upon delivery.

6.1 Chinese Legislations on ship finance

On June 9, 2009, China promulgated the *Plan on Adjusting and Revitalizing the Ship Industry*, to cope with the international financial crisis, and to enhance industrial upgrading and promote the sustainable, healthy and stable development of the Chinese ship industry.³²⁸ This Plan has outlined the basic principles, targets and major tasks for the shipping and shipbuilding sectors. It also has listed six main policy guidelines, as

South Korean shipbuilding industry holds orders of 53.63 million CGT and only 33.8% of the world's market share. See *China set to become world's largest shipbuilding country*, People's Daily Online, (10 Nov., 2009).

³²⁵ Hui Ching-hoo, *China yards post 770% rise in new orders*, Lloyd's List (23 Mar. 2010).

³²⁶ See Marine Money Asia Edition, vol. 6, issue 17, page 3, August 25, 2011.

³²⁷ *Id.*

³²⁸ *Plan on Adjusting and Revitalizing the Ship Industry* (promulgated by the General Office of the St. Council, June 9, 2009, effective June 9, 2009) (P.R.C.)

follows: 1. Stabilize shipbuilders' order books, 2. Stimulate demand for newbuildings, 3. Develop the offshore support sector, 4. Develop the ship repairing industry, 5. Encourage restructuring and mergers, 6. Promote research and development in new technology.³²⁹

The 2001 *Some Provisions of the Supreme People's Court on the Scope of Cases to be Entertained by Maritime Courts* provides that maritime courts could accept "[c]ases on disputes over contracts on financial lease of vessels."³³⁰ However, under *Maritime code of the People's Republic of China* (hereinafter referred to as "CMC"), the main bodies of mortgages, maritime liens do not include the parties involved in ship financing transactions.³³¹ It is not in line with the development of the Chinese shipping finance, and thus should be amended. As to the financial lease contract, it is defined in *Contract Law of the People's Republic of China* (hereinafter as "Contract Law").³³² The definition of a ship financial lease contract is different from that in a general lease financing transaction, and the former embodies the latter. The whole lease financing transaction also involves other contracts, such as the ship sale contract with a third party, the seller. The laws and regulations with regard to the ship lease financing are scattered. Various laws, such as, *General Principles of the Civil Law*³³³, *Civil Aviation Law*³³⁴, *Contract*

³²⁹ See *Id.*

³³⁰ *Some Provisions of the Supreme People's Court on the Scope of Cases to be Entertained by Maritime Courts*, art. 17 (adopted by the Judicial Comm. of the Sup. People's Ct. at the 1187th Meeting, Aug. 9, 2001) (P.R.C.)

³³¹ See *Maritime Code* (promulgated by Order No. 64 of the President of the People's Republic of China, Nov. 7, 1992, effective July 1, 1993) (P.R.C.)

³³² *Contract Law of the People's Republic of China*, art. 237 (promulgated by the Second Session of the Ninth Nat'l People's Cong., Mar. 15, 1999, effective Oct. 1, 1999) (P.R.C.) (construing that a financial leasing contract is a contract whereby the lessor, upon purchase of the lessee-selected lease item from a lessee-selected seller, provides the lease item to the lessee for its use, and the lessee pays the rent.)

³³³ *General Principles of the Civil Law* (adopted at the Fourth Session of the Sixth Nat'l People's Cong., and promulgated by Order No. 37 of the president of the People's Republic of China, Apr. 12, 1986, and effective as of Jan. 1, 1987) (P.R.C.)

*Law*³³⁵, *Measures for the Administration of Finance Leasing Companies*³³⁶, *Maritime Code*³³⁷, work together to constitute a statutory and regulatory framework of the Chinese lease financing regime.

Registration of ship financial lease is operated according to that in a bareboat charter. Nevertheless, it cannot be wholly covered by the registration of the bareboat charter. Neither CMC nor *Regulations of the People's Republic of China Governing the Registration of Ships* (hereinafter referred to as *Ship's Registration Statute*) has any regulations concerning this issue.³³⁸ It is an inevitable trend to amend CMC to address this problem, in order to better reduce the investment risk and to accelerate the development of ship lease financing.

Can a vessel be arrested under ship financial lease? According to *Special Maritime Procedure Law of the People's Republic of China*³³⁹ (hereinafter referred to as *Maritime Procedure Law*), theoretically, a ship under the financial lease contract can be arrested if it has satisfied the conditions of a demise charter.³⁴⁰

³³⁴ *Civil Aviation Law* (adopted at the Sixteenth Session of the Standing Comm. of the Eighth Nat'l People's Cong., Oct. 30, 1995) ch. 3, sec. 4 (P.R.C.)

³³⁵ See ch. 14.

³³⁶ *The Measures for the Administration of Finance Leasing Companies* (adopted at the 55th chairman's meeting of China Banking Regulatory Commission, Dec. 28, 2006, effective Mar. 1, 2007) (P.R.C.)

³³⁷ See ch. 6.

³³⁸ *Regulations of the People's Republic of China Governing the Registration of Ships* (promulgated by Decree No. 155 of the St. Council of the People's Republic of China, June 2, 1994, effective Jan. 1, 1995) (P.R.C.)

³³⁹ *The Special Maritime Procedure Law of the People's Republic of China* (adopted by the thirteenth Session of the Standing Comm. of the Ninth People's Cong., Dec. 25, 1999, effective July 1, 2000), art. 23. (P.R.C.)

³⁴⁰ See *Maritime Procedure Law*, art. 29. If, on the expiration of the period of arresting a ship, the party who opposes the claim fails to provide guarantee, and the ship is not suitable for being arrested longer, the maritime claimant may apply to the maritime court arresting the ship for auction of the ship after bringing a law suit or applying for arbitration.

The Chinese ship financing market is yet to be mature, and the laws and regulations governing this industry need to be more comprehensive. For these reasons, different types of risks spread over the fields of operation, financing, politics, and natural disasters. Thus, securities, mortgages and insurances are required for the operation of ship financing transactions.

6.2 Chinese Lending capacity

Regarding China's lending capacity to the international market, Clarksons Financial Services has commented as follows³⁴¹:

“Chinese banks have quietly lent billions of dollars to blue chip western shipowners since the banking crisis broke in September 2008 and traditional home turf sources of funds dried up overnight, ship finance specialist in Hong Kong have confirmed stringent banking secrecy makes the overall total impossible to quantify, although anecdotal evidence suggests that the number of deals is up by a factor of over 10, albeit from a low base. Bank of China, Industrial and Commercial Bank of China, China Construction Bank, the Export-Import Bank of China, Bank of Communications and China Development Bank³⁴² are all active in the market. Meanwhile, two separate sources have told Lloyd's List that ICBC has poached a star local ship finance specialist of overseas Chinese extraction from a European bank, a direction of

³⁴¹ See Ship Finance-A changing environment, by Alun Hatfield, Clarksons Financial Services, Shipbuilding contracts and related ship finance issues, London Shipping Law Center Maritime Business Forum, April 28th 2010.

³⁴² See Rongsheng inks pact with China Development Bank, Lloyd's List Asia (August 29, 2011). China Rongsheng Heavy Industries obtained a 30bn yuan (\$4.7bn) line of credit from the China Development Bank to support its offshore activities, in the latest round of lending commitments it has garnered this summer.

travel that would have been unthinkable only a few years ago. Neither was willing to name the individual ahead of a public announcement.

Prominent industry figures in Hong Kong now predict that Chinese ship finance will emerge on the world stage in force with a matter of years, especially if London, New York and Hamburg in effect hand them the business on a plate. With Germany's KG system clearly in decline and the UK Financial Services Authority set to spring a regulatory onslaught across the City, a full scale rout may even be on the cards. "

Chinese banks have every incentives to keep domestic shipyards working. In a development widely reported by the maritime trade press, the Chinese government has established a special fund that will assist Greek shipowners in financing vessels built in Chinese yards. Having originally pledged US\$5 billion, Chinese banks have spoken of the potential to extend the fund and improve the speed of closing loan transactions in order to stay competitive with other lenders.³⁴³ As we know, COSCO Pacific, a port operator subsidiary of China's State-owned shipping giant COSCO, has signed a \$4.2 billion deal to take over management of an Athens container port.³⁴⁴

However, should Chinese regulators decide to cool down an economy that some analysts believe is overheating on the back of a huge asset bubble³⁴⁵, the tap of Chinese

³⁴³ See Chinese Fund for Greek Shipowners by Ince & Co publications, *see also available* at <http://incelaw.com/ourknowledge/publications/chinese-fund-greek-shipowners>. *See also* China Banks to Lift Lending to Greek Shippers, Kathimerini Says, Bloomberg.

³⁴⁴ See Chen Jialu, China acquires rights to Athens port, China Daily, available at http://www.chinadaily.com.cn/bizchina/2010-07/13/content_10099685.htm.

³⁴⁵ See China says bank must prevent asset price bubbles, *available* at <http://business.asiaone.com/Business/News/Story/A1Story20110823-295830.html>.

banks' lending spree could suddenly be turned off. It makes sense for China to become a major force in providing funds for the global shipping, it supports Chinese shipyards, which employ a lot of people and use steel from Chinese steel mills, which will also employ a lot of steel workers.

6.3 Ship Financial Lease

Ship financial lease combines financing as its inherent economic nature and bareboat charter as its appearance. With regard to its relationship with the charter party, is it paratactic or appurtenant? Although bareboat charter is deemed to be one of the important forms of the ship financing, it nonetheless differs from the ship financial lease. Ship lease financing contracts represent a set of contracts of the entire transaction, while the charter party serves only as one component part. Hire in the lease financing transaction also differs with the hire in a normal charter party. Moreover, it is not the same thing as the price of the ship in a sale contract. Lessees don't pay hire according to the agreement. Lessors can claim the damages upon terminating the contract and get the ship back.³⁴⁶

With respect to the ship lease transactions operated by a financial lease corporation in China, the common operations and types of lease agreements can be described as follows:

6.3.1 Typical financial lease operation

6.3.1.1 Direct lease

³⁴⁶ See *Contract Law*, art. 113(1). Where a party fails to perform its obligations under the contract or its performance fails to conform to the agreement and cause losses to the other party, the amount of compensation for losses shall be equal to the losses caused by the breach of contract, including the interests receivable after the performance of the contract, provided not exceeding the probable losses caused by the breach of contract which has been foreseen or ought to be foreseen when the party in breach concludes the contract.

Under this operation, the lessor purchases the ship according to the requirement and option by a shipping company and leases such ship to that company (lessee). This is the most traditional financial lease operation that involves three parties: lessor, lessee and supplier. The transaction actually comprises two contracts: the purchase contract between lessor and supplier and the lease agreement between lessor and lessee. It is intended to finance the lessee to possess and operate on the ship in the form of the combination of these two contracts. Such transaction falls within the regulation by Chapter Fourteen of Chinese Contract Law.³⁴⁷ Though the relevant provisions under the Contract Law are silent on the risk shifting regarding the subject ship, the ordinary practice in the market dictates that the risk relating to the subject ship shall be borne by the lessee after the delivery of the subject ship. In addition, the lessee shall bear the duty to maintain the subject ship and pay the taxes accrued during the operation of the subject ship. In direct lease operation, the lessee is usually required to pay the full price of purchasing the subject ship by the form of hire and the lessee obtains the ownership of the subject ship upon the expiration of the lease agreement.

6.3.1.2 Sale-leaseback

Sometimes the lessee sells the subject ship to the lessor for the purpose of optimizing the asset structure on the balance sheet, relieving the tax burdens, and readjusting the cash position, and then leases the same ship back for its daily operation. The ownership of the subject ship shifts from the lessee to the lessor in this operation, but the elements in their legal relation remain unchanged. The distribution of risks and duties between the lessor and the lessee is the same with the direct lease as mentioned above. Upon the expiration of the lease agreement and when the lessee pays full purchase price by the form of hire, the lessee regains the ownership of the subject ship.

³⁴⁷ See *Contract Law*, ch. 14.

6.3.2 Leverage lease

This type of financial lease operation indicates that the lessor only pays part of the purchase price of the subject ship, usually ranging from 10% to 20%, and then arranges other sources to finance the project such as from a bank loan or equity fund, etc. In practice, the lessee is often expected to subscribe fund for the project to a certain percentage, usually at approximately 10% to 20%. The lessor will arrange the finance for the remaining amount other than his own underwritten share. All the participants for financing the project shall share the revenues arising from the investment.

6.3.3 Operational lease

Under the operational lease, though the lessor purchases the subject ship according to the choice for the ship and supplier made by the lessee and the subject ship is leased to the lessee on a long-term lease agreement, the lessee is not expected to pay the full purchase price by the form of hire upon the expiration of the lease term. In other words, the lessee will not gain the ownership of the subject ship when the lease term ends. Under this kind of operation, the lessor, in addition to the revenue of hire, shall dispose of the subject ship when the lease expires to cover its total cost and expectation profits. As distinguished from the typical financial lease operation, operational lease operation is based on a different theory in rating the hire and exposure of the transaction. This operation can further be classified into:

6.3.3.1 “wet” lease

Under wet lease, the lessor not only provides the subject ship, but also takes the responsibility of manning, operating and maintaining the subject ship.

6.3.3.2 “dry” lease

Under dry lease, the lessor simply provides the subject ship and leaves the operation of the subject ship to the lessee. Obviously, under such type of operation, the lessor takes

a less responsibility compared with the wet lease, as the risk in the operation shifts to the lessee accordingly.

6.3.4 Sub-lease

Sub-lease is developed from the original financial lease, which contemplates that the sub-lessor leased the subject ship from the original lessor according to the choice and requirement for the ship made by the sub-lessee, and then leases such ship to the sub-lessee. The ordinary rules of the financial lease also apply to the relation between the sub-lessor and sub-lessee. As for the relation between the original lessor and sub-lessor, it can either be by a common lease agreement or a financial lease agreement depending on the specific contents of the contract between them. In other words, the operation of sub-lease can be deemed as a kind of a back-to-back transaction.

6.3.5 Authorized lease

Authorized lease, a similar transaction as authorized loan in accordance with the *General Rules on Loans*, recites that the lessor takes the subject ship from the principal and, pursuant to the authority of the principal, leases the subject ship to the lessee appointed by the principal. During the term of the lease agreement, the ownership of the subject ship remains with the principal. The lessor, in this circumstance, simply charges some handling fees accruing from bridging the principal and the lessee. The lessor's capital is not involved in this transaction. In compliance with the characteristics of this operation, the lessor is totally free from any risks.

6.3.6 Joint lease

Joint lease is a co-operation among a variety of financial lessors usually for a huge project. This operation can be understood as the equivalent of a syndicated loan in the financial lease transaction. Under the joint lease, a financial lessor will take the lead and

arrange a couple of other lessors to enter into a financial lease agreement with the lessee on a joint and several basis. All the participating lessors shall finance the purchase of the subject ship in the proportion to their contribution respectively and in the manner provided for in the agreement, and in the meantime share the risks and revenues therefrom accordingly.

For the purpose of encouraging the growth of the ship exportation in China, Chinese government promulgated some favorable policies and rules concerning the tax bonus and rebate.³⁴⁸ Chinese financial lease corporations tend to establish a special purpose vehicle (“SPV”) in the bonded area to do ship financial lease transactions with a domestic shipping company because the bonded area is deemed to be outside the Chinese territories for the purpose of trade in accordance with the relevant laws.³⁴⁹ In addition, the transaction between such SPV company and a domestic enterprise can be conducted in Chinese Yuan (RMB), thus the transaction will not be likely to be barred or restricted by foreign exchange control laws, regulations or rules.³⁵⁰ Furthermore, for the construction of the city of Shanghai into the world financial and shipping hub drive, the entities registered in Yangshan Bonded Port Area³⁵¹ in Shanghai will be exempted from imposition of business tax upon the revenue accruing from the engagement of shipping

³⁴⁸ See *The Provisional Measures Concerning the Export of Second-handed Equipment*, Guo Shui Fa No. 16 (2008).

³⁴⁹ See *Supervisory Measures of Customs Authority for the Bonded Area*, General Administration of Customs Order No. 65, art. 13.

³⁵⁰ See *Regulatory Measures Concerning Foreign Exchange for Bonded Area*, Hui Fa No. 74 (2002), art. 5.

³⁵¹ Yangshan bonded port area is the first of its case approved by the State Council, including Xiao Yangshan port area, Donghai Bridge and specific regions connected with the bridge. Yangshan bonded port area has a planned land scale of 8.14 sqkm, 7.2 sqkm for the first phase. Among which, Xiao Yangshan covers an area of 2.14 sqkm; on land regions are located at Nanhui District Luchao Port with a planned area of 6 sqkm. See available at the website of Shanghai Foreign Investment Development Board.

business.³⁵² In the meantime, any transactions between both entities within the Yangshan Bonded Area are free from business tax and consumption tax.³⁵³ Due to the above-mentioned favorable policies, we witness a trend that more and more ship financial lease transactions will move from the domestic market to the bonded area in China.

6.4 Refund Guarantee

Where the shipowner is required to pay the building price by installments, particularly in the event that the payments stand for a substantially large portion of the total sum before the delivery of the subject ship, the usual practice to protect the shipowner is for the shipowner to request the provision by the shipyard of a Refund Guarantee issued by a third party that is satisfactory and acceptable to the shipowner. The most common institution to issue such guarantee is a commercial bank. The purpose of such guarantee is to secure the repayment of the sum prepaid by the ship owner to the shipyard for building the subject ship where the repayment obligations imposed by the ship building contract accrues. It is of utmost importance to the shipowner with the purpose to avoid such risks as to the loss arising from the failure of performance of the building contract during the contract term. Considering the ship building process is long and prone to a wide range of risks, some ship owners, therefore, even provide in the shipbuilding contract that the issuance of the Refund Guarantee is one of the conditions precedents. In addition, the issuance of the Refund Guarantee is also one of the prerequisites for the shipowner to get the loan to finance the building from a commercial bank or other financing sources.³⁵⁴

³⁵² See *Circular Concerning the Business Tax Policy in Relation to the Construction of Shanghai into International Financial Center and International Shipping Center*, Cai Shui No. 91(2009).

³⁵³ See *the Management Measures for the Yangshan Bonded Port Area*, Hu Order No. 63.

³⁵⁴ Zheng Lei, *Introduction to Legal Aspects Concerning Financing the New Buildings and Security for the Finance*, at *2 (2002).

In the practice of the shipbuilding nowadays, almost all Refund Guarantee is of a nature of “on demand.” Compared with the traditional guarantee, the “on demand” guarantee embraces the following features³⁵⁵:

Firstly, it gains the independence from the underlying contract. Though the “on demand” guarantee is issued based on the underlying contract, it comes into validity and force upon the issuance independent from the underlying contract. It will be executed completely in accordance with its own clauses regardless of what the underlying contract says. In other words, the underlying contract can by no means be used as defense against the beneficiary of the guarantee. However, such non-defense is subject to some limited exception. For example, in most Refund Guarantee, the commencement of proceeding arising from or in connection with the shipbuilding contract can be a due cause for the guarantor to defer the payment under the refund guarantee.³⁵⁶

Secondly, it is unconditional in the enforcement. With such unconditional and automatic feature, the guarantor shall effect the payment under the “on demand” guarantee forthwith upon the request by the beneficiary. In this circumstance, whether such request is rationally grounded or whether the secured debt is satisfied is not relevant.

Thirdly, the responsibility imposed on the guarantor under the “on demand” guarantee is limited to pecuniary payment other than the actual performance of all the obligations in default by the debtor under the underlying contract.

In conformity with the aforementioned features, the guarantor is entitled to recourse against the debtor upon the payment to the beneficiary under the guarantee. Such recourse right is also independent from the underlying contract, and therefore it will not

³⁵⁵ Shen Daming & Feng Datong, *Banking Guarantee Used in the International Economic Transaction* 51, 52 (1987).

³⁵⁶ Paul Ho, Ince & Co. Shanghai Office, *Brief Overview: Cancellation and Restructuring of Chinese Shipbuilding Contracts and Claim under Refund Guarantees* at *4, address at Marine Money Conference (Sept., 2009, Singapore).

be affected by the underlying contract and the debtor under the underlying contract is prohibited to suppress such recourse by reason of the invalidity of the underlying contract. The possible defense open to the debtor under the underlying contract against such recourse appears to be either that guarantor breaches the provisions of the guarantee in the fulfillment of the payment to the beneficiary or that the request for payment under the guarantee by the beneficiary falls within the fraud or other abuse in rights.³⁵⁷ In addition, though the guarantor is imposed an absolute and unconditional duty to make the payment under the “on demand” guarantee to the beneficiary, the guarantor shall, in the event that the underlying contract violates the public policy, refrain from making such payment to the beneficiary.³⁵⁸

As mentioned above, the most common issuer for the Refund Guarantee is a commercial bank. In considering the issuance of the Refund Guarantee, one of the profitable intermediary businesses for the bank, a commercial bank usually will focus on such factors as the market circumstances for the subject ship to be built, the building capacity and technology of the ship yard, and the operational ability and credit of the shipowner, etc. As the payment effected by the shipowner is in accordance with the progress the building process and the last installment is usually made upon the delivery of the subject ship, thus the amount under the Refund Guarantee is always a percentage of the total building price of the subject ship. In practice, the percentage usually stands at 80%. In addition, for the purpose to facilitate the finance of shipowner for the newbuildings, the Refund Guarantee is usually contemplated assignable in practice.³⁵⁹ Sometimes the Refund Guarantee also allows reassignment to facilitate the refinance

³⁵⁷ Yao Meizhen, *Introduction to International Economic Law* 531 (2000).

³⁵⁸ Li Renzhen, *Specialized Book on International Financial Law* 281(1995).

³⁵⁹ John Lin, *Legal Aspects Concerning the Ship Building Finance* 22-23 (2009).

activity.³⁶⁰ On the other hand, the bank that issues the Refund Guarantee will require that the Refund Guarantee shall not be assigned without the prior consent of the bank in writing and upon assignment a notification shall be forwarded to the bank. This is an ordinary practice for the bank to contain the exposure in the issuance of the Refund Guarantee.

In the practice, we should also note that when the delivery of the subject ship is extended pursuant to the building contract, the Refund Guarantee should also be extended accordingly.³⁶¹ In the circumstance that the ownership of the subject ship under construction is shifted to the shipowner, the importance of the Refund Guarantee is lessened. However, notwithstanding the foregoing lessening, the issuance of the Refund Guarantee is still requested as the usual practice for the reason that though the shipowner has the ownership of the subject ship under construction, it is exceedingly difficult to assess the value of a ship under construction and possibly subject to the jurisdiction of the state where the ship yard is located for the sale and auction of the subject ship under construction. These will all lead up to the increase the risk for the shipowner to be put in fund of the prepayment of the building price.³⁶²

Another issue worth of our attention is that due to some restrictions imposed the relevant law of a certain state (e.g. the United States), a commercial bank is prohibited to issue a guarantee. Hence in such states, the alternative instrument in this regard is a standby letter of credit.³⁶³ In terms of bank's duties, a guarantee and a standby letter of

³⁶⁰ *Id.*

³⁶¹ Zheng Lei, *Introduction to Legal Aspects Concerning Financing the New Buildings and Security for the Finance 2* (2002).

³⁶² *Id.*

³⁶³ Paul B. Stephan, Julie A. Roin, and Don Wallace, Jr., *International Business And Economics: Law And Policy* 480-81 (2004).

credit are functional equivalents, but there are some technical distinctions between them.³⁶⁴

However, sometimes when a ship yard approaches a commercial bank for the issuance of a Refund Guarantee, the ship yard will fail to have the guarantee issued because of various factors including, inter alia, that the bank lacks the knowledge and expertise for the shipping business, the applicant used up the credit facility or has inadequate credit facility, or the bank figures out an unfavorable profitability expectation, etc. In the Chinese market, an alternative solution has been created to deal with this dilemma known as “Taizhou Mode”, or the absorption of private capital into the shipbuilding.³⁶⁵ Such solution is based on the cooperation between a shipyard and private equity. With the injection of the fund into the shipyard, the shipyard is capable of building a ship for sale instead of building a ship upon the order from the shipowner.³⁶⁶ Though it is deemed as a solution for the failure to get a Refund Guarantee, it, in the meantime, exposes the shipyard to a variety of risks. The shipyard will, in this mode, assume more market fluctuation risk when it builds a ship without an order from the shipowner. In addition, as the ship is not built according to the design and requirement of the shipowner, the ship may probably not satisfy some particular needs that a shipowner expects of, thus it increases the difficulty for the sale of the ship. Hence, the shipyard also bears the risk of the depreciation of the stock if the ship cannot be sold within a short period of time upon the completion of construction. Furthermore, this double-edged

³⁶⁴ *Id.*

³⁶⁵ John Lin, *supra* note 60, at 29.

³⁶⁶ *Id.*

solution also gives rise to the dispute as to the ownership of the subject ship in accordance with Chinese law.³⁶⁷

According to the *Property Rights Law of People's Republic of China* (the "Property Rights Law"), promulgated on 16 March 2007 and effective as of 1 October 2007, account receivables may be pledged.³⁶⁸ It was the first time the term 'account receivables' was mentioned in a legal context. Accordingly, the People's Bank of China ("BOC") formulated the "*Measures for the Registration of Pledge Receivables*" (the "Measures") under the authority of Article 228 of the Property Rights Law. As prescribed under Article 4 of the Measures, the term "receivables" refers to the rights to demand a debtor to make payments which are obtained by a creditor for offering goods, services, or facilities, including accrued and potential money claims and the proceeds thereof, but not including the rights to claim a payment incurred from bills or other negotiable securities. The "receivables"³⁶⁹ as mentioned in the Measures includes the following rights:

- (1) a creditor's rights derived from sale, including the sale of goods, the supply of water, power, gas and heat, and the permitted use of intellectual property;
- (2) a creditor's rights derived from the lease of movable and immovable properties;
- (3) a creditor's rights derived from providing services;

³⁶⁷ *Id.*

³⁶⁸ Article 223 of Property Rights Law states that the following rights for which a debtor or a third party has the right of disposal may be pledged: (1) bank draft, cheque, promissory note; (2) bond, certificate of deposit; (3) warehouse receipt, bill of lading; (4) transferable funds units and equity; (5) transferable intellectual property rights such as patent rights, exclusive use of registered trademarks, copyrights etc; (6) account receivables; and (7) other property rights that can be pledged according to any law or administrative regulation.

³⁶⁹ As construed in the Measures, account receivables include both accrued account receivables, future account receivables, and the proceeds thereof. Albeit the BOC categorizes future account receivables as a class of registrable receivables under the Property Rights Law, it remains uncertain whether such interpretation will be accepted by the courts in China.

(4) rights to charge payment for the use of immoveable properties such as highway, bridge, tunnel and ferry, etc.; and

(5) a creditor's rights derived from granting loans or other credits.

Article 219 of the Property Rights Law states that in the event of non-performance of due debt by the debtor or any of the circumstances for realizing the right of pledge as stipulated by the parties concerned occurs, the pledgee may agree with the pledgor on the priority in receiving payments from the proceeds incurred from the auction or sale of the pledged property. By taking security over the account receivables, it ensures that on the pledgor's insolvency, the secured creditor will rank in priority to other creditors regarding the secured account receivables.

Nature of Floating Charge and Security over Bank Account

As to the floating charge over receivables, Article 181 of the Property Rights Law states that upon the written agreement between the concerned parties, an enterprise, individual industrial and commercial household, or agricultural production operator may mortgage the manufacturing facilities, raw materials, semi-manufactured goods, and products it has already owned or potentially owns. The creditors shall be entitled to seek preferred compensation in respect of the mortgaged chattels in the event that a debtor fails to discharge its due debts or any of the circumstances for realizing the mortgage rights as stipulated by the parties concerned occurs. Article 181 is analogous to a floating charge, a well-established legal concept in foreign laws. In the context of PRC law, a floating charge is a security, which covers the present and potential assets that the chargor owns and it is specific only to the manufacturing facilities, raw materials, semi-manufactured goods, and products. If the chargor fails to pay its due debts, the chargee is entitled to seek preferred payments in respect of the secured assets.

In China, a floating charge can only be created over the types of assets specified under Article 223 of the Property Rights Law, which are limited to manufacturing facilities, raw materials, semi-manufactured goods, and products. According to Article 181, a floating charge cannot be established over account receivables in China.

Moreover, generally speaking, security over bank accounts is prohibited under PRC law, except for loans in export refund custodian accounts. Such loans are interpreted and regulated by the Provisions of Pledged Loans in Export Rebate Custodian Accounts promulgated by the Supreme Court on 22 November 2004, and effective as of 7 December 2005.

The establishment of the pledge of account receivables

Article 228 of the Property Rights Law provides that the parties concerned shall establish the pledge by a written contract, and the right of the pledge is established upon its registration with the relevant credit rating institution. After the account receivables have been pledged, the pledgor shall not transfer the pledge, unless it is otherwise agreed by the pledge. The pledgor shall use the proceeds from the transfer of the account receivables to settle the due debt, or submit the aforesaid money to a competent authority. As stated above, such relevant credit rating institution mentioned in the Property Rights Law is the Credit Information Center of the BOC (Credit Information Center), which is also the registration authority of pledged receivables. The pledge of account receivables is established once the registration procedures are complied with.

The transfer of pledge of account receivables

Article 14 of the Measures states that should there be any omissions, mistakes, or changes in the registration information, the pledge is obliged to rectify and ensure that the provided information is accurate. If a new pledged receivable is added to the registration,

the newly added part shall be deemed as an independent pledged registration, and its registration time shall be time once the pledge completes the information of the new pledged receivable and submits the information to the registration publicity system.

Article 17 of the Measures further states that the pledgee should handle the formalities for deregistration within 10 working days upon the occurrence of any of the following events: (1) the principal creditor's right is eliminated; (2) the pledgee's rights are realized; (3) the pledge releases all the rights under the pledge to the registered receivables; or (4) other circumstances which lead to the elimination of the registered rights of the pledge. Whereas the formalities and the procedures of alteration of registration and deregistration of a pledge of receivables are stated in the Measures, no laws or regulations expressly provide procedures for the transfer and the registration of a pledge under PRC law.

In the commercial mortgage backed securities securitization transaction initiated by China Minsheng Bank, the debtors created a pledge on the account receivables in favor of the lending bank. The aim of the securitization is to enhance the liquidity of the assets. Under the pledge contract, the pledged assets include the accrued and future account receivables. The account receivables include but are not limited to the following rights: the pledgee's rights to receiving charter income from the charter, the charter, the lessee's rental deposits and other incomes derived from the charter; the sale revenue, deposits, and other incomes derived from the sale contract; rights to receive incomes and proceeds thereof in other contracts (for example, securitization proceeds, interest from deposits and dividends).

As permitted under the pledge contract, the lending bank is entitled to withdraw proceeds from the supervised account to discharge the debts owed to the creditors in accordance with the priority as stipulated under the contract. In case the balance in the

supervised account is insufficient to pay off the debts owed to the creditors under the pledge contract, the lender may, by reaching an agreement with the pledgor, convert the pledge into money or seek preferred payments from the money incurred from the auctions or the sale of the pledge.

7. Ship Financing in the United States

American interest and activity in the ship financing has expanded substantially in the past few decades.³⁷⁰ The number, size, and kinds of vessels requiring financing have also increased.³⁷¹ The form of ship financing consists of direct loan, ship mortgage loan, ship lease financing, and so on so forth. In 1952, the first leasing company was established in the United States, inaugurating a new era of finance lease.³⁷² The 1972 Ship Financing Act was enacted to regulate a new method of ship financing industry, namely, ship lease financing, which causes almost no risk to the investors.³⁷³

The traditional approach to financing U.S. built vessels has been for the prospective United States citizen-owner to arrange through his U.S. commercial banking contacts to provide the short-term construction financing and to arrange through his U.S. investment banking contacts to provide, through public offering or private placement, long-term mortgage financing. Depending on the borrower's credit-worthiness, the construction financing was secured or unsecured. The long-term financing was almost universally secured. The impact of high interest rates, inflationary factors, and increasing foreign competition has been developing a shift from the traditional financing format to techniques that utilize U.S. tax advantages available to U.S. citizen shipowners and operators.

³⁷⁰ See Edward H. Mahla, *Some Problems in Vessel Financing – A Lender's Lawyer's View*, 47 TUL. L. REV. 629, 629 (1972-73).

³⁷¹ *Id.*

³⁷² Leasing evolved from being a manufacturer's selling technique into a specialized financial service with the formation of the first independent leasing company in 1952 in the United States. The industry extended to Europe and Japan in the 1960s and has been spreading through developing countries since the mid-1970s. See Laurence W. Carter, Teresa Barger, and Irving Kuczynski, *Lessons of Experience No. 3: Leasing in Emerging Markets Executive Summary*, IFC summary, available at <http://www.ifc.org/ifcext/publications.nsf/Content/LessonsofExperienceNo3ExecSummary>; See also Bank of Cardiff, *Leasing History*, available at <http://www.bankofcardiff.com/cgi-bin/main.pl?page=history>.

³⁷³ Federal Ship Financing Act, 1972, [PL 92-507, 86 Stat. 909 (46 U.S.C. §§ 1177 note, 1271 to 1276, 1279, 1279a, 1279b)]. See also Niels West, *Marine Affairs Dictionary: Terms, Concepts, Laws, Court Cases, and International Conventions and Agreements* 209 (1st ed. 2004).

In 1996, Congress enacted the lease financing provisions to the vessel documentation laws.³⁷⁴ Every year the U.S. Congress considers a bill to authorize funds for the U.S. Coast Guard. The additional measures Congress included in the bill which, when signed on August 9, 2004 by President Bush, became known as the Coast Guard and Maritime Transportation Act of 2004 (hereinafter referred to as “the Maritime Act of 2004”). Two of the additional measures included in the bill by Congress are an exemption for certain passive owners (primarily institutional lenders and lessors) from the strict liability provisions of the Oil Pollution Act of 1990 (hereinafter referred to as “OPA”), and changes to the citizenship requirements in the U.S. coastwise trade laws. In addition, Section 608 of the Coast Guard and the Maritime Act of 2004 added a requirement that foreign owners annually certify that they are not affiliated with any charterer or anyone who has the ability to control the operation of the vessel.

Congress passed OPA in the wake of the oil spill involving the EXXON VALDEZ, like its counterpart, the Comprehensive Environment Response, Compensation, and Liability Act (CERCLA) which deals with all pollutants, except oil, OPA sets forth an extensive liability scheme designed to insure that, in the event of a spill or release of oil, the responsible parties are liable for the removal costs and damages that result from the incident. Under OPA, the owner, operator and demise charterer of a vessel are all responsible parties. The interaction between OPA and CERCLA can be muddy. Both statutes are essentially strict liability laws that impose on the shipowner the responsibility to clean up the spill and pay certain types of damages, regardless of fault for the spill. Thus, even passive financial institution lessors holding title to a vessel, such as financial lessors, had a significant risk of joint and several liabilities with the operator and the demise charterer for all pollution damages that occur in U.S. waters.

³⁷⁴ See 46 U.S.C. 12119.

In 1996, CERCLA was amended to protect lenders who held an indicia of ownership to protect their security interest in a vessel or facility from the strict liability imposed by CERCLA. However, not all lenders were protected; only those who did not participate in management. To guide lenders through stormy seas when they might be forced to foreclose on a vessel to protect their security interest, the CERCLA amendment provided safe harbors in which lenders could act without subjecting themselves to liability. Financial lessors were held to be within the category of lenders who held an indicia of ownership. However, OPA was never revised to provide the same protection to similarly situated financing institutions.

Through the Maritime Act of 2004, OPA was amended to provide substantially the same protection to demise charter lessors; thereby making leasing a more lessor friendly financing option for vessels that trade in U.S. waters. Now, OPA has been amended to redefine the term “owner” to exclude passive financing entities that are lessors in vessel lease financing transactions. The OPA amendments generally follow the same language as found in CERCLA and incorporate some definitions and provisions by cross reference. Consequently, the definition of owner is the same under both OPA and CERCLA. Now, an owner or operator does not include a lender “that holds indicia of ownership primarily to protect the security interest of the person in the vessel . . .” An OPA lessor is the same as a CERCLA lender because both are passive financial entities.

The Maritime Act of 2004 also includes modifications to the requirements that lessors must meet under U.S. coastwise trade laws (known as the Jones Act) in order for the vessel they own to participate in the U.S. coastwise trade. Except for the limited exemptions, a vessel must be U.S. built, U.S. flagged and owned by a U.S. entity, 75% of whose equity interests are owned by U.S. citizens in order to engage in the U.S. coastwise

trade. One of the existing exemptions to these requirements dealt with vessels owned by U.S. financing entities which could not meet the 75% ownership rule (foreign lessors).

Under the Jones Act, an entity which did not meet the citizenship requirements for operation of a vessel in the U.S. coastwise trade could still qualify for such trade if it could meet the tests for a foreign lessor exemption. The foreign lessor exemption was initially enacted to encourage lease financing structures where the title of a vessel engaged in coastwise trade could be held by a company that did not meet the coastwise trade citizenship requirements, but the vessel was bareboat chartered to a U.S. citizen qualified to engage in the coastwise trade. This exemption was intended to be used by U.S. based, but non-U.S. owned, financial institutions. However, it was also used by non-U.S. citizen shipowners who established U.S. based “leasing companies” who then brought U.S. flag vessels and chartered them to their affiliates. The changes made to the OPA and the Jones Act by the Maritime Act of 2004 should make lease financing of U.S. flag vessels and vessels operating in U.S. waters more attractive to true financing entities.

7.1. Coastwise Trade Endorsement

The international consensus among shipping nations generally favors the exclusion of foreign vessels from domestic maritime trades.³⁷⁵ The United States, a coastal nation, has also adopted cabotage laws to protect the American shipbuilding trade and to promote the continued viability of the domestic merchant marine industry.³⁷⁶ In 1789, the First Congress exercised the sovereign powers of the United States attempting to legislate away competition from foreign vessels and to reserve coastwise trades for vessels built

³⁷⁵ See Robert L. McGeorge, *United States Coastwise Trading Restrictions: A Comparison of Recent Customs Service Rulings with the Legislative Purpose of the Jones Act and the Demands of a Global Economy*, 11 NW. J. INT’L L. & BUS. 62, 62 (1990).

³⁷⁶ See *Black’s Law Dictionary* 230 (9th ed. 2009) (cabotage is construed as “The carrying on of the trade along a country’s coast; the transport of goods or passengers from one port or place to another in the same country. The privilege to carry on this trade is usu. limited to vessels flying the flag of that country.”).

within the United States or operated under the U.S. flag.³⁷⁷ As provided by this law, it only permitted vessels built in the U.S. to be registered, which largely encouraged the fledgling U.S. shipbuilding industry. Later in 1817, Congress explicitly prohibited foreign vessels from engaging in the domestic trade.³⁷⁸

The three primary coastwise statutes are known as the Nicholson Act, the Transportation of Passengers in Foreign Vessels Act, and the Jones Act.³⁷⁹ Among them, the Jones Act requires merchandise carried between United States ports to be shipped in American bottoms.³⁸⁰ The U.S. coastwise trade is governed by Section 27 of the Merchant Marine Act of 1920, commonly referred to as the Jones Act. Currently codified in 46 U.S.C. §55102, Jones Act bars the transportation of merchandise by water between points in the United States in the coastwise trade in vessels not built in the United States, documented under the U.S. laws, and owned by the U.S. citizens.³⁸¹ A coastwise endorsement entitles a vessel to engage in the coastwise trade.³⁸² Any vessel engaged in transportation of passengers or merchandise between U.S. ports must be issued a coastwise endorsement.³⁸³

³⁷⁷ Act of Sept. 1, 1789, ch. xi, §1, 1 Stat. 55 (1789).

³⁷⁸ Act of March 1, 1817, ch. xxxi, §4, 3 Stat. 351 (1850).

³⁷⁹ See Debra C. Buchanan, *United States Coastwise Laws in the Pacific*, 31 J. MAR. L. & COM. 119 n. 1 (2000) (“The Nicholson Act, 46 U.S.C. App. § 251 requires fish to be brought ashore in American bottoms; the Transportation of passengers in Foreign Vessels Act, 46 U.S.C. app. §289 requires passengers sailing between United States ports to be carried in American bottoms.”)

³⁸⁰ See *id.*

³⁸¹ 46 U.S.C. § 55102 (2006), formerly cited as 46 U.S.C. App. §883 (In the context of the Jones Act, the coastwise trade is defined as “the transportation of merchandise by water, or by land and water, between points in the United States to which the coastwise laws apply, either directly or via a foreign port.” See 46 U.S.C. §55102(b)).

³⁸² See *Id.* § 12112(b); 46 C.F.R. § 67.19(a) (2009).

³⁸³ Sean D. Kennedy, *Short Sea Shipping in the United States---The New Marine Highways*, 33 TUL. MAR. L.J. 203, 217 (2008); see also 46 C.F.R. § 67.19.

Government involvement in ocean transportation is motivated not only by traditional regulatory concerns such as health, safety, and liability issues, but also by concerns such as national security, national prestige, competition policy, and trade protection.³⁸⁴ The significance of the coastwise trade laws reflects the paramount historical national policies of the United States to maintain and enhance an adequate domestic merchant marine essential to the national defense and commercial welfare, to protect the economic interests of U.S. shipyards against foreign counterparts, and to reserve domestic coastal trades for domestic fleets which are insulated from competition with lower-cost foreign vessels.³⁸⁵

A. Jones Act

In 1920, with the primary motivation to encourage a strong United States-flagship Merchant Marine, Congress enacted Section 27 of the Merchant Marine Act. Popularly referred to as the Jones Act³⁸⁶, it aims to reserve coastwise trade between two United States points, directly or via a foreign point, to vessels built in the United States and owned by United States citizens that have been issued a certificate of documentation with a coastwise endorsement.³⁸⁷ Under 46 U.S.C. § 55102(b), only the vessel that is wholly owned by the U.S. citizens and has maintained a coastwise endorsement may engage in coastwise trade.³⁸⁸ With certain exceptions delineated in 46 U.S.C. § 55101(b), the

³⁸⁴ THOMAS J. SCHOENBAUM, 1 ADMIRALTY & MAR. LAW §10-2 (4th ed. 2010).

³⁸⁵ See generally McGeorge, *supra* note 74, at 62-65.

³⁸⁶ For the purpose of this comment, references to the “Jones Act” are limited to Section 27 of the Merchant Marine Act of 1920.

³⁸⁷ 46 U.S.C. § 55102.

³⁸⁸ Formerly cited as 46 U.S.C. App. §883 (emphasis added) (“[N]o vessel which has acquired the lawful right to engage in the coastwise trade, by virtue of having been built in, or documented under the laws of the United States, and which has later been rebuilt, shall have the right thereafter to engage in coastwise

“coastwise laws apply to the United States, including the island territories and possessions of the United States.”³⁸⁹

In 2006, the Jones Act was codified into positive law along with other provisions in Title 46 pertaining to shipping.³⁹⁰ The Jones Act’s provisos, thirteen³⁹¹ of which accumulated over time, are now sprinkled throughout Title 46 of the U.S. code.³⁹² The various parts of the Jones Act work together to restrict U.S. domestic trade to U.S.-built, U.S. citizen-owned, and U.S.-operated U.S.-flag vessels.³⁹³ Jones Act attempted to limit coastwise privilege to U.S.-built vessels with the effect to protect the U.S. shipping industry “[b]ecause building ships and manning them in the United States was and remains more expensive than in other countries.”³⁹⁴

B. Second Proviso to the Jones Act

The Jones Act and its Second Proviso govern the Coast Guard’s issuance of certifications that license vessels for coastwise trade.³⁹⁵ In 1956 and 1960, Congress passed and amended the Second Proviso to the Jones Act. Despite existing under the purview of the cabotage law in coastwise trade, prior to 1956, U.S. law did not prohibit

trade, *unless the entire rebuilding, including the construction of any major components of the hull or superstructure of the vessel, is effected within the United States.*”)

³⁸⁹ 46 U.S.C. § 55101(a).

³⁹⁰ See 120 Stat. 1485 (2006) (now contained in various sections of Title 46 U.S.C. Chapter 121, Documentation of Vessels (46 U.S.C. §§ 12101-12152) and Title 46 U.S.C. Chapter 551, Coastwise Trade (46 U.S.C. §§ 55101-55121)).

³⁹¹ Merchant Marine Act, 1920 (Jones Act (Merchant Marine)) (June 5, 1920, ch. 250, 41 Stat. 988) (now codified as 46 U.S.C. §§ 12101, 12120, 12132, 55102, 55105, 55106, 55107, 55108, 55110, 55115, 55116, 55117, 55119).

³⁹² Constantine G. Papavizas, *U.S.-flag vessel financing and citizenship requirements update*, 32 TUL. MAR. L.J. 35,38 (2007).

³⁹³ *Id.*

³⁹⁴ *OSG Bulk Ships, Inc. v. U.S.*, 132 F.3d 808, 809 (D.C. Cir. 1998).

³⁹⁵ See *Shipbuilders Council of America v. U.S. Coast Guard*, 578 F.3d 234, 237 (4th Cir. 2009).

domestic ships from being rebuilt overseas.³⁹⁶ In 1956, the House Merchant Marine Committee pointed out the apparent gap of law³⁹⁷:

“With major developments in technology in recent years there have been instances of American-owned, American-built vessels which have been substantially rebuilt in foreign shipyards, and then have returned to operate in American coastwise trade. Even though these rebuildings have been so extensive as to completely change the character of the vessels, the existing law does not subject the owners to payment of duty, nor is there any restriction against their use in domestic shipping service. This appears to be a gap in the law, which is clearly inconsistent with traditional policy. This bill is designed to close the gap and deny the right of vessels rebuilt abroad to operate thereafter in the domestic trade.”

Responding to this problem, a bill was introduced in Congress in 1956 and later passed both House and Senate.³⁹⁸ The aim of the bill was to assist the shipyards of the United States by making applicable to vessels built in foreign yards the historic policy of exclusion from the coastwise trade.³⁹⁹ The initial proposal of the bill had language defining the term “rebuilt” with the Second Proviso.⁴⁰⁰ The Treasury Department, the former supervising federal agency of the Jones Act, suggested to Congress that the definition of that term “would apparently be broad enough to include a minor alteration affecting tonnage.”⁴⁰¹ It also noted that “[f]or such a relative trifle, the vessel involved might be deprived forever of the valuable right of engaging in the coastwise trade.”⁴⁰² Ultimately, when Congress enacted the Second Proviso, it did not define the term

³⁹⁶ See *American Hawaii Cruises v. Skinner*, 713 F. Supp. 452, 462 (D.D.C. 1989).

³⁹⁷ *Id.* (quoting H. Rep. No. 2293, 84th Cong., 2d Sess. 2 (1956) (H. REP. 84-2393)).

³⁹⁸ H.R. 6025, 84th Cong., 1st Sess. (1955).

³⁹⁹ See S. REP. 84-2395, 1956 U.S.C.C.A.N. 3162, 3162.

⁴⁰⁰ H.R. 6025, §3, 84th Cong., 1st Sess. (1955); see also S. REP. 84-2395, 1956 U.S.C.C.A.N. 3162 (the proposal defined that term “rebuilt” as “altered in form of burden, by being lengthened or built upon, or from one denomination to another, by the mode or method of rigging or fitting.” *Id.* 3167).

⁴⁰¹ S. REP. No. 2395, 84th Cong., 2d Sess. 1-2 (1956) (S. REP. 84-2395), 1956 U.S.C.C.A.N., at 3162-63.

⁴⁰² 1956 U.S.C.C.A.N., at 3165.

“rebuilt” and authorized the Treasury Department to “prescribe such regulations as may be necessary to carry out the purposes of this Act.”⁴⁰³ The final amendment contains the restriction as follows: “*Provided further*, that no vessel of more than five hundred gross tons which has acquired the lawful right to engage in the coastwise trade . . . and which has later been rebuilt outside the United States . . . shall have the right thereafter to engage in the coastwise trade.”⁴⁰⁴ Thus, the Second Proviso bars existing Jones Act eligible vessels from the coastwise trade that have been rebuilt abroad. This Act would “aid this seriously distressed industry (shipbuilding), and would assist the Department of Defense in its attempts to maintain the mobilization capacity of this country’s shipyards.”⁴⁰⁵

The Treasury Department had adopted the generally accepted definition of the term “rebuilt” based on the principle of United States v. The Grace Meade as “a vessel is considered rebuilt if any considerable part of the hull of the vessel in its intact condition, without being broken up, is built upon . . .”⁴⁰⁶ The definition has been adopted by the Supreme Court in New Bedford Dry Dock Co. v. Purdy (The Jack-O-Lantern).⁴⁰⁷ One year after the 1956 Act, Bureau of Customs under the Treasury Department, which was then in charge of the vessel documentation, amended its regulation using the abovementioned Grace Meade definition.⁴⁰⁸

⁴⁰³ See Pub. L. No. 84-714, § 1, 70 Stat. 544 (1956); see also 70 Stat. 544, § 3, see *Am. Hawaii Cruises*, 713 F. Supp. at 463.

⁴⁰⁴ Pub. L. No. 714, 84th Cong., 2d Sess., 1956 U.S.C.C.A.N. 622.

⁴⁰⁵ S. REP. No. 2395, 84th Cong., 2d Sess. 1, 2 (1956).

⁴⁰⁶ 25 F. Cas. 1387, 1389 (D.C.Va. 1876).

⁴⁰⁷ 258 U.S. 96, 100 (1922) (describing the definition in Grace Meade as “both sound and helpful”).

⁴⁰⁸ *Am. Hawaii Cruises*, 713 F. Supp. at 463; see also 22 Fed. Reg. 6,380, 6,381 (1957).

After enactment of the Second Proviso, sophisticated shipowners sought to evade the “rebuild” requirement by constructing large vessel sections⁴⁰⁹ abroad, bringing them back to the U.S. shipyards, and installing them in the middle of Jones Act qualified vessels documented under U.S. laws.⁴¹⁰ Bureau of Customs ruled that installation of these “midbodies” would not violate the “rebuild” requirement contained in the Second Proviso and determined such vessel conversion process, known as “jumboizing,” would not result in the forfeiture of the vessel’s coastwise trade privileges.⁴¹¹ The Bureau based its ruling on the ground that the removable false bow required to facilitate towing did not make the midbody a “vessel” because “this ‘false bow’ is a temporary structure, bolted in place, readily removable, and reusable.”⁴¹²

At the protest of U.S. shipping interests, Congress reacted to this “‘loophole’ concerning the domestic addition of midbodies” by amending the Second Proviso in 1960.⁴¹³ The 1960 amendment forbade coastwise trading “unless the entire rebuilding, including the construction of any major components of the hull or superstructure of the vessel, is effected within the United States.”⁴¹⁴ As codified by Congress in 2006, the Second Proviso regarding the foreign rebuilding of coastwise privileged vessels now resides at 46 U.S.C. §§ 12132(b) and 12101(a). “A vessel eligible to engage in the coastwise trade and later rebuilt outside the United States may not thereafter engage in

⁴⁰⁹ The large vessel sections are usually seen as vessel hull or superstructure.

⁴¹⁰ *Am. Hawaii Cruises*, at 463.

⁴¹¹ H.R. REP. No. 1887, 86th Cong., 2nd Sess. (1960), 1960 U.S.C.C.A.N. 2664, 2665-66.

⁴¹² H.R. REP. No. 1887, 86th Cong., 2nd Sess. (1960), 1960 U.S.C.C.A.N. 2664, 2665.

⁴¹³ *Am. Hawaii Cruises*, 713 F. Supp. at 463 (citing H. REP. No. 1887, 86th Cong., 2d Sess. 3 (1960), 1960 U.S.C.C.A.N. 2664).

⁴¹⁴ Pub. L. No. 86-583, § 2, 74 Stat. 321 (1960).

coastwise trade.”⁴¹⁵ Further, “a vessel is deemed to have been rebuilt in the United States only if the entire rebuilding, including the construction of any major component of the hull or superstructure, was done in the United States.”⁴¹⁶ Thus, the Jones Act provides that if any major component of the hull or superstructure of a vessel has been constructed in foreign countries, even if added as part of rebuilding at a domestic shipyard, it constitutes foreign rebuilding, and is thus ineligible to engage in coastwise trade.

Shortly thereafter, Bureau of Customs amended the definition “rebuilt” in its regulation consistent with the 1960 Act.⁴¹⁷ Congress did not intend to insulate coastwise carriers from other domestic competition, but the broad Congressional intent underlying the 1956 and 1960 enactments was “to stimulate and encourage resort to domestic shipyards and thus ensure them sufficient business so that their facilities would be adequate in time of national emergency.”⁴¹⁸

C. The United States Coast Guard Administrative Regulations

a. USCG’s authority to administer vessel documentation statutes

In 1967, the Treasury Department transferred vessel documentation functions to the Coast Guard.⁴¹⁹ Since then, the Coast Guard has been designated as the federal agency empowered to administer the vessel documentation laws.⁴²⁰ The Coast Guard, a

⁴¹⁵ 46 U.S.C. § 12132(b).

⁴¹⁶ *Id.* § 12101(a).

⁴¹⁷ 25 Fed. Reg. 13,687,13,687 (1960).

⁴¹⁸ *The Pennsylvania Railroad Co. v. Dillon*, 335 F.2d 292, 295 (D.C. Cir. 1964).

⁴¹⁹ *See Transfer of Certain Functions to Coast Guard*, 32 Fed. Reg. 2,463 (Feb. 4, 1967).

⁴²⁰ In 1967, the Coast Guard moved from the Department of the Treasury to the newly formed Department of Transportation. Following the 11 September 2001 terrorist attacks, it was placed under the Department of Homeland Security in 2002.

component of the Secretary of Homeland Security, has administrative power to issue certificates of documentation with proper endorsement and to determine whether a vessel may receive a coastwise endorsement.⁴²¹ The Secretary of Homeland Security delegates broad authority over vessel documentation to the Commandant of the Coast Guard, who in turn sub-delegates the authority to the Director of the National Vessel Documentation Center.⁴²² The National Vessel Documentation Center is the unit of the Coast Guard responsible for making rebuild determinations.⁴²³ Thus, the Coast Guard has responsibility for certifying vessels for the purpose of the Jones Act.

b. USCG's prior implementing regulations to the Jones Act

Congress did not define the terms in the Second Proviso relating to “foreign rebuilt” and instead delegated regulatory authority to the Treasury Department to promulgate regulations defining the term. As the district court in American Hawaii Cruises v. Skinner noted, “[a]t no time did Congress attempt to draw a line articulating how much foreign rebuilding would violate the second proviso, nor did it list the specific components that it considered to be ‘major.’”⁴²⁴ Thus, the task of interpreting the terms was then left to the supervising agency, which was originally the Treasury Department, followed by the Coast Guard.⁴²⁵

⁴²¹ See 46 U.S.C. §§ 12105 (Issuance of documentation), 12106 (Surrender of title and number), 12113 (Fishery endorsement); see also *Id.* §2104 (authorizing the “Secretary” to delegate duties and powers to the Coast Guard).

⁴²² See 33 C.F.R. § 1.05-1; see also 46 C.F.R. 1.01-10(b)(1)(ii)(D).

⁴²³ See 46 C.F.R. §67.3 (2009) (it is defined as “the organizational unit designated by the Commandant to process vessel documentation transactions and maintain vessel documentation records.”)

⁴²⁴ *Am. Hawaii Cruises*, 713 F. Supp. at 464.

⁴²⁵ See *Shipbuilders Council v. Dept. of Homeland Sec.*, 551 F. Supp.2d 447, 449 (E.D.Va. 2008).

The Vessel Documentation Act of 1980 was the culmination of several attempts by Congress to revise and modernize the laws pertaining to the documentation of vessels.⁴²⁶ In 1981, the Coast Guard initiated an administrative rule-making to “prescribe regulations to carry out the mandate of the Act.”⁴²⁷ The effectiveness of the Act will depend upon the ability of the Coast Guard to develop a regulatory scheme consistent with the legislative framework.⁴²⁸ In 1982, the Coast Guard issued a regulation that modified the original definition of “rebuilt” by deleting the words “in its intact condition without being broken up.”⁴²⁹ It also deleted the language of “entire rebuilding” for the first time since 1960.⁴³⁰ The Coast Guard rephrased and retained the old definition of “rebuilt” as: “[a] vessel is rebuilt when any considerable part of its hull or superstructure is built upon or is substantially altered” codified in Section 67.27-3(a) of its 1982 regulation.⁴³¹

In the 1989 case American Hawaii Cruise, the issue to be resolved was the extent of permissible rebuilding under the new regulations. The parties disputed the definition of the phrase “entire rebuilding” in the Second Proviso that Congress had been silent on.⁴³² The plaintiffs challenged the Coast Guard’s application of the 1982 regulations to the vessel MONTEREY, arguing that the Second Proviso prohibited any rebuilt vessel from the coastwise trade unless the “entire rebuilding” occurred in the United States.⁴³³ The Court determined that “[i]n requiring that ‘major’ components be built in the United

⁴²⁶ Meredith L. Hathorn, *The Vessel Documentation Act of 1980*, 7 MAR. LAW. 303, 303 (1982).

⁴²⁷ *Documentation of Vessels*, 46 Fed. Reg. 56,318, 56,318 (proposed Nov. 16, 1981).

⁴²⁸ Hathorn, *supra* note 125, at 307.

⁴²⁹ 47 Fed. Reg. 27,490, 27,503 (June 24, 1982).

⁴³⁰ 46 Fed. Reg. 56,318, 56,322 (Nov. 16, 1981).

⁴³¹ 47 Fed. Reg. 27,490, 27,503 (1982).

⁴³² *Am. Hawaii Cruises*, at 461.

⁴³³ *Id.* at 461-62.

States, the second proviso implies that some components need not.”⁴³⁴ However, the court held that the Coast Guard regulation did not adequately articulate the test for determining whether the rebuilding of a vessel was “structural.”⁴³⁵ Though the court recognized that “it would be manifestly unjust to revoke the license of the S/S MONTEREY because of the inability of the Coast Guard to satisfactorily explain its test,” it concluded that “the agency should state how it defines a ‘major component’ within the meaning of the second proviso . . . [a] blanket statement that the second proviso has been complied with simply will not do.”⁴³⁶ Accordingly, the case was remanded for further administrative proceedings.

c. USCG’s current implementing regulations to the Jones Act

Responding to the District of Columbia decision in American Hawaii Cruises, the Coast Guard attempted to revise its vessel documentation regulations by initiating a notice and comment rulemaking. The Coast Guard renumbered its regulations, moving foreign rebuilding from 46 C.F.R. § 67.27-3 to 46 C.F.R. § 67.177.⁴³⁷ The rulemaking also added the definitions of the terms “hull” and “superstructure” that currently reside at 46 C.F.R. § 67.3.⁴³⁸ In 1996, the Coast Guard, pursuant to the Second Proviso, issued the

⁴³⁴ *Id.* at 462.

⁴³⁵ *Id.* at 466-69.

⁴³⁶ *Id.* at 469.

⁴³⁷ 57 Fed. Reg. 10,544, 10,548 (Mar. 26, 1992).

⁴³⁸ See 46 C.F.R. § 67.3 (A “hull” is defined as the “shell, or outer casing, and internal structure below the main deck which provide both the flotation envelope and structural integrity of the vessel in its normal operations.” And, the “superstructure” is “the main deck and any other structural part above the main deck.”)

final regulation governing whether a vessel is “rebuilt” outside of the United States.⁴³⁹ Section 67.177 sets out a comprehensive scheme for determining whether work done abroad constitutes foreign rebuilding.⁴⁴⁰ The 1996 Rule defined that vessel modification work could qualify as foreign rebuilding if it involves either: (1) the construction of a considerable part of the hull (the “considerable part test”); or (2) the addition of a major component to a vessel’s hull (the “major component test”).⁴⁴¹

1) Considerable part test (46 C.F.R. § 67.177(b))

The considerable part test is a test derived from the aforementioned decision in The Grace Meade in the nineteenth century, and adopted by the Supreme Court in The Jack-O-Lantern, that Congress incorporated into the 1956 Second Proviso to the Jones Act.⁴⁴² Thus, the 1956 amendment was the genesis for the considerable part test. The United States Coast Guard has established regulatory thresholds to determine whether proposed vessel modification on a vessel constitutes a “considerable part” of the hull or superstructure, which is set out in the current regulation 46 C.F.R. Section 67.177(b), as follows:

“A vessel is deemed rebuilt foreign when any considerable part of its hull or superstructure is built upon or substantially altered outside of the United States. In determining whether a vessel is rebuilt foreign, the following parameters apply:

(a) Regardless of its material of construction, a vessel is deemed rebuilt when a major component of the hull or superstructure not built in the United States is added to the vessel.

(b) For a vessel of which the hull and superstructure is constructed of steel or aluminum—

(1) A vessel is deemed rebuilt when work performed on its hull or

⁴³⁹ CGD 95-014, 60 FR 31605 (June 15, 1995); CGD 94-040, 61 FR 17815 (April 22, 1996); USCG-2009-0702, 74 FR 49230 (Sept. 25, 2009).

⁴⁴⁰ See 46 C.F.R. § 67.177; see also *Shipbuilders Council of America*, 578 F.3d 234, 238.

⁴⁴¹ See 46 C.F.R. 67.177 (a)-(b); see also *Shipbuilders Council of America*, 578 F.3d 234, 238.

⁴⁴² See S.REP. 84-2395 at 1-2 (It was cited with approval by the Senate Committee on Interstate and Foreign Commerce when the Second Proviso was enacted in 1956).

superstructure constitutes more than 10 percent of the vessel's steelweight, prior to the work, also known as discounted lightship weight.

(2) A vessel may be considered rebuilt when work performed on its hull or superstructure constitutes more than 7.5 percent but not more than 10 percent of the vessel's steelweight prior to the work.

(3) A vessel is not considered rebuilt when work performed on its hull or superstructure constitutes 7.5 percent or less of the vessel's steelweight prior to the work . . . ”

With respect to this test, the Coast Guard applies the percentage limitations in § 67.177(b) to ascertain the meaning of “considerable part.” Any work not involving the addition of a major component built in foreign countries, according to § 67.177(a), will be assessed under this test. Specifically, the provisions listed in § 67.177(b) apply for steel vessels. Furthermore, Section 67.177 sets forth provisions applying to vessels made of materials other than steel or aluminum and to vessels of mixed construction as well.⁴⁴³ According to subsection (b)(1), the vessel modification will result in the loss of the coastwise privilege if the work performed abroad constitutes more than 10 percent of the vessel’s “discounted lightship weight.” Exceeding the bright-line 10 percent threshold will result in per se determination that the vessel was “foreign rebuilt.” Furthermore, based on subsection (b)(2), if the added steelweight percentage is between the range of 7.5 percent and 10 percent, it will fall within the threshold of work by which the vessel may, *but need not*, be considered rebuilt. The Coast Guard has discretion to determine whether it is foreign rebuilt under this circumstance.

2) Major component test (46 C.F.R. § 67.177(a))

The major component test emerged from the subject of the 1960 amendment to the Jones Act to remedy the “jumboizing” problem.⁴⁴⁴ The “considerable part test” thus

⁴⁴³ See 46 C.F.R. 67.177 (c)-(d).

⁴⁴⁴ *Am. Hawaii Cruises*, at 464 (The legislative history makes clear that the term “major component” was specifically designed to address the midbody problem.)

predates the “major component test,” which Congress included into the federal regulation after the enactment of the 1960 amendment. The Coast Guard tracks the definition in the Second Proviso and applies this test when there is an addition of a major component of the hull or superstructure, as provided in 46 C.F.R. § 67.177(a). The addition of a major component, which is foreign built, will automatically result in the revocation of a vessel’s coastwise endorsement. However, Congress did not list the specific components that it considered to be “major.” In merely restating the operative language from the Second Proviso, the Coast Guard did not provide any guidance as to what Congress meant by “major components.” Nevertheless, the Coast Guard has traditionally found that objects weighing in excess of 1.5% of the vessel’s discounted lightship weight are “major” components. The Coast Guard also has indicated that, “[a] vessel is rebuilt if it meets the ‘considerable part’ test but fails the ‘major component’ test.”⁴⁴⁵

3) Section 67.97

The Coast Guard considers a vessel to be “United States built” if (1) “[a]ll major components of her hull and superstructure are fabricated in the United States;” and (2) “[t]he vessel is assembled entirely in the United States.”⁴⁴⁶ As straightforward as the regulatory formula may appear, it has spawned numerous conflicts over the meanings of a “major component” and “assembly.”⁴⁴⁷ Although the Coast Guard has defined several pertinent terminologies in its regulation set out under 46 C.F.R. §67.3, it did not clarify the meaning of these two terms.⁴⁴⁸

⁴⁴⁵ See *Shipbuilders Council of America, Inc. v. U.S. Dept. of Homeland Sec.*, 2008 WL 3048646, at *8, Memorandum in Support of Plaintiffs’ Motion for Summary Judgment (May 2, 2008) (citing 12/15/99 Coast Guard Ltr. (APP-7)).

⁴⁴⁶ See 46 C.F.R. § 67.97(a)-(b).

⁴⁴⁷ Francis X. Nolan, III, Remarks at the 2009 Conference of the International Bar Association in Madrid, Spain: *Recent Developments Affecting Marine Financing in the United States* 5 (Oct. 9, 2009).

⁴⁴⁸ See 46 C.F.R. § 67.3; USCG-2005-20258, 71 FR 61417 (Oct. 18, 2006). “Coastwise trade” in its regulation is regarded as the transportation of passengers or merchandise between points in the United

4) Procedures for filling requests for rebuilding determinations by the USCG

In addition, the Coast Guard regulation also provides procedures for applying for rebuilt determinations by the USCG. For a vessel currently entitled to coastwise or fisheries endorsements which is subsequently altered outside the United States and the alternations either (1) constitute greater than 7.5 percent of the vessel's steelweight prior to the work, or (2) include the addition of a major component of the hull or superstructure not built in the United States, the owner of the vessel must file a request for a rebuilt determination "with the National Vessel Documentation Center."⁴⁴⁹ The application must be filed within 30 days following the earlier of completion of the work or redelivery of the vessel to the owner or owner's representative."⁴⁵⁰

Additionally, before undertaking vessel modifications in foreign countries a vessel owner may apply for a "preliminary rebuilt determination" by submitting materials required under subsection (e).⁴⁵¹ In order to receive a coastwise endorsement from the Coast Guard, a vessel owner must file a CG-1258 form, namely, "Application for Initial Issue, Exchange, or Replacement of Certificate of Documentation; Re-documentation." The applicant must certify that the vessel has not been "rebuilt" under U.S. law, and then

States embraced within the coastwise laws. The Coast Guard defined "vessel" as including "every description of watercraft or other contrivance capable of being used as a means of transportation on water, but does not include aircraft."

⁴⁴⁹ See 46 C.F.R. § 67.177 (e).

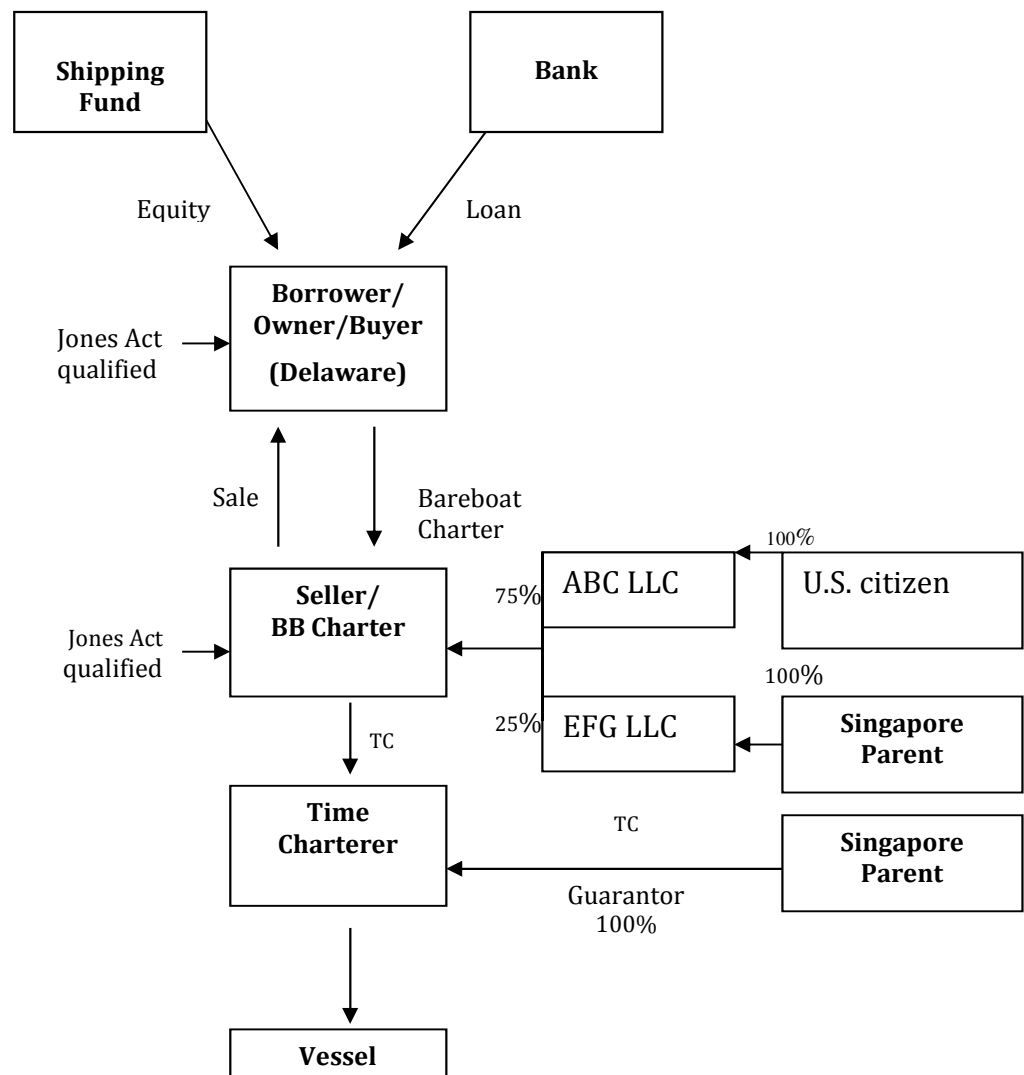
⁴⁵⁰ *Id.* (The application must contain: "(1) A written statement applying for a rebuilt determination, outlining in detail the work performed and naming the place(s) where the work was performed; (2) Calculations showing the actual or comparable steelweight of the work performed on the vessel, the actual or comparable steelweight of the vessel, and comparing the actual or comparable steelweight of the work performed to the actual or comparable steelweight of the vessel; (3) Accurate sketches or blueprints describing the work performed; and (4) Any further submissions requested by the National Vessel Documentation Center.")

⁴⁵¹ See *Id.* § 67.177 (g).

the Coast Guard may approve the application.⁴⁵²

⁴⁵² See USCG website, available at <http://www.uscg.mil/hq/cg5/nvdc/nvdcforms.asp>.

7.2. Jones Act Sale Leaseback



The author would like to discuss a Jones Act vessel sale leaseback transaction based on the above hypo. In this hypo, the borrower is a special purpose company owned by one or more investment funds managed by a New York registered private equity investor, incorporated in the State of Delaware (the “Borrower”). The Borrower will purchase the vessel, which will be registered with the United States flag, from the seller under the MOA. The Borrower/Buyer will also become the Owner of the Jones Act vessel. The seller/Bareboat Charterer, a Jones Act qualified management company, will demise charter the vessel for 9 years to conduct coastwise trade between points of the States. The

Bareboat Charterer is owned 75% by ABC LLC, an entity wholly-owned by a U.S. citizen, and 25% by EFG LLC, a wholly-owned subsidiary of its Singapore parent. The vessel will then be time chartered to the Time Charterer, a wholly owned subsidiary of the Singapore parent company.

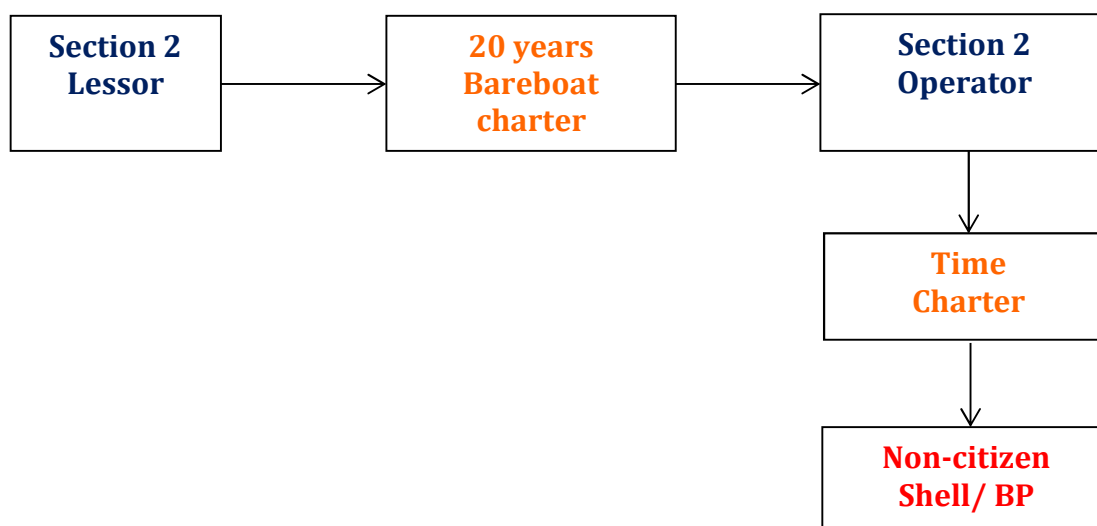
The acquisition will be financed partially by the private equity's funds and by the bank's term loan of up to the lesser of U.S.\$18,000,000 and 70% of the charter-free Fair Market Value of the Vessel. Time Charter hire shall be paid to an account controlled by the Owner and pledged to the Lender. The net proceeds in this account, after paying the monthly Bareboat hire, shall be released to the Bareboat Charterer.

The security for the loan obligations of the Owner/Borrower are the following:

- First preferred Mortgage over the vessel for any amounts outstanding under the loan facility;
- Assignments of earnings and requisition compensation;
- Assignment of Insurances;
- Pledge or charge over the Earnings Account to be opened with "Bank M";
- Specific assignment of the Bareboat Charter;
- Specific assignment of the Time Charter;
- Specific assignment of the Time Charter Guarantee;
- Specific assignment of time charterparties in excess of 12 months;
- Pledge or charge over the Borrower's membership interests.

Jones Act Lease Financing

Section 2 of the 1916 Act defined the U.S. citizenship requirements.



An exception exists in the Jones Act trades where a non-citizen party will not be qualified to own or operate qualifying vessel tonnage. As illustrated by the above diagram, while both owner lessor and operator are U.S. citizens under Section 2 of the 1916 Act, BP/Shell are non-citizens who require vessel services in U.S. domestic trades.

The non-citizen U.S. flag vessel lease financing transactions were structured following the passage of the Merchant Marine Act of 1970. In these transactions, the U.S. flag vessels were owned by a leasing company affiliate of a section 2 citizen, bareboat chartered to an affiliate of a section 2 citizen operator and time chartered to a non-citizen user such as BP or Shell.⁴⁵³ Until 1992, time charters to non-citizens require Maritime Administration (MARAD) approval.⁴⁵⁴

⁴⁵³ H Clayton Cook, Jr., *Current Opportunities for Lease Financing in the Coastwise Trades*.

⁴⁵⁴ *Id.*

Mr. Clayton Cook, based in Seward and Kissel's Washington, D.C. office, described as follows: "[T]hese transactions involved the ownership of the vessel by a section 2 citizen financial institution, with the vessel demised (or bareboat chartered) to the section 2 <of the Shipping Act of 1916> citizen vessel operator, and then time chartered to the creditworthy end-user for a period not in excess of 80 percent of the vessel's useful life. The roster of lease financing transactions accomplished during this period included Alaska crude carriers and coastwise product tankers time chartered to non-citizen petroleum majors such as British Petroleum and Shell."⁴⁵⁵

The above diagram also illustrates the use of an alternative financing to the U.S. shipowners, namely, Capital Construction Fund program. The Capital Construction Fund (CCF) program was created to assist owners and operators of United States-flag vessels in accumulating capital necessary for the modernization and expansion of the U.S. merchant marine. The program encourages construction, reconstruction, or acquisition of vessels through the deferment of Federal income taxes on certain deposits of money or other property placed into a CCF.⁴⁵⁶ Operators of American-flag vessels are faced with a competitive disadvantage in the construction and replacement of their vessels relative to foreign-flag operators whose vessels are registered in countries that do not tax shipping income. The CCF program helps counterbalance this situation through its tax-deferral privileges.

The shipowner who wishes to take advantage of this program applies to the MARAD for enrolment, and after its application has been approved enters into a CCF agreement

⁴⁵⁵ See <http://www.marinemoneyoffshore.com/node/5684>.

⁴⁵⁶ See http://www.marad.dot.gov/ships_shipping_landing_page/capital_construction_fund/capital_construction_fund.htm.

with MARAD.⁴⁵⁷ Vessel owners are entitled to an income tax deduction for the amount deposited into the CCF attributable to income from eligible agreement vessels. Earnings on funds in the CCF are tax deferred in a similar manner to funds in an Individual Retirement Account.⁴⁵⁸

Eligible vessels must operate in such trades for twenty years from the date of acquisition. Second hand qualified vessels must operate in such trade for ten years from the date of acquisition. CCF vessels must be built in the United States and documented under the laws of the United States for operation in the Nation's foreign, Great Lakes, Short-Sea Shipping or noncontiguous domestic trade or its fisheries.⁴⁵⁹

In order to attract additional equity to the lease financing market, in 1996, Congress acted to allow non-citizen ownership of vessels that were demised to U.S. citizen operators for a period of at least three years in lease financing transactions. Under Section 12106(e) of Title 46 (now codified as 46 U.S.C. 12119), Congress authorized the issuance of coastwise vessel endorsements if: (1) the vessel was eligible for documentation; (2) the vessel's owner, the parent of the owner, or a subsidiary of the parent of the owner, was primarily engaged in leasing or other financing transactions; the vessel was under a demise charter to a U.S. citizen eligible to engage in coastwise trade under section 2 of the 1916 Act; and (4) the demise charter was for a period of at least three years. Section 1113(d) of the Coast Guard Authorization Act of 1996 removed the U.S. citizenship requirement for vessel owners, so long as the non-citizen owner was "primarily engaged in leasing or other financing transactions," and the vessel was demised to a U.S. citizen for a period of at least three years.

⁴⁵⁷ See generally 46 CFR Ch. II, Pt. 391(10-1-07 Edition).

⁴⁵⁸ *Id.*

⁴⁵⁹ *Id.*

These provisions were amended in 2004, to clarify what had been the 1996 legislation's original intent, and to expressly limit their availability to non-citizen passive investor owners. In early 2004, the Coast Guard promulgated revised regulations that would enable non-U.S. financial institutions, but not foreign shipping companies, to engage in ownership of Jones Act vessels to be leased to U.S. citizen companies, thereby closing the pathway for foreign ship-owners into the Jones Act.⁴⁶⁰

7.3. Financing risks of vessel modification outside the United States

As mentioned above, a vessel is deemed to be built in the U.S. only if all major components of the hull and superstructure are fabricated in the U.S. and the vessel is entirely assembled in the US (46 CFR 67.97). The U.S. Coast Guard has consistently held that items not integral to the hull or superstructure, such as propulsion machinery, consoles, wiring harnesses and other outfitting that has no bearing on a U.S. build determination, may be foreign built without compromising the vessel's coastwise eligibility. The U.S. Coast Guard has also held that foreign components amounting to less than 1.5 per cent of a vessel's steel weight are not considered 'major'.

7.3.1. Philadelphia Metal Trades Council v. Allen (2008)

As mentioned earlier, the longstanding USCG regulation 46 C.F.R. Section 67.97 does not explicate what the term "assembled" means.⁴⁶¹ Recently in 2008, the United States District Court Eastern District of Pennsylvania addressed the meaning of "assembled" in the context of the modular construction in Philadelphia Metal Trades Council v. Allen. Its holding is best summed up by the adage that "the whole can indeed

⁴⁶⁰ See <http://www.conconnect.com/Workingpapers/janeskvaernerosg.pdf>.

⁴⁶¹ See 46 C.F.R. § 67.97.

be greater-or at least more coastwise-than the sum of parts.”⁴⁶² The plaintiff organizations argued that the United States Coast Guard erred in ruling that certain of Aker Philadelphia Shipyard, Inc.’s (“Aker”) tankers qualified as “U.S. built” under the Jones Act and Coast Guard Regulation 46 C.F.R. Section 67.97, even though the tankers contained large, foreign-built equipment modules.⁴⁶³ The district court ruled in favor of the Coast Guard and upheld the agency’s interpretation of its own regulation.⁴⁶⁴

In October 2004, Aker’s predecessor in interest, Kvaerner Philadelphia Shipyard (“KPS”), first requested to the National Vessel Documentation Center (“NVDC”) for confirmation that the inclusion of “certain foreign-built engine room-related macro modules in the construction of new build vessels” would not result in the forfeiture of vessels’ coastwise endorsements.⁴⁶⁵ In December 2004, the NVDC ruled in favor of KPS and explained the finding by noting the Coast Guard’s longstanding stance that “the items not integral to the hull or superstructure, such as propulsion machinery, machinery, consoles, wiring, certain mechanical systems and outfitting have no bearing on a U.S. build determination . . . [and] the use of small engine room equipment modules of foreign origin will not affect a U.S. build determination.”⁴⁶⁶ On April 25, 2006, before constructing ten Veteran Class MT-46 Product tankers, Aker applied to the NVDC, seeking confirmation that its tankers would be deemed as “U.S. built”.⁴⁶⁷ Later, the

⁴⁶² *Philadelphia Metal Trades Council V. Allen*, 2008 WL 4003380, at *3 (E.D.Pa. 2008).

⁴⁶³ *Id.* at *1.

⁴⁶⁴ *Id.* at *20.

⁴⁶⁵ *Id.* at *3 (KPS described the modules in its application that “macro modules [would consist of] equipment, and other supporting systems and outfitting, to be grouped into two-deck modules that would be incorporated into the construction of a vessel in its yard in Philadelphia. Outfitting of the modules would include machinery components and foundations, equipment, piping, switchboards, cabling, lighting, stairs, ladders, railings, and floor-grating.”)

⁴⁶⁶ 2008 WL 4003380, at *3.

⁴⁶⁷ *Id.* at *4.

NVDC determined that “Aker’s use of certain foreign pre-assembled and pre-outfitted equipment modules and piping systems did not violate the statute or the regulations.”⁴⁶⁸ Labor unions PMTC and MTD then appealed the ruling of the NVDC contending that “the assembly of the modules themselves should be considered an integral part of the assembly of the vessel and, thus, should occur on U.S. soil.”⁴⁶⁹ On November 15, 2006, the Coast Guard denied the appeal and analyzed that “while ‘manufactured parts’ [i.e., the modules] may be constructed outside the United States, the ‘complete machine’ [i.e., the tanker itself] must be assembled in the United States.”⁴⁷⁰ The Coast Guard’s main concern was that the unions’ position might cause “every nut or bolt incorporated into a vessel, or into any of its outfit or equipment, [to] undergo ‘assembly’, or ‘preassembly’, in the United States.”⁴⁷¹

Consequently, PMTC and MTD filed suit against the Coast Guard, along with the NVDC.⁴⁷² Aker and General Dynamics NASSCO (“NASSCO”) intervened as defendants.⁴⁷³ Alleging that the ruling of the NVDC/Coast Guard “allow[ed] Aker to outsource assembly and pre-outfitting of certain equipment modules and piping systems to foreign facilities, thus reducing the work available to American shipyard employees, contrary to the protections guaranteed by the Jones Act,” plaintiffs sought a court order declaring that the Coast Guard’s ruling was arbitrary and capricious, and injunctive relief

⁴⁶⁸ 2008 WL 4003380, at *4.

⁴⁶⁹ *Id.* at *5 (PMTC is a labor union comprised of members who work for Aker Philadelphia Shipyard, Inc. MTD is a labor organization, acting on behalf of PMTC and its employees in litigation efforts.)

⁴⁷⁰ *Id.*

⁴⁷¹ *Id.*

⁴⁷² *Id.* at *1.

⁴⁷³ *Id.*

enjoining the Defendants from certifying vessels based on the challenged interpretation.⁴⁷⁴

Under 46 C.F.R. Section 67.97, a vessel must meet both of the following requirements to be considered built in the United States: (a) “[a]ll major components of its hull and superstructure are fabricated in the United States” and (b) “[t]he vessel is assembled entirely in the United States.”⁴⁷⁵ The court recognized that the Coast Guard has not defined the terms “component,” “assembled” or “entirely.”⁴⁷⁶ Citing dictionary definitions of “assemble” and “entirely,” plaintiffs argued that “the plain meaning of the unambiguous language [of 46 C.F.R. § 67.97(b)] is that the fitting together of manufactured parts into a complete vessel, or a structure or unit of the vessel, must be performed exclusively in the United States.”⁴⁷⁷ The Government defendants’ response was that “[t]he regulation does not address the assembly of parts for the vessel,” and that plaintiffs’ argument was misguided since it ignored the basic subject of Section 67.97(b), namely, the “vessel” itself.⁴⁷⁸ Plaintiffs further relied on the Webster’s Dictionary definition of “assembly” to reach the conclusion that it means “the fitting together of the parts of both the whole and its subunits.”⁴⁷⁹ Government defendants in turn urged the court to hold that “the plain and unambiguous meaning of the regulation is [] that the vessel itself, not every individual part, must be assembled entirely in the United

⁴⁷⁴ See *Id.* at *5.

⁴⁷⁵ See 46 C.F.R. § 67.97(a) & (b).

⁴⁷⁶ See 2008 WL 4003380, at *11.

⁴⁷⁷ See *Id.* at *12.

⁴⁷⁸ See *Id.*; see also 46 C.F.R. § 67.97(b) (“The vessel is assembled entirely in the United States.”)

⁴⁷⁹ See 2008 WL 4003380, at *12; see also n.15 (Webster’s Dictionary at 109, defining “assembly” as “the fitting together of manufactured parts into a complete machine, structure or unit of a machine”).

States.”⁴⁸⁰ In the alternative, because neither interpretation was “the only reasonable interpretation,” the court found the language of the Coast Guard regulation was ambiguous.⁴⁸¹

Finding Section 67.97(b) to be ambiguous, the Court then evaluated the agency’s interpretation of the regulation.⁴⁸² Plaintiffs argued that the Coast Guard’s interpretation of Section 67.97(b) was plainly erroneous because it did not comport with the requirement that the entire vessel be assembled in the United States by “permit[ting] the assembly of the requirements [sic] modules to be performed outside the United States, provided only that the final attachment of those modules into the vessel is performed in the United States.”⁴⁸³ Plaintiffs also suggested an adverse ruling would produce the illogical result whereby “American shipbuilders would have the capacity to build only ‘floating envelope[s],’ not functional ships” if “the only subparts of the vessel that must be assembled entirely in the United States are the ‘major components of the hull and superstructure.’”⁴⁸⁴ Rejecting plaintiffs’ allegation that allowing “preassembly” to take place in foreign countries would deny American union members work, the court concluded “[h]owever compelling as a matter of national pride and the economic well-being for an important segment of our community Plaintiffs’ goals undeniably may be, the Court cannot consider Plaintiffs’ organizational *raison d’être* regarding the interpretation of the Coast Guard regulation.”⁴⁸⁵ Thus, the court found in favor of the

⁴⁸⁰ See 2008 WL 4003380, at *13.

⁴⁸¹ *Id.*

⁴⁸² *Id.* at *13-20.

⁴⁸³ *Id.* at *13.

⁴⁸⁴ See *Id.*

⁴⁸⁵ See *Id.*

Coast Guard's interpretation of its regulation as neither plainly erroneous nor inconsistent with the regulation.⁴⁸⁶

Finally, the court addressed a line of rulings cited by defendant NASSCO, as early as 1882, by various agencies, including the Coast Guard, the Treasury Department, and the U.S. Attorney General, in support of its contention that in accordance with precedent shipbuilders are permitted to use “not only small foreign-made parts, but also major components and machinery made and even assembled offshore.”⁴⁸⁷ The court found that Congress' lack of action to rescind the Coast Guard's longstanding interpretation sufficient evidence of Congress's implicit approval, thus confirming the reasonableness of the Coast Guard's ruling.⁴⁸⁸ Therefore, the court concluded that the agency's interpretation “has remained consistent over time and consistent with its statutory origins,” and accepted the agency's interpretation that “assembly” means final assembly of the vessel, not the assembly of parts of the vessel.⁴⁸⁹

7.3.2. Shipbuilders Council v. U.S. Coast Guard (2009)

The case arose out of work performed in a Chinese shipyard on an existing U.S.-flag petroleum product tanker, the *M/V SEABULK TRADER*.⁴⁹⁰ On August 21, 2009, the U.S. Court of Appeals for the Fourth Circuit in Shipbuilders Council v. U.S. Coast Guard ruled that the Coast Guard should be granted discretion in interpreting rules on installation of

⁴⁸⁶ See *Id.* at *14.

⁴⁸⁷ See *Id.* at *16-17; see also the Coast Guard explanation in its 1984 rule, 49 Fed. Reg. 4944 (“the shipbuilder has always been able to use foreign material in the hull and superstructure and has been free to install some foreign machinery and components.”)

⁴⁸⁸ See 2008 WL 4003380, at *17-18.

⁴⁸⁹ See *Id.* at *18.

⁴⁹⁰ *Shipbuilders Council v. Dept. of Homeland Sec.*, 551 F. Supp.2d 447, 448 (E.D.Va. 2008).

double hulls on oil tankers.⁴⁹¹ The Fourth Circuit reversed and remanded the decision by the U.S. District Court for the Eastern District of Virginia, and reinstated the determination of the United States Coast Guard.⁴⁹²

Seabulk Petroleum Transport Inc. owned the *SEABULK TRADER*, built in 1981, for exclusive use in the coastwise trade.⁴⁹³ It was required that a double hull be installed in order to continue to operate with the Oil Pollution Act 1990 (OPA'90) requirements.⁴⁹⁴ Otherwise, it would have been forced to retire in 2011 absent a retrofit of its hull.⁴⁹⁵ In order to meet the double hull requirement, Seabulk proposed to install an "inner hull" throughout the vessel's cargo block and to reconfigure the vessel's existing ballast tanks.⁴⁹⁶

Seabulk applied to the USCG for a preliminary determination that proposed work on the *SEABULK TRADER* in China would not constitute a foreign rebuilding.⁴⁹⁷ The Coast Guard issued a preliminary determination that the proposal would not constitute a foreign rebuilding or a foreign installation of segregated ballast tanks.⁴⁹⁸ Following the preliminary issuance, Seabulk had a double hull for its tanker installed, and also reconfigured the ballast tank system in China.⁴⁹⁹ In total, the added steelweight to the

⁴⁹¹ *Shipbuilders Council of America v. U.S. Coast Guard*, 578 F.3d 234, 236-37 (4th Cir. 2009).

⁴⁹² *Id.*

⁴⁹³ *Id.* at 237.

⁴⁹⁴ *Id.*

⁴⁹⁵ 551 F. Supp.2d 447, 450, n.4.

⁴⁹⁶ *Id.* at 450.

⁴⁹⁷ 578 F.3d 234, 237.

⁴⁹⁸ *Id.*

⁴⁹⁹ *Id.*

SEABULK TRADER constituted 8.15% of the vessel's pre-modification steelweight.⁵⁰⁰ In determining whether the Seabulk could maintain its coastwise endorsement following the foreign modification, the Coast Guard applied the federal regulation 46 C.F.R. § 67.177.⁵⁰¹ Because the added portions of the hull did not exceed the 10% threshold of added steelweight set forth in § 67.177(b), the Coast Guard determined that the tanker had not been rebuilt foreign and thus granted a coastwise endorsement for the *SEABULK TRADER*.⁵⁰² In other words, the Coast Guard pertinently concluded in its findings that Seabulk's work project, in accordance with the Second Proviso and its regulations described above, did not constitute a "major component of the hull"; did not exceed the prohibited steelweight thresholds; and did not constitute the foreign installation of segregated ballast tanks.⁵⁰³ The plaintiffs ("Shipbuilders")⁵⁰⁴ brought action in district court attacking the Coast Guard's decision to issue Seabulk a coastwise endorsement as "arbitrary and capricious, an abuse of discretion."⁵⁰⁵

In applying the regulation § 67.177(b), the Coast Guard faced a choice of tests. The Coast Guard needed to assess whether the added steel constituted a separable component before its addition, and thus required the "major component test", or was not a separable component, meaning "considerable part test" treatment.⁵⁰⁶ The Coast Guard accordingly ruled that the installation of the steel to form the inner hull did not constitute a

⁵⁰⁰ *Id.*

⁵⁰¹ *Id.*

⁵⁰² *Id.* at 238.

⁵⁰³ 551 F. Supp.2d 447, 453.

⁵⁰⁴ The Shipbuilders Council of America is the largest and most broad-based national trade association representing the U.S. shipyard industry that primarily builds and repairs commercial vessels, *available at* <http://www.shipbuilders.org/home/RightLinks/ShipyardsatGlance/tabid/105/Default.aspx>.

⁵⁰⁵ 578 F.3d 234, 238.

⁵⁰⁶ *Id.*

“separable” component of the tanker so it did not use the “major component test.”⁵⁰⁷ Then the Coast Guard evaluated the installation of the inner hull under the “considerable part test,”⁵⁰⁸ concluding that the added steelweight percentage would fall between 7.97% and 8.57%, and was therefore not a rebuild under § 67.177(b).⁵⁰⁹ Significantly, the outcome could have been different, since the Coast Guard has discretion to determine whether a vessel has been rebuilt foreign where the work constitutes between 7.5 percent and 10 percent of the discounted lightship weight.⁵¹⁰

After evaluating the major component and the considerable part tests separately, the district court invalidated the Coast Guard's interpretation of each.⁵¹¹ The district court concluded that whether an added part is a separable component had “no foundation in statute or regulation.” The court further held that “[t]he Coast Guard's vague separable/inseparable distinction, which it used to grant a certificate of coastwise eligibility to the *SEABULK TRADER*, is likewise unfaithful to the text, history, and purpose of the Second Proviso.”⁵¹² Therefore, the district court found that the Coast Guard's interpretation of the “major component test” was not persuasive, and struck it down.⁵¹³ The district court did however give deference to the Coast Guard's interpretation of the “considerable part test.”⁵¹⁴ Yet, as to the steelweight percentage calculation, the court agreed with plaintiffs that the Coast Guard “failed to offer an

⁵⁰⁷ *Id.*

⁵⁰⁸ *Id.*

⁵⁰⁹ 551 F. Supp.2d 447, 450.

⁵¹⁰ See 578 F.3d 234, 243; see also 46 C.F.R. § 67.177(b)(2).

⁵¹¹ See 578 F.3d 234, 243.

⁵¹² 551 F. Supp.2d 447, 456.

⁵¹³ See 578 F.3d 234, 238-39.

⁵¹⁴ See *Id.* at 239.

adequate explanation for its decision”⁵¹⁵ and ordered the revocation of the coastwise endorsement of the *SEABULK TRADER*.⁵¹⁶

The Coast Guard and owner of *SEABULK TRADER* appealed. The Fourth Circuit ruled in favor of the Appellants, and held that the lower court erred in rejecting the Coast Guard’s interpretation of its own regulatory scheme governing the issuance of the coastwise endorsements.⁵¹⁷ As the court noted, the Coast Guard appealed only the district court’s decision that the agency improperly applied the “major component” test in determining that the *SEABULK TRADER* did not fall under the foreign rebuilt classification.⁵¹⁸ The Coast Guard argued that the “major component test” and the “considerable part test” apply under different circumstances.⁵¹⁹ It defined a “major component” as any “new, separate and completely-constructed unit” weighing more than 1.5% of the vessel’s steelweight.⁵²⁰ According to the Coast Guard, “the inner hull is not a separable component because it was constructed ‘by adding steel, which [was] then built upon steel piece-by-piece,’” and thus the “major component test” did not apply.⁵²¹ Responding to the district court’s ruling, the Coast Guard contended that: “the separable/inseparable distinction is a necessary part of its holistic interpretation of the regulation. Only by drawing a firm line . . . can both prongs of the regulation be given effect.”⁵²²

⁵¹⁵ 551 F. Supp.2d 447, 456-57.

⁵¹⁶ *Id.* at 460.

⁵¹⁷ *See* 578 F.3d 234, 236-37.

⁵¹⁸ *See Id.* at 240.

⁵¹⁹ *See Id.* at 243.

⁵²⁰ *See Id.* (citing Appellant’s Br. at 32).

⁵²¹ *See* 578 F.3d 234, 243; *see also* 551 F.Supp.2d 447, 454 (quoting Def. Opp’n, at 19).

⁵²² *See* 578 F.3d 234, 244.

Relying on precedent, the Fourth Circuit noted that: “the fact that the separable/inseparable distinction is not found in the text of either the regulation or the statute does not deprive the interpretation of its persuasive power in instances where the language of the regulation is ambiguous.”⁵²³ Moreover, with reference to American Hawaii Cruises, the court concluded that “[the Coast Guard’s interpretation] is longstanding, has been consistently applied in the same manner, and comports with the congressional intent of the governing statute.”⁵²⁴ Consequently, the court reversed the district court’s ruling that invalidated the Coast Guard’s interpretation of the major component test of 46 C.F.R. §67.177.⁵²⁵

7.3.3. Shipbuilders Council of America, Inc. v. U.S. Dept. of Homeland Sec.
(2009)

On December 3, 2009, the United States District Court Eastern District of Virginia ruled in favor of the U.S. Coast Guard and Matson Navigation Company, Inc. (“Matson”) in a vessel foreign rebuild case.⁵²⁶ Matson is the owner of the container ship, *M/V MOKIHANA*, which undertook significant rework in a Chinese shipyard for 100 days. Specifically, the aft end of the vessel was converted from an area for container storage to

⁵²³ See *Id.* at 245 (citing Barnhart v. Walton, 535 U.S. 212, 221 (2002)). In this case, the Supreme Court held that the agency’s interpretation through means less formal than notice and comment rulemaking does not automatically deprive the interpretation of judicial deference.)

⁵²⁴ See *Id.* (citing *Am. Hawaii Cruises*, 713 F. Supp. at 466 (“Deference should be accorded to an agency’s interpretation of a statute ‘where the administrative determination was made contemporaneously with the statute, is longstanding, and has been applied consistently.’”))

⁵²⁵ See 578 F.3d 234, 246.

⁵²⁶ *Shipbuilders Council of America, Inc. v. U.S. Dept. of Homeland Sec.*, 2009 WL 4572784, at *19 (E.D.Va. 2009).

a lower garage for vehicle storage.⁵²⁷ In addition, the Chinese shipyard also prepared the vessel for the second phase of the bifurcated project-the installation of an upper garage in a shipyard in Alabama.⁵²⁸ A shipbuilders' trade association and a shipping company brought actions against Department of Homeland Security.⁵²⁹ The plaintiffs challenged the Coast Guard's issuance of a certificate of documentation with a coastwise endorsement on the basis of a determination that the *M/V MOKIHANA* was not foreign rebuilt under the major component or considerable part tests.⁵³⁰ The court stayed the case in November 5, 2008 pending appeal to the Fourth Circuit of the *SEABULK TRADER* case.⁵³¹ Given the similarity to the factual posture of *Seabulk*, the court applied the Fourth Circuit's reasoning to the *M/V MOKIHANA*.⁵³² Because the *M/V MOKIHANA*'s second deck was built piece-by-piece, with no piece exceeding the 1.5% discounted lightship weight threshold, the court concluded that the second deck did not violate the "major component test," and thus that the *M/V MOKIHANA* was not rebuilt foreign.⁵³³ Plaintiffs also asserted that the Coast Guard erroneously failed to include the Chinese shipyard's installation of auto platforms and ramps in the steel calculation and should have included both removed and added steel in that calculation.⁵³⁴ Moreover, the

⁵²⁷ *Id.* at *6.

⁵²⁸ *Id.* at *5.

⁵²⁹ *Id.* at *3.

⁵³⁰ *Id.* at *19.

⁵³¹ *Id.* at *6 (After the Fourth Circuit issued its opinion on August 21, 2009, the stay in this case was lifted and the parties resumed the proceedings.)

⁵³² *Id.* at *13-14 (The court recognized that the decision of the Fourth Circuit in the *SEABULK TRADER* case to uphold the Coast Guard's "separable/inseparable" distinction was dispositive and controlling in the instant case.)

⁵³³ *Id.* at *14.

⁵³⁴ *Id.* at *15.

plaintiffs argued that the work completed in the Alabama shipyard should have been included as part of the steelweight calculation under the “considerable part test” in determining the “foreign rebuild” question.⁵³⁵ The court disagreed, concluding that: “it is reasonable, and not inconsistent with the regulation’s terms, that the considerable part test only applies to work done ‘outside the United States.’”⁵³⁶ The court also rejected the plaintiffs’ other arguments, finding in each instance that the Coast Guard did not act arbitrarily and capriciously.⁵³⁷

Pursuant to the cabotage regime under the Jones Act, ships that are being built in U.S. shipyards are primarily for U.S. trade, or for military and national security purposes. In other words, the act provides a captive market for the U.S. shipyard industry.⁵³⁸ A strong shipbuilding industrial base is critical to build the ships that keep America secure and economically prosperous.⁵³⁹ Shipbuilding interests’ dissatisfaction with the Coast Guard’s application of the regulations that might have severely harmed the ability of American yards is echoed in Philadelphia Metal Trades, SEABULK TRADER and M/V MOKIHANA.⁵⁴⁰ The court in Philadelphia Metal Trades evaluated Jones Act provisions and agency regulations controlling ship newbuilding. In contrast, in SEABULK TRADER and M/V MOKIHANA, the Fourth Circuit and the district court in Virginia examined those controlling the rebuilding of vessels.

⁵³⁵ *Id.* at *18.

⁵³⁶ *Id.*

⁵³⁷ *Id.* at *15-19.

⁵³⁸ See *An Evaluation of Maritime Policy in Meeting the Commercial and Security Needs of the United States* at *42, prepared by IHS Global Insight, Inc. for US Department of Transportation Maritime Administration (Jan. 7, 2009).

⁵³⁹ See American Shipbuilding Association Homepage, available at <http://www.usships.org>.

⁵⁴⁰ See 2008 WL 4003380, at *19.

All of these cases highlight risks to the financial viability of vessel construction and modification projects presented by U.S. cabotage legal requirements, especially in an environment where competitors and labor groups have standing to mount court challengers to the decisions of regulatory bodies.⁵⁴¹ Keeping in mind the holdings of these three cases, before conducting potential newbuild or rebuild work, shipowners should analyze with caution 46 U.S.C. §§ 12101, 12132 and 46 C.F.R. §§ 67.97 and 67.177, and ask themselves three questions: (1) if the vessel is assembled in the U.S.; (2) if the proposed work may fall within the “major component test”, in that case whether it is “separable;” (3) if it may be subject to the “considerable part test,” in that case whether the added steelweight is below the 10% threshold.⁵⁴² It is worth noting that steel work in excess of 7.5 percent but less than 10 percent of the vessel’s steelweight can also be found as foreign rebuilt unless the Coast Guard in its discretion approves the amount.⁵⁴³ Moreover, shipowners are well-advised to take advantage of Section 67.177 which provides a process whereby they may obtain a preliminary rebuild determination from the Coast Guard in advance of the shipyard work being done in order to obtain assurance that the work will not be disqualifying.⁵⁴⁴ After the work is complete, the prudent shipowner should also apply to obtain a final rebuild determination to confirm that the actual work does not result in “foreign rebuilt.”⁵⁴⁵

⁵⁴¹ Nolan, III, *supra* note 146, at 7.

⁵⁴² See *Winston Maritime Clients Prevail in Key Judicial Decisions*, Winston & Strawn LLP Briefing, available at http://www.winston.com/siteFiles/Publications/Briefing%2012_8_09v2.pdf (Dec. 9, 2009) (“the Coast Guard’s view that a ‘major component’ should be judged based on whether it is ‘separable’ was validated.”)

⁵⁴³ *Id.*

⁵⁴⁴ See *Id.*

⁵⁴⁵ See 46 C.F.R. § 67.177 (e).

The statutory and regulatory framework is the lens through which the Coast Guard's decision must be viewed.⁵⁴⁶ In these recent cases, the Coast Guard's interpretation of the Jones Act and the application of its regulations promulgating the statutes are consistent with the history of the statutes and the congressional intents. The issues regarding "built" and "rebuilt" in the United States have relevance in determining whether the Coast Guard may issue a coastwise endorsement on a U.S. flagged vessel's Certificate of Documentation, a necessary prerequisite to entry into the coastwise trade in the U.S.⁵⁴⁷ Therefore, the Coast Guard's clarification of the standard for determining foreign rebuilding will help vessel owners and operators make better business decisions regarding work to be performed on their vessels.⁵⁴⁸ As the National Vessel Documentation Center posts U.S. build determination letters and preliminary and final rebuild determination letters online, vessel owners may also borrow others' experience for reference.

Rather than having a common interest with shipyards, shipowners want to buy ships wherever the price is more attractive, especially from the world's leading shipbuilding countries, China, South Korea and Japan. U.S. shipyards face higher costs than foreign yards and as a result have a very small share of the ocean vessel market.⁵⁴⁹ As Maritime Administer Mr. Clyde J. Hart, Jr. addressed in a speech in 1998, "[m]ajor barriers have also impeded the U.S. shipbuilding industry from competing in the international market, including substantial shipbuilding subsidies by foreign governments and greater economies of scale, efficiencies in foreign shipyards derived through series production of standardized vessels and disparate worker health and safety and environmental

⁵⁴⁶ 2009 WL 4572784, at *2.

⁵⁴⁷ Nolan, III, *supra* note 146, at 4.

⁵⁴⁸ See available at <http://www.uscg.mil/hq/cg5/nvdc/nvdcbuild.asp>.

⁵⁴⁹ See *supra* note 167, at *42.

standards.”⁵⁵⁰ In the backdrop of the world financial crisis, these countries have especially carried out government stimuli to subsidize their shipbuilding industries.⁵⁵¹

Imposing limitations on the source of the parts for building ships might render the American construction of ships too expensive to pursue.⁵⁵² With respect to the “part” and “assembly” question, as the court in Philadelphia Metal Trades noted, the Coast Guard’s position is generally that forcing American shipyards or shipowners to stop using less expensive equipment of foreign manufacture, sometimes unavailable in the domestic market, will “add an element of cost to shipbuilders, shipowners, and the public generally which is not [] justified by the Vessel Documentation Act.”⁵⁵³ The undesired consequence of the protectionism of the U.S.-built and the U.S.-rebuilt requirements is “the disincentive to private investment in efficient and profitable alternative modes of domestic freight transport due to the prohibitive cost of acquiring suitable vessels.”⁵⁵⁴ Thus the stage is set for the inevitable clash of shipowners’ interest in lower prices and shipbuilders’ interest in preserving jobs, which in 1992 had been urged by the Shipbuilders Council of America.⁵⁵⁵

Moreover, Congress has specified a number of important purposes for the Jones Act. Apart from the shipbuilding industry’s private economic interests, the Coast Guard is administratively responsible for implementing the policies of the Jones Act: both to

⁵⁵⁰ CLYDE J. HART, JR., Dep’t of Transp. Statement of Mar. Adm’r, Speech Before the Subcomm. on Coast Guard and Mar. Transp. U.S. House of Representatives (Sept. 24, 1998).

⁵⁵¹ See Rodricks Wong, *Government Stimuli: An update on global packages and their relevance to shipping*, Marine Money Asia, 8th Annual Marine Money Asia Week (Sept. 29, 2009, Singapore).

⁵⁵² See 2008 WL 4003380, at *19.

⁵⁵³ See *Id.*, at *15; see also 48 Fed. Reg. 20,250-51.

⁵⁵⁴ Kennedy, *supra* note 82, at 219.

⁵⁵⁵ See generally John Stocker, President of Shipbuilders Council of America Arlington, Va., *There's Still Time to Save U.S. Shipbuilding*, N.Y.TIMES, April 15, 1992.

protect the shipyards and its workers, and to improve and modernize the domestic fleet.⁵⁵⁶

In any event, the protection of the U.S. shipbuilding benefits is only one purpose of the Jones Act. In Philadelphia Metal Trades, the court emphasized that “the agency’s interpretation need not further every statutory purpose in the [maritime] Act. [The agency’s] approach furthers the overall purpose of the statute.”⁵⁵⁷ From the Coast Guard’s recent decisions, we can draw the conclusion that the agency’s interpretation of statutes and regulations is in line with the policy of the United States to do whatever may be necessary to develop and encourage the maintenance of a viable merchant marine.⁵⁵⁸ Although as a protectionist statute, the Act does not preclude all foreign work on vessels. This best proves the reason why the 1956 Second Proviso deleted the original definition of “rebuilt” which may invoke even trivial alterations on vessels. Indeed, the improvement of a domestic fleet will ensure more jobs and efficiency of transportation between U.S. points.

The Coast Guard as the interpretive body best positioned to consider a number of factors, its regulatory scheme now seems to be the best way to deal with the conflicting interests, without undermining or offending the goal of developing a strong domestic fleet. In Shipbuilders Council v. U.S. Coast Guard, the court pointed out that:

“[while the regulation is silent on] how to determine [] whether the major component test or the considerable part test should be applied[,] the Coast Guard is the interpretive body best positioned to take account of the myriad factors involved in arriving at a reasonable construction of the complex regulatory scheme for coastwise endorsement . . . ”⁵⁵⁹

7.4. How Jones Act affects the operation of U.S. offshore wind energy projects

⁵⁵⁶ See 2008 WL 4003380, at *19.

⁵⁵⁷ See *Id.* at *20 (*OSG Bulk Ships*, at 816).

⁵⁵⁸ See Merchant Marine Act of 1920, Pub.L. No. 66-261, § 1, 41 Stat. 988 (1920).

⁵⁵⁹ See 578 F.3d 234, 245.

Also, the Jones Act also affects the development and operation of U.S. offshore wind energy projects. Offshore wind energy projects require vessels for monopole and transition piece installation, foundation and jacket construction, turbine and blade installation, service platform construction, cable laying and maintenance.

The Outer Continental Shelf Lands Act (“OCSLA”) provides⁵⁶⁰:

“The laws of the United States are “extended to the subsoil and seabed of the outer Continental Shelf and to all artificial islands, and all installations and other devices permanently or temporarily attached to the seabed, which may be erected thereon for the purpose of exploring for, developing, or producing resources therefrom, or any such installation or other device (other than a ship or a vessel) for the purpose of transporting such resources....”

If amended as proposed⁵⁶¹, the OCSLA would provide:

“The laws of the United States are “extended to the subsoil and seabed of the outer Continental Shelf and to all artificial islands, and all installations and other devices permanently or temporarily attached to the seabed, which may be erected thereon for the purpose of exploring for, developing, or producing resources therefrom **or producing or supporting production of energy from sources other than oil and gas**, or any such installation or other device (other than a ship or a vessel) for the purpose of transporting such resources **or transmitting such energy**....”

A recent Custom and Border Patrol (CBP) ruling speaks directly to the fact that the act of installing a wind tower is likely not be “coastwise trade” or “transportation of merchandise” between points, and concludes that in the context of a wind farm,

“CBP has long held that neither drilling nor pile driving, in and of itself, conducted by a stationary vessel, constitutes coastwise trade or coastwise transportation. See HQ 109817, dated November 14, 1988 and HQ 111412, dated November 28, 1990, respectively. The proposed activity with respect to the driving of a monopile foundation into the seabed is very similar to pile driving and is governed by the same principle. Therefore, we find that the activity of the stationary construction vessel described above, involving driving of a monopile foundation into the seabed and then adding a platform deck, anemometer tower, and other components does not constitute coastwise trade or coastwise transportation. In summary, we find that the engagement in the proposed activity

⁵⁶⁰ 43 U.S.C. § 1333(a)(1).

⁵⁶¹ 43 U.S.C. § 1333(a)(1) as proposed to be amended by H.R. 501 § 204.

will not result in a violation of 46 U.S.C. § 55102.”⁵⁶²

Based on the above CBP ruling, a vessel used in monopole installation, and even the installation of the turbines themselves, does not constitute coastwise trade under the Jones Act. Foreign-flagged vessels and crews may be used for these activities.

Developers and contractors can comply with the Jones Act by using a combination of coastwise eligible vessels and vessels that do not qualify for United States coastwise trade in compliance with the Jones Act, such as, the components installed would have to be transported by a U.S. flag coastwise qualified vessel unless all such transportation can be arranged from a foreign port directly to the installation site with no US entry.⁵⁶³

8. UK Tax Lease

The tonnage tax regime was introduced in 2000 as part of a package of measures designed to revive the UK shipping industry. As at December 2004, 76 shipping operators had entered the regime.⁵⁶⁴

As described in a report of OECD Council Working Party on Shipbuilding that, “The UK Tax Leasing scheme was traditionally a source of long-term bareboat lease financing that was most suitable for newbuilding vessels because lessees achieved a net present value benefit while lessors enjoyed accelerated depreciation. The U.K. tax lease has always been credit driven and generally requires an investment grade end-user.”⁵⁶⁵

Under UK tax lease scheme (paragraph 94 of Schedule 22 to the Finance Act 2000), a lessor leasing a ship to a company in tonnage tax can claim annual writing down

⁵⁶² CBP, HQ H105415 (May 27, 2010).

⁵⁶³ Douglas Burnett and Michael Hartman, *The Jones Act – One more variable in the offshore wind equation*.

⁵⁶⁴ See <http://www.wfw.com/Publications/Publication192.html>.

⁵⁶⁵ See Report on ship financing, OECD Council Working Party on Shipbuilding (WP6), page 40, available at www.oecd.org/dataoecd/55/6/47128870.pdf.

allowances at 20 per cent, on a reducing balance basis, of the first £40 million of expenditure on a ship and at 10 per cent, on a reducing balance basis, on the second £40 million.

Changes were made to the tax lease regime, which have now been enacted in Schedule 7 to the Finance Act 2005 and subsequent statutory instruments. Currently a lessor of a ship to a tonnage tax company is not entitled to claim capital allowances if the lease forms part of a sale and leaseback transaction. There is an exception to this provision if the ship is newly-constructed and the transaction takes place within four months of the ship coming into use. Under the Finance Act 2005 this exception is expanded to include transactions the proceeds of which are used for a refit of the vessel that costs more than 33% of the total value of the vessel.⁵⁶⁶

9. Ship Financing in Japan and Korea

International shipbuilding center has transited from West Europe to Japan in 1950s and then to Korea in 1970s. Japan ranked as the No. 1 shipbuilding country, within ten years. Korea surpassed Europe and the United States within nine years, becoming the second largest shipbuilder, and overtook Japan in 2000.⁵⁶⁷ Both Japan and Korea have implemented a series of financing support policies during different periods of the shipbuilding development. During the period when the shipbuilding launched, Japanese government actualized the planning scheme for shipbuilding industry. Japanese government, along with Bank of Japan and Development Bank of Japan, offered favorable financing conditions to domestic ship newbuildings involved in the plan, in a way of providing a big line of credit for a long period at a low interest. Japanese

⁵⁶⁶ See <http://www.wfw.com/Publications/Publication192.html>.

⁵⁶⁷ See China set to become world's largest shipbuilding country, People's Daily Online, November 10, 2009.

government has also financially supported establishing shipbuilding groups to arrange and lease ships to different shipping companies.

Korea actively catered to OECD's policy on relaxing the restrictions of financing requirements, and accordingly amended the regulations concerning the longest repayment period of export ship financing loan and related interests. Korean shipyards have adopted OECD's regulation on the requirement of shipowner's deferred payment.⁵⁶⁸ In March 2004, the first ship financing company in Korea, also known as the first one in Northeast Asia, successfully raised funds for shipbuilding from the public by equity capital. In response to the global recession, Export-Import Bank of Korea (Korea Eximbank) and Korea Export Insurance Corporation (KEIC) will be extending and providing loans and payment guarantees of up to 9.5 trillion won (USD 7.6 billion) for shipbuilders and suppliers. Out of which, 7 trillion won will be set aside to support small and medium sized shipyards.⁵⁶⁹ Shipping funds have launched in the shipping finance market in South Korea, known as KDB Shipping Fund and KAMCO Shipping Fund.⁵⁷⁰ Korea Development Bank has unveiled its "KDB Let's Get Together Fund", with approximately US\$1.6 billion as the program size and an investment period of 2-3 years.⁵⁷¹

Structured finance programs for ships used by export credit agencies such as KEXIM, are largely typical asset-based finance, except that loan repayment relies on the cash flow

⁵⁶⁸ Cash payment of 20% of the ship's price, the rest 80% should be paid back in 8.5 years at an annual interest of 8%.

⁵⁶⁹ Rodricks Wong, *supra* note 242.

⁵⁷⁰ KDB shipping fund involves 11 shipping companies, total 40 vessels in process, and KAMCO Shipping Fund involves 16 shipping companies, total 62 vessels applied, 17 vessels have been financed for the first round sale and leaseback. See Dong Hae Lee, Head of Shipping Finance Team of KDB, *What is happening in the World's Greatest Shipbuilding Nation*, presented at the 8th Annual Marine Money Asia Week (Singapore, 29 Sept. 2009).

⁵⁷¹ See Dong Hae Lee, Head of Shipping Finance Team of KDB, *What is happening in the World's Greatest Shipbuilding Nation*, presented at the 8th Annual Marine Money Asia Week (Singapore, 29 Sept. 2009).

generated by the financed ships in addition to the first priority mortgage over the ships. KEXIM is one of the most active shipbuilding finance institution in the world due to Korea's leading role in the international shipbuilding industry. KEXIM works in strict compliance to guidelines set by the OECD. In effect, KEXIM began to be active in the international shipping finance market after the Commercial Interest Reference Rates⁵⁷² were introduced in the Sector Understanding on Export Credits for Ships through the amendment of that Understanding in 2002.⁵⁷³

In contrast, China Exim is not constrained by the OECD consensus on export credit, which allows the bank to offer financing on more competitive terms than available from other ECAs.⁵⁷⁴ Whether the disparity in financing creates a competitive advantage for Chinese shipyards is hard to assess, but it has led to calls from other shipbuilding countries, such as Korea and Japan, for China to be invited into the OECD. One source at Kexim said it is a "critical issue" that China adopt the terms laid down by OECD Working Party 6 on the use of export credits for ships.⁵⁷⁵

⁵⁷² Commercial Interest Reference Rates (CIRRs) are the official lending rates of Export Credit Agencies. They are calculated monthly and are based on government bonds issued in the country's domestic market for the country's currency. In the case of the US dollar, the CIRR is based on the U.S. Treasury bond rate. Ex-Im Bank's updated CIRR rates are published on the Internet on the Monday preceding the 15th of the month and are effective on the 15th of the month. Available at: http://www.exim.gov/tools/cirr_about.cfm.

⁵⁷³ The Sector Understanding on Export Credits for Ships (SSU) sets common rules for government-supported export credits for ships, in particular concerning interest rates and the duration of credits. Available at: http://www.oecd.org/document/15/0,3343,en_2649_34211_40197967_1_1_1_1,00.html.

⁵⁷⁴ China Exim does not charge an exposure fee and allows some flexibility in repayment profiles, with balloon payments on the export tranche sometimes a possibility.

⁵⁷⁵ See the website of Asset Finance International, available at: <http://asset-finance-international.com/81/Crediting%20shipping>.

4 SHIP MORTGAGE

1. International Legislation and Conventions

Three important conventions that regulate ship mortgages entered into force successively, known as, *Maritime Lien & Mortgage International Convention for the Unification of Certain Rules of Law relating to Maritime Liens and Mortgages*, 1926, 1967 (hereinafter referred to as “Maritime Lien & Mortgage ’26,” “Maritime Lien & Mortgage ’67”) and *International Convention on Maritime Liens and Mortgages*, 1993 (hereinafter referred to as “Maritime Liens and Mortgages ’93”).⁵⁷⁶ However, these conventions do not regulate any substantial issues, such as establishment, content of rights, and effectiveness of ship mortgages. Further, due to different recognition of ship mortgages in different law systems, there is no definition of “ship mortgage” under existing conventions. Thus, there leaves room for countries to make their own legislations according to their domestic conditions.

Ship mortgages are governed by the law of the ship’s flag state. The form of the mortgage is determined by the legal system of that state. Typically, there are two types of ship mortgage: (i) statutory mortgages: they are in short forms which contain provisions allowing subsequent transfers and discharges. A deed of covenant is typically used as a document collateral to the statutory mortgage that contains the assignment of earnings, insurance and requisition compensation as well as operational and maintenance covenants; and (ii) preferred mortgages: such as in Panama, Liberia and Marshall Islands, they are longer documents containing covenants from the owner, such as insurances, maintenance and ship covenants.

⁵⁷⁶ The first international convention regarding maritime liens, International Convention for the Unification of Certain Rules of Law Relating to Maritime Liens and Mortgages, was adopted in Brussels in 1926, the second, in 1967 in Brussels, and the third, International Convention on Maritime Liens and Mortgages, in Geneva in 1993.

2. Ship Mortgage in China

Mortgage and security for a vessel under construction currently comes to the fore in China, though many problems that have emerged from practice remain unsolved. On June 9, 2009, China promulgated *Interim Measures for the Registration of Ship Mortgage under Construction* (hereinafter referred to as “Measures”) to regulate this issue.⁵⁷⁷ For the Measures to apply, the ship under construction as the collateral, if its construction has been segmented, it should have completed at least one or more of the ship sections in the construction stage; if the ship is constructed as a whole, it should have been placed in the keel in the construction stage.

Based on the current ship mortgage system under Chinese laws, the concept of the floating charge might be introduced to China. It is a floating security reaching over all trade assets of the mortgagor for the time being, intending to facilitate upon and bind on the existing assets at the time when the mortgagee intervenes. In other words, the mortgagor makes himself a trustee of his own business for the purpose of the security. Further, the trust is to remain dormant till the mortgagee calls it into operation.

As CMC stipulates, the aim of the establishment of the ship mortgage is to have the specific creditor’s rights be secured by the specific vessel. The floating charge will be a breakthrough to the specific characteristics of the ship mortgage under CMC. If the Chinese system employs floating charge, all the assets of the shipyard may be mortgaged as security, including stocks, external creditor’s rights, future revenues and intangible assets. Thus, in the event that the shipyard defaults and breaches the contract, or has no capacity to repay debts, the bank can take over the whole project, avoiding a big loss

⁵⁷⁷ See *Interim Measures for the Registration of Ship Mortgage under Construction*, Maritime Safety Administration of the People’s Republic of China, HAI CHUAN BO [2009] NO. 273 (June 9, 2009) (P.R.C.)

under the circumstances when no remedy is available but the resort to auction the collateral. Therefore, the import of floating charge will contribute to the prosperity of the Chinese shipbuilding industry and its ship finance regime.

3. Ship Mortgage in the United States

In 1920, Congress passed the Ship Mortgage Act, which gave maritime lien status to certain ship mortgages.⁵⁷⁸ The Act provides for a “preferred ship mortgage” that creates a maritime lien against the mortgaged vessel, in order to make clear the lienholders’ status and to improve lienholders’ security.⁵⁷⁹

The Supreme Court upheld the statute’s constitutionality in *The Thomas Barlum*⁵⁸⁰. As we have seen, the Ship Mortgage Act and FMLA (The Federal Maritime Lien Act) are together re-codified at 46 U.S.C. § 30101 and §§ 31301-31343. In order to have lien status, a ship mortgage must qualify as a “preferred ship mortgage.”⁵⁸¹ Congress has eliminated the requirements that the mortgagee be either a State, the United States, a federally insured bank, or a citizen of the United States.⁵⁸² The preferred ship mortgage lien “has priority over all claims against the vessel (except for expenses and fees allowed by the court, costs imposed by the court, and preferred maritime liens).”⁵⁸³ The principal advantage of receiving a preferred ship mortgage is the entitlement of the mortgagee to a

⁵⁷⁸ Thomas J. Schoenbaum, Pocket Part by Thomas J. Schoenbaum and Jessica L. McClellan, Admiralty and Maritime Law Current through the 2006 Update, §9-5 The preferred ship mortgage.

⁵⁷⁹ In 1988, the Act was recodified. 46 U.S.C. §§31301 to 31343.

⁵⁸⁰ See 293 U.S. 21 (1934).

⁵⁸¹ 46 U.S.C. §31322(a) (listing three basis requirements for a preferred ship mortgage: (1) It must include the whole of the vessel. (2) It must be filed with the Coast Guard “in substantial compliance” with the requirements of section 31321. (3) It must cover a documented vessel or a vessel for which an application is filed that is in substantial compliance with documentation statute and regulations.)

⁵⁸² See §§ 31326 (b)(1) and 31301(5).

⁵⁸³ 46 U.S.C. § 31326 (b)(1).

maritime lien on the vessel that can be enforced through an in rem action against the vessel.⁵⁸⁴ To be eligible for a preferred mortgage, a vessel must be a “vessel of the United States,” and only vessels registered pursuant to law are vessels of the United States.⁵⁸⁵ The only mortgage on a ship, which may invoke the admiralty jurisdiction for its foreclosure, is the one executed in accordance with the Ship Mortgage Act.

The Ship Mortgage Act also recognizes mortgages on ships registered abroad.⁵⁸⁶ Under 46 U.S.C. §§ 31325 to 31326, the mortgages over foreign vessels can be enforced through foreclosure and sale in the U.S. courts. However, such preferred mortgage on a foreign vessel is subordinate to a maritime lien for necessities provided in the U.S.⁵⁸⁷

The United States has no law providing for preliminary registration in a ship register of a ship under construction. U.S. federal law does not currently allow for registration of vessels under construction. In 2009 the U.S. Maritime Law Association proposed legislation that would permit a vessel under construction to be documented in the name of the party who actually has title to the vessel construction project under the terms of the construction contract, but this proposed legislation has not yet been enacted. If this proposed legislation becomes law, it would permit the party who has documented the vessel under construction to subject the vessel to a preferred mortgage that would enjoy the same priority benefits and the benefit of admiralty foreclosure procedure that is now enjoyed by the mortgagee of a completed vessel.

Consequently, the only way to mortgage a vessel under construction is to use a chattel mortgage or, in modern terms, to grant a security interest in the vessel pursuant to Article

⁵⁸⁴ See Robert Force, *Admiralty and Maritime Law* 178 (Federal Judicial Center, 2004).

⁵⁸⁵ Ship Mortgage Act, 1920, § 30.

⁵⁸⁶ See William Tetley, *International maritime and Admiralty Law* 488 (International Shipping Publications, 2004). See also 46 U.S.C. 31301(6)(B).

⁵⁸⁷ See 46 USC § 31326 (b)(2).

9 of the Uniform Commercial Code.⁵⁸⁸ Under the typical construction contract⁵⁸⁹⁵⁹⁰, the shipbuilder retains title until completion of the vessel⁵⁹¹, and only the shipbuilder can provide such a mortgage or security interest. While such a security interest does not constitute a maritime lien and must be replaced on delivery with a mortgage that will constitute a maritime lien, it is not entirely valueless, and in the event of the bankruptcy of the shipbuilder, the security interest may be of considerable value.

Purpose of a ship mortgage is to encourage private investment by protecting creditors in the cases of default. A preferred mortgage is a lien on the mortgaged vessel in the amount of the outstanding mortgage indebtedness secured by the vessel, and upon default of any term or condition of the mortgage, it may be enforced in a civil action in rem, that is, in an action in which the court determines the title to property and the rights of the parties.⁵⁹² When the vessel is sold by court order in a civil action in rem brought to enforce a preferred mortgage lien, any claim in the vessel existing on the date of sale is terminated, and the vessel is sold free of all those claims.⁵⁹³

⁵⁸⁸ See generally Article 9, secured transactions.

⁵⁸⁹ However, the parties to a shipbuilding contract may agree as to when title passes from the builder to the buyer. See also *Getting the deal through Shipbuilding 2013* at 116 (Law Business Research Ltd, 2013).

⁵⁹⁰ Under US law, a contract for construction of a vessel is a contract for the sale of tangible personal property and is not a maritime contract. Thus, such contracts are subject to articles 2 and 9 of the UCC in the relevant state as well as other applicable state laws.

⁵⁹¹ Generally, property in and title to the vessel and all risk and loss remain with the builder until the contract price has been paid in full and the vessel is actually delivered to and accepted by the buyer as evidenced by a protocol of delivery and acceptance signed by both parties.

⁵⁹² 46 U.S.C. §31325(b)(1).

⁵⁹³ 46 U.S.C. §31326(a).

Preferred ship mortgages are distinct from maritime liens in that preferred ship mortgages must be recorded in order to be valid while maritime liens need not be recorded.⁵⁹⁴

In a recent Massachusetts case in *L&L Electronics, Inc. et al. v. Tropical Aircraft Company, Ltd.*, the judge held that lender's first preferred ship mortgage took priority over contractors' subsequent maritime liens.⁵⁹⁵ The Court's award of the sale proceeds to the mortgagee was challenged by both L&L and Essex on the ground that mortgage was invalid because the mortgagee was not a "stranger to the vessel," in other words that the mortgagee should be deemed the owner of the yacht for purposes of the rule that an owner may not have a maritime lien on his own vessel. The Court rejected this argument holding that rules governing maritime liens are not applicable to ship mortgages. The Court also rejected arguments that the mortgage should be equitably subordinated to the maritime lien claims.⁵⁹⁶

In the case, Watersedge Group, LLC ("**Watersedge**") was formed as a Connecticut limited liability company on January 15, 2008 and Prior owned 80% of Watersedge and Baxter owned the remaining 20%.⁵⁹⁷ Watersedge purchased the m.v. Osprey and was the record owner of the vessel at all times until the court-ordered interlocutory sale on June 4, 2010.⁵⁹⁸ As the "backer" or money man of Watersedge, Prior made loans to the company in connection with the purchase of Osprey, which were secured by a first preferred ship

⁵⁹⁴ See 46 U.S.C. §§31321, 31343. See also *Custom Fuel Services, Inc. v. Lombas Indus., Inc.*, 805 F.2d 561, 569 (5th Cir. 1986).

⁵⁹⁵ *L&L Electronics, Inc. et al. v. Tropical Aircraft Company, Ltd.*, 764 F.Supp. 2d 270 (D. Mass. 2011).

⁵⁹⁶ Glen T. Oxtan, Ship Mortgages in Favor of an "Owner": An Update, *BENEDICT'S MARITIME LAW BULLETIN*, Vol. 9, No.1, p. 9, 2011.

⁵⁹⁷ *L&L Electronics* at 271.

⁵⁹⁸ *Id.*

mortgage on the vessel.⁵⁹⁹ The mortgage was filed with the U.S. Coast Guard Documentation Center on April 2, 2008.⁶⁰⁰ Later on June 16, 2009, Prior assigned his interests in the loan notes and the mortgage to Tropical of which Prior is the President and sole shareholder.⁶⁰¹ The assignment was also filed.⁶⁰²

Respectively in March 2008 and April 2008, Watersedge hired L&L and Essex for certain electronic works and so forth on the vessel.⁶⁰³ After their performances, Watersedge failed to make payment.⁶⁰⁴ Maritime liens of L&L and Essex arose after the mortgage was recorded.⁶⁰⁵ In March through June of 2009, Watersedge failed to make loan repayments to Prior and defaulted on the notes.⁶⁰⁶ Prior then accelerated the balances due and Tropical took possession of the vessel pursuant to the terms of the mortgage.⁶⁰⁷ Watersedge filed dissolution on November 12, 2009.⁶⁰⁸ On or about June 4, 2010, the U.S. Marshall conducted the Interlocutory Sale of the vessel.⁶⁰⁹

The Court stated that, “under the Ship Mortgage Act, Tropical’s first preferred ship mortgage would ordinarily take priority over L&L and Essex’s maritime liens.”⁶¹⁰

⁵⁹⁹ *Id.*

⁶⁰⁰ *Id.*

⁶⁰¹ *Id.* at 271-72.

⁶⁰² *Id.* at 272.

⁶⁰³ *Id.*

⁶⁰⁴ *Id.*

⁶⁰⁵ *Id.*

⁶⁰⁶ *Id.*

⁶⁰⁷ *Id.*

⁶⁰⁸ *Id.*

⁶⁰⁹ *Id.*

⁶¹⁰ *Id.* citing 46 U.S.C. § 31326(b)(1).

However, Plaintiffs contended that the mortgage should not take priority over their maritime liens under the so-called “stranger to the vessel” doctrine.⁶¹¹ Under this doctrine, it indicates that “owners of a vessel, or those that have authority over a vessel such that they are in a similar position to owners, are denied maritime liens.”⁶¹² The Plaintiffs asserted that, “Prior and Tropical should not be able to hold a preferred ship mortgage in the *Osprey* since Prior is also a member and manager of Watersedge, the owner of the *Osprey*.”⁶¹³

The Court ruled that the “stranger to the vessel” doctrine shall not be extended to preferred ship mortgages as the doctrine was developed “in the limited context of maritime liens.”⁶¹⁴ The Court followed the precedent of the First Circuit in *Mullane v. Chambers* and noted:

“[M]aritime liens and the admiralty jurisdiction that comes with them are a way of making the provision of services to vessels are safe and predictable as the provision of services to land-based business. A creditor with a maritime lien, not unlike the holder of a materialman’s lien, can seek payment even if the person she negotiated with has absconded. The overarching goal is keeping the channels of maritime commerce open –by ensuring that people who service vessels have an efficient way of demanding reimbursement for their labor and are thus willing to perform the services necessary to keep vessels in operation.”⁶¹⁵

⁶¹¹ *Id.*

⁶¹² *Id.* (internal citations omitted)

⁶¹³ *Id.* at 273.

⁶¹⁴ *Id.*

⁶¹⁵ *Id.* at 273.

Moreover, the court further stated its rationale as follows:

“The purpose of a maritime lien, therefore, is to encourage the provision of goods and services, especially in distant ports, by providing an in rem claim against the vessel itself should the party controlling the vessel’s affairs abscond. Since owners are the ones that control the vessel’s affairs, or have access to the entity that controls the vessel’s affairs, they do not require such a mechanism. The “stranger to the vessel” doctrine, accordingly, exists to exclude owners from the protection of maritime liens.”⁶¹⁶

The Court also quoted the precedent of the Fifth Circuit, stating “[a] shareholder may lend money to a wholly-owned corporation and become a bona fide creditor.”⁶¹⁷ The Court also did not find any fraud, unfair dealing, or other inequitable conduct contemplated by this case.⁶¹⁸ The Court further held that there was no evidence supporting the Plaintiffs’ arguments that the mortgage lien should be equitably subordinated because Watersedge was undercapitalized, was a mere instrumentality of Prior, was unjustly enriched and engaged in tortious conduct.⁶¹⁹ Therefore, the court concluded that Tropical’s first preferred ship mortgage takes priority over the Plaintiffs and is thus entitled to the full amount of the proceeds of the sale of the vessel.⁶²⁰

- Distinctions between Preferred Ship Mortgage and Maritime Liens

⁶¹⁶ *Id.*

⁶¹⁷ *Id.* at 274.

⁶¹⁸ *Id.*

⁶¹⁹ *Id.* at 275.

⁶²⁰ *Id.*

The existence of maritime liens rest on the principle that a vessel is a legal entity itself, apart from its ownership. The lien is not a security interest arising from the personal obligation of the vessel's owner or operator under a contract, but instead the vessel itself owes obligations that may be breached.

As previously discussed, the preferred mortgage lien is often confused with a maritime lien and, there has been some confusion to apply traditional maritime lien rules under the Maritime Lien Act⁶²¹ to a ship mortgage. The Ship Mortgage Act was enacted in the aim of encouraging financing of ships and establishment of a strong U.S. merchant marine, while the Maritime Lien Act is intended to protect local merchants.⁶²² In *Oil Shipping v. Sonmez Denizcilik Ve Ticaret A.S.*⁶²³, the United States Third Circuit decided that the Ship Mortgage Act presumptively applies to determine questions of priorities between maritime liens and ship mortgages in United States Courts.⁶²⁴

The nature of the preferred mortgage lien and the maritime lien is different, which was well explained in the article of *Ship Mortgages in Favor of "Owners"*:

"In fact, the ship mortgage lien is a statutory lien that bears little resemblance to a traditional maritime lien. This distinction has been recognized by the courts. *U.S. v. Golden Dawn*, 222 F.Supp. 186 (E.D.N.Y. 1963); *Custom Fuel Services, Inc. v. Lombas Industries, Inc.*, 805 F.2d 561 (5th Cir. 1986) [] Maritime liens are secret liens, whereas ship mortgages must be recorded in a public registry. Maritime liens rank in inverse order to the time they are incurred while the priority of ship mortgages is based on the first to be filed. Unlike maritime liens, ship mortgages are not subject to laches."⁶²⁵

⁶²¹ 46 U.S.C. §§31341-42.

⁶²² Benedict's Maritime Bulletin, Vol.7, no.1, First Quarter 2009, p.16.

⁶²³ 10 F.3d 1015, 1994 AMC 892 (3d Cir. 1993).

⁶²⁴ Thomas J. Schoenbaum, ADMMARL §9-5, 1 Admiralty & Mar. Law §9-5 (4th ed.)

⁶²⁵ Benedict's Maritime Bulletin, Vol.7, no.1, First Quarter 2009, p.16.

Furthermore, the Ship Mortgage Act, 46 U.S.C. §31326 expressly states that, “When a vessel is sold . . . to enforce a preferred mortgage lien or a maritime lien . . . the vessel is sold free of all those claims.” It differentiates preferred mortgage lien from maritime lien.

Under 46 U.S.C. §31301(5), “preferred maritime lien” means a maritime lien on a vessel –

- (A) arising before a preferred mortgage was filed under section 31321 of this title;
- (B) for damage arising out of maritime tort;
- (C) for wages of a stevedore when employed directly by a person listed in section 31341 of this title;
- (D) for wages of the crew of the vessel;
- (E) for general average; or
- (F) for salvage, including contract salvage.

Under 46 U.S.C. §31301(6), “preferred mortgage” –

- (A) means a mortgage that is a preferred mortgage under section 31322 of this title; and
- (B) also means in sections 31325 and 31326 of this title, a mortgage, hypothecation, or similar charge that is established as a security on a foreign vessel if the mortgage, hypothecation, or similar charge was executed under the laws of the foreign country under whose laws the ownership of the vessel is documented and has been registered under those laws in a public register at the port of registry of the vessel or at a central office.

The Ship Mortgage Act provides that the preferred mortgage lien shall have priority over all claims against the vessel except (1) preferred maritime liens and (2) costs and expenses in *custodia legis*.⁶²⁶ Therefore, preferred ship mortgages rank after preferred maritime liens.

Determining lien priorities is important if there is not enough money to satisfy all claims at the time of the admiralty sale. Liens will be ranked by class and time. Generally, the last claim within a class to accrue is the first to be paid. Lien priorities can change if a preferred ship mortgage exists. When a ship mortgage exists, the Ship Mortgage Act determines the ranking. If not, the general maritime law determines the

⁶²⁶ 46 U.S.C. § 31326 - Court sales to enforce preferred mortgage liens and maritime liens and priority of claims.

ranking. Professor Force of Tulane Law School outlined the ranking of maritime lien claims on the basis of the claims by the district courts and courts of appeals in conjunction with the Ship Mortgage Act⁶²⁷:

1. “expenses of justice during *custodia legis* (*see* 46 U.S.C. §31326(b)(1));
2. the following “preferred maritime liens” (*see* 46 U.S.C. §31301(5)(A)-(F)):
 - (a) wages of the crew and master; maintenance and cure, wages of stevedores when directly employed by the shipowner or the shipowner’s agent (*see* 46 U.S.C. §31341);
 - (b) salvage (including contract salvage) and general average;
 - (c) maritime torts (including personal injury, property damage, and cargo tort liens);
 - (d) all maritime contract liens that arise before the filing of a preferred ship mortgage (U.S. flag vessel) (*see* 46 U.S.C. 31301(5)(A)) – these include liens for “necessaries,” such as repairs, supplies, towage, and the use of a dry dock or marine railway (*see* 46 U.S.C. 31301 (4)), as well as cargo damage liens and charterer’s liens;
3. preferred ship mortgages (U.S. flag vessels);
4. other maritime contract liens that accrue after the filing of a preferred ship mortgage (U.S. flag vessels) and prior to a foreign preferred ship mortgage; however, liens for all necessities provided in the United States have priority over foreign preferred ship mortgages irrespective of the time they arose (*see* 46 U.S.C. §31326(b)(2));
5. foreign preferred ship mortgages; and
6. maritime contract liens, excluding those for necessities provided in the United States, accruing after foreign preferred ship mortgages, such as contractual claims for cargo damage liens and charterer’s liens.”

All contract liens (preferred maritime liens) that predate the mortgage at the time of the mortgage prime the mortgage.⁶²⁸ Arguably, a supplier of necessities to the vessel who is not in breach prior to a ship mortgage being recorded but has a lien against the vessel for some breach of that contract after the recording of a mortgage might trump a mortgage. It will be difficult for the lender/mortgagee to foresee the remote possibility.

From the other perspective, for instance, if a person or a company has a maritime lien that comes after the First Preferred Ship Mortgage, and the First Preferred Ship Mortgage

⁶²⁷ Robert Force, *Admiralty and Maritime Law*, 2d Edition at 182 (Federal Judicial Center, 2013).

⁶²⁸ *Id.* at 184.

is more than the value of the vessel, it does not make sense to arrest the vessel because the vessel will be sold at auction and the person/company will get nothing for his/its claim.

When does a maritime lien arise? – A maritime lien attaches at the moment the goods or services are furnished.⁶²⁹ In *Bank One Louisiana N.A. v M/V Mr. Dean*⁶³⁰, BargeCaribe, Inc. (the “charterer”) chartered the vessel from Offshore Supply Ships (“OSS”), Inc. for a period of one year, during which period OSS sold the vessel to Global Towing, LLC (“Global”). Global obtained a loan from Bank One to assist the acquisition, and as security of the loan, Bank One was granted a preferred ship mortgage, which was recorded toward the end of the charterparty. Global later breached the charterparty (after the mortgage was recorded with the Coast Guard). Global also defaulted under the loan and Bank One arrested the vessel. The charterer intervened in Bank One’s lawsuit and asserted that it had a maritime lien arising from the breach of the charterparty.

In that case, the Fifth Circuit concluded that a maritime lien attached at the commencement of the charter, and that the subsequent breach of the charter perfected the lien and that the lien related back to the time of the beginning of the charter. Therefore, the maritime lien “arose” before the mortgage was filed and thus the charterer had priority to the sales proceeds over Bank One.

As Professor Force said, maritime liens are secret liens and they do not require recordation.⁶³¹ Unless the vessel is sold at admiralty sale, a lien will generally follow the vessel, even in the case of good faith purchaser. As maritime liens can arise out of

⁶²⁹ Schoenbaum, Thomas J., *Admiralty and Maritime Law*, §9-1 (4th Ed. 2004).

⁶³⁰ 293 F3d 830 (5th Cir 2002).

⁶³¹ Robert Force, *Admiralty and Maritime Law*, 2d Edition at 173-74.

maritime torts and contracts, in general, the owner, supplier, cargo owner, barge owner, fleeter, repair facility, stevedore, crew, insurer may furnish goods or provide service to a vessel and incur liens.

4. Ship Mortgage in Liberia and the Marshall Islands

The Liberian maritime Law was adopted in 1949, and was modeled on the U.S. maritime statutes. It incorporates reference the general maritime law of the U.S. to the extent not inconsistent with the Liberian statutes. In 1990, the Marshall Islands adopted a Maritime Law that followed very closely the Liberian statute.

Moreover, Marshall Islands Business Corporation Act ("MI BCA") is based almost entirely on the corporation laws of the States of New York and Delaware. In fact, Section 13 of the MI BCA specifically provides that the "Act shall be applied and construed to make the laws of the Republic, with respect to the subject matter hereof, uniform with the laws of the State of New York and other states of the United States of America with substantially similar legislative provisions." Section 13 further provides that the judicial decisions in those jurisdictions are "hereby declared to be and hereby are adopted as the law of the Republic", thus authorizing Marshall Islands courts to follow cases decided by U.S. courts as precedent in the Marshall Islands.

Both Liberian and Marshall Islands statutes state that ship mortgage have preferred status: "A valid mortgage, whenever made, which at the time it is made includes the whole of any vessel, shall have a preferred status in respect of such vessel as of the date of its recordation if the mortgage is recorded as provided herein and the mortgage does not stipulate that the mortgagee waives the preferred status thereof." Liberian Maritime Law §101. Mortgages: preferred status.

“A Preferred Mortgage shall constitute a maritime lien upon the mortgaged vessel in the amount of the outstanding mortgage indebtedness secured by such vessel. The lien of a Preferred Mortgage shall not be in any way impaired or affected because the vessel's document following recording of the mortgage has expired, or has been restrictively endorsed, suspended, revoked or cancelled.”⁶³²

Other than the characteristic of the ship mortgage lien as a “maritime lien”, ship mortgages under the laws of both Liberia and Marshall Islands have the same characteristics as to U.S. ship mortgage when compared to maritime liens. It is unclear whether such characterization is an error.

Section 112 of the Liberian Maritime Law provides that the lien of a preferred mortgage may be enforced in Liberia by a suit in rem in admiralty upon the default of any term or condition thereof. The lien of a preferred mortgage may also be enforced by a suit in rem in admiralty or otherwise in any foreign country in which the vessel shall be found, pursuant to the procedure of the said country for the enforcement of the ship mortgages constituting maritime liens on vessels documented under the laws of said country. In addition, the mortgagee may bring suit in personam against the mortgagor in any court of competent jurisdiction for the amount of the outstanding mortgage indebtedness.

Section 316 of the Marshall Islands Maritime Act, as amended, provides that the lien of a preferred mortgage may be enforced by a suit in rem in the High Court of the Republic of the Marshall Islands, sitting in admiralty upon the default of any term or condition thereof. The lien of a preferred mortgage may also be enforced by a suit in rem in admiralty or otherwise in any foreign country in which the vessel shall be found, pursuant to the procedure of said country for the enforcement of ship mortgages

⁶³² Liberian Maritime Law §107 Lien of Preferred Mortgage.

constituting maritime liens on vessels documented under the laws of said country. In addition, the mortgagee may bring suit in personam against the mortgagor in any court of competent jurisdiction for the amount of the outstanding mortgage indebtedness.

5 SHIP CONSTRUCTION, SALE AND PURCHASE

Sale and purchase of ship is one of the most important activities in the shipping industry. It involves a huge amount of money in term of more than hundred millions US dollar and it requires different kinds of profession knowledge like knowledge of particular type of ships and functions, legal knowledge as well as dealing and bargaining knowledge. Shipping finance, put very simply, is the process by which money is made available to a ship owner to assist in a ship-related investment. This can be anything from buying a new ship under construction at a shipyard, acquiring a ship second hand from another ship owner, repairing, converting, altering or modifying an existing ship to refinancing existing debt on a ship.

1. Chinese Shipbuilding

Shipbuilding is among China's 10 major industries.⁶³³ Figures from Chinese Ministry of Industry and Information Technology (MIIT) showed China took 61.6 percent of new orders worldwide in 2009, much higher than that of South Korea, which is home to seven of the world's top 10 shipbuilders. For the first time, China overtook the Korea as world's largest shipbuilding nation in new orders.⁶³⁴

As of the end of October 2010, China's production completion of shipbuilding was 50.90 million deadweight tons (dwt), an increase of 58.4%, and new orders of the industry were 54.62 million dwt or 2.9 times that of the same period of 2009,

⁶³³ The Chinese Central Government announced that 10 major industries in China - automobile manufacturing, electronic information, equipment manufacturing, iron and steel production, light industry, logistics, nonferrous metals production, petrochemicals, textile manufacturing and shipbuilding - were to be reformed and upgraded. These industries accounted for more than 80% of the country's total industrial output value and about one-third of the GDP.

⁶³⁴ Chinese shipbuilders grab bigger market share in financial crisis, Jan. 25, 2010, http://www.china.org.cn/business/2010-01/25/content_19304098.htm.

respectively.⁶³⁵ According to statistics from the China Shipbuilding Industry Association, China's shipbuilding output was 42.43 million deadweight tons (DWT) in 2009, rising 47% from 2008. According to statistics issued by Clarkson, Chinese accomplished shipbuilding output was 56.76 million deadweight tonnages from January to November of 2010, with an increase of some 55.4% compared with the same period of 2009. New ship orders were 26 million deadweight tons in 2009, which was down 55% compared with the same period of 2008. The market share of Chinese accomplished shipbuilding output, new ship orders and ship orders in hand accounted for 34.8%, 61.6% and 38.5% respectively of the world's totals in 2009.

Although the China shipbuilding industry has enjoyed remarkable growth, the impact of the international financial crisis has been transferred to the shipbuilding industry in which new building orders continue to decline in number and the currency appreciation and cost increase will impact the profits of the China's shipbuilding companies in long term. Due to the 2008 financial crisis, China's shipbuilding industry experienced significant slowdown in production completion, cancellation of existing orders, and huge drop in new orders in late 2008 and 2009. In helping the industry overcome its difficulties the State Council passed the "The Plan on the Adjustment and Revitalization of the Shipbuilding Industry" in February 2009 with three critical targets: 1) Stalling the declining demand; 2) Promoting mergers and acquisitions (M&A), and restructuring; and 3) Encouraging indigenous innovation and R&D.⁶³⁶ The marine industry will become one of the pillars of China's economy.

As Richard A. Bitzinger, Associate Professor, Asia-Pacific Center for Security Studies, has noted:

⁶³⁵ <http://www.globalsecurity.org/military/world/china/shipbuilding.htm>.

⁶³⁶ "The Plan on the Adjustment and Revitalization of the Shipbuilding Industry" in February 2009.

"Following an initial period of basically low-end commercial shipbuilding - such as bulk carriers and container ships - China's shipyards have since the mid-1990s progressed toward more sophisticated ship design and construction work. In particular, moving into commercial shipbuilding began to bear considerable fruit beginning in the late 1990s, as Chinese shipyards modernized and expanded operations, building huge new dry-docks, acquiring heavy-lift cranes and computerized cutting and welding tools, and more than doubling their shipbuilding capacity. At the same time, Chinese shipbuilders entered into a number of technical cooperation agreements and joint ventures with shipbuilding firms in Japan, South Korea, Germany, and other countries, which gave them access to advanced ship designs and manufacturing technologies - in particular, computer-assisted design and manufacturing, modular construction techniques, advanced ship propulsion systems, and numerically controlled processing and testing equipment."⁶³⁷

Three types of firms make up China's shipbuilding industry:

- 1) large state owned enterprises [SOEs] with mega-size production and technology capacity;
- 2) small private shipbuilding enterprises in the coastal provinces; and
- 3) joint ventures of foreign and domestic companies.

Two mega parenting conglomerates dominate China's shipbuilding industry. CSSC (China State Shipbuilding Corporation) handles shipbuilding activities in the east and the south, while CSIC (China Shipbuilding Industry Corporation) handles those in the north and the west. They are directly under the supervision of the central government. To restructure through M&A, the Plan aims to strengthen the global competitiveness of CSSC and CSIC, promote integration of large enterprises in the value chain. Although the government intends to provide capital fund, financing and credit loans for the restructuring, there has been little progress.

China is developing its offshore drilling rig industry as a future alternative to traditional shipbuilding. Since 2003, China has been constructing the world's largest shipbuilding base in the Changxing island, a deep water coast in Shanghai; the base is

⁶³⁷ Richard A. Bitzinger, Civil-military integration and Chinese military modernization, available at <http://asianresearch.org/articles/2429.html> (12/26/2004).

expected to be completed by 2015.⁶³⁸ The central government's 11th five-year plan (2005 to 2010) pointed out that the key to strengthening the shipping industry lies in design capability, marine equipment supply, large-scale shipbuilding construction, and optimizing the three main ship types: bulk-carriers, oil tankers, and container vessels.

2. Bill of Sale

The ship S&P process can be broken down into two stages: (i) the negotiation of the Memorandum of Agreement (“MOA”), and (ii) the passing of ownership in exchange for the payment.⁶³⁹ Contracts for sale of purchase of ships are subject to general contract law if the contract is governed by common law. For newbuildings, there are standard forms, which are heavily negotiated between the yard and the buyer. Detailed provisions covering buyer’s supervision on site, trials to determine vessel’s speed, consumption and deadweight capacity, builder’s guarantee of work and materials for one year after delivery and vessel technical standards, all of which are negotiated. For second-hand vessels, negotiations are usually concluded through S&P brokers.

A commonly used pro forma for the MOA is the Norwegian Sales Form (1993), though the shorter 1987 version is still in use. The memorandum sets out the administrative details for the sale (i.e. where, when and on what terms) and lays down certain contractual rights, such as the right of the buyer to inspect class society records.⁶⁴⁰

Clause 9 of NSF form “Encumbrances” seeks to ensure that the buyer does not receive a vessel which is subject to a maritime lien or any other debts which would

⁶³⁸ The country planned to build three major shipbuilding bases in the Bohai Gulf area, East China Sea and South China Sea. When completed in 2015, the Changxing base will be the largest shipyard in the world with annual shipbuilding capacity reaching eight million tons.

⁶³⁹ Shipping Finance, 3d Edition, at 254.

⁶⁴⁰ See Martin Stopford, *Maritime Economics* 199 (3rd ed. 2009).

interfere with its title and use of the vessel. Clause 11 “Condition on Delivery” has broad principle that the vessel is to be delivered as she is at the time of inspection, fair wear and tear excepted.

According to Clause 13 “Buyer’s Default”, the seller has an express right to terminate the contract if the buyer is in breach of either of its two principal payment obligations, i.e. (a) to pay the deposit and (b) to pay the purchase price. According to Clause 14 “Seller’s Default”, it deals with non-delivery or late delivery by the seller.

3. Shipbuilding Contracts

As noted by a maritime lawyer, “[s]hipbuilding contracts are like chameleons, when the shipbuilder changes the colour of the ink he uses to keep his books of account, the clauses and terms of a shipbuilding contract also are likely to change.”⁶⁴¹ The essential elements of the shipbuilding contract are construction of the vessel to an agreed specification within a defined time scale and payment by the buyer in installments.

The boom in shipbuilding orders for all classes of ships in the period 2003-2008 has been followed by an equally dramatic fall in freight rates in late 2008 and the termination of many shipbuilding contracts and cancellation of orders.⁶⁴² Also, since the beginning of the economic crisis, numerous orders at the world’s shipyards have been cancelled. According to Fairplay shipping weekly, it reports a “dearth of new orders ..., with the renegotiation of existing contracts now taking up more time for shipbuilders than new

⁶⁴¹ See Brad M. Caldwell, *Ship Building Contracts*, Mariner Life Sept. 2002; Fisherman Life Oct.2002; reprinted Mariner Life Mar. and Apr. 2006.

⁶⁴² See *Employment, Orderbook and Perspectives of the Shipbuilding Industry in Germany*, Institute Labour and Economy, University of Bremen, available at <http://www.oecd.org/dataoecd/46/37/44212704.pdf>.

enquiries.”⁶⁴³ While shipowners’ lawyers try to find clauses that allow for the termination of orders without penalty, shipyards’ lawyers work hard to make sure that companies that have ordered new vessels stick to their commitments. In the long term, there is a common interest between both parties to reduce the volatility of the shipbuilding cycle; both sides should aim at postponing existing orders.

A maritime arbitrator summarized the common features of disputes as follows⁶⁴⁴:

- alleged failures to meet deadlines for stages of construction prescribed by the contract;
- allegations that delays are, or are not, excusable as “force majeure” or “permissible delay”;
- allegations that ships when tendered do not comply with the technical specification, and disputes as to the materiality of alleged discrepancies; and
- allegations that parties have made representations about their intentions with regard to the exercise of rights of cancellation, which have allegedly been relied on by the other party to their detriment.

In simplified form, the author would like to illustrate an example of a shipbuilding contract dispute⁶⁴⁵:

A buyer agrees with a builder that the latter will build a ship. The buyer agrees to pay the price in 5 installments. The contract states that on receiving each installment the builder will provide a bank guarantee that ensures that if the ship is not built and the buyer terminates the contract for

⁶⁴³ See Fairplay Shipping Weekly, May 7, 2009.

⁶⁴⁴ Ian Gaunt MA (Cantab), FCI Arb, DiplCarb, Hon Secretary LMAA, Common Issues in Shipbuilding Contract Arbitrations, London Maritime Arbitrators Association Seminar (Seoul, April 22, 2010).

⁶⁴⁵ The example is based on the author’s practice experience.

stated reasons in the contract (for example, a delivery delay of 180 days), the builder or its bank will repay the installments with interest.

A delay of that period occurs and the buyer terminates the contract pursuant to the termination clause, claiming the payments mentioned above. The builder says to the buyer that is all I am liable for. The buyer disagrees, saying that even without the express termination right, the delay constitutes a repudiatory breach that the buyer has “accepted” by terminating the contract using his contractual right, and seeks damages for loss of the bargain.

Similar issues have been analyzed, Chen-Wishart on contract law gives an example:

“Courts may treat termination under an agreed ‘termination clause’ as less potent than that for breach of a condition proper: thereby restricting the damages available. In *Financings Ltd v Baldock* (1963) B bought a van from F on hire-purchase on payment of 100 pounds immediately and monthly installments of 28 pounds for two years. Clause 8 gave F the right to terminate the contract if any installment was more than 10 days late. F terminated the contract when B failed to make the first two payments and later sold the van for 140 pounds. The court confined F to the recovery of the two late installments but denied its claim for loss of future installments (i.e. loss of the bargain) since the latter was only available when terminating for a repudiatory breach. Here, F merely exercised a power conferred by the contract on an event happening which does not amount to a repudiatory breach.”⁶⁴⁶

⁶⁴⁶ See Mindy Chen-Wishart, *Contract law*, Part V. 14, (Oxford University Press., 3rd ed.)

In a British Court of Appeal case *Gearbulk v Stocznia Gdynia*, the author wants to discuss about the damages and determination in connection with Shipbuilding Contracts. In 2000 and 2001 the appellant, Gearbulk Holdings Ltd (“Gearbulk”), entered into contracts with the respondent, Stocznia Gdynia S.A. (“the Yard”), for the construction of six ‘Fleximax’ vessels for delivery on various dates between 2001 and the end of March 2004.⁶⁴⁷ A separate contract was signed in relation to each vessel, but in all material respects they were in the same form.⁶⁴⁸ The present appeal is concerned with three of those contracts, namely, the Contracts for Hulls 24, 25 and 26.⁶⁴⁹ None of the three vessels in question was delivered as some steel cutting was carried out in relation to Hull 24, but work on the vessel later stopped and no construction work of any kind was carried out on Hulls 25 and 26.⁶⁵⁰

As a result of an unsuccessful discussion between Gearbulk and the Yard, on November 7, 2003, Gearbulk wrote to the Yard terminating the contract in respect of Hull 24 and then exercised its right to recover under a bank guarantee the first installment of the price.⁶⁵¹ Gearbulk then took similar steps to terminate contracts relating to Hulls 25 and 26 respectively and to recover the first installments of the price paid in respect of those two vessels.⁶⁵²

⁶⁴⁷ *Gearbulk v Stocznia Gdynia*, [2009] 1 Lloyd's Rep 461, [2009] EWCA Civ 75, available at <http://www.bailii.org/ew/cases/EWCA/Civ/2009/75.html>.

⁶⁴⁸ *Id.*

⁶⁴⁹ *Id.*

⁶⁵⁰ *Id.* para. 2.

⁶⁵¹ *Id.*

⁶⁵² *Id.* para. 3.

Dispute arose between the parties as Gearbulk asserted that it was entitled in each case to recover damages for the loss of its bargain, whilst the Yard said that because Gearbulk had exercised a right to terminate given by the contract its remedy in each case was limited to the recovery of the installments of the price in accordance with the contract and nothing more.⁶⁵³ The dispute was referred to arbitration in accordance with the terms of the contract.⁶⁵⁴

The arbitrator held that at the time each of the contracts was terminated the Yard had repudiated it. He also held that, “Article 10 [“DELAY in DELIVERY and DEFICIENCIES: SELLER’S DEFAULT”] did not exclude any of the rights that would otherwise arise by operation of law, either the right to treat the contract as discharged on the grounds of repudiatory breach or the right to recover damages for the loss of bargain.”⁶⁵⁵

The appeal of the Arbitration Award was heard by Judge Burton, who reformulated the issues of this case⁶⁵⁶:

- i. Whether Article 10 is a contractual code, which excludes all rights of termination in respect of the events that occurred here (“the first issue”).
- ii. Whether the exclusion clause in Article 10 of the contract excludes any claim for damages in respect of what has occurred (“the second issue”).
- iii. Whether the termination of the contracts pursuant to and in reliance upon the contractual termination provisions (coupled with the claim in each case made upon [the bank] under the refund guarantee) precludes the buyer from subsequently claiming to have terminated at common

⁶⁵³ *Id.* para. 4.

⁶⁵⁴ *Id.*

⁶⁵⁵ *Id.* para. 8.

⁶⁵⁶ *Id.* para. 9.

law (“the third issue”).

The Judge stated that “[w]hether a breach is sufficiently serious to go to the root of the contract depends on the terms of the contract and the nature of the breach, but it is open to the parties to agree that the breach of a particular term, however slight, is to be treated as having that effect and shall therefore entitle the other to treat the contract as repudiated.”⁶⁵⁷ He was of the view that “it is wrong to treat the right to terminate in accordance with the terms of the contract as different in substance from the right to treat the contract as discharged by reason of repudiation at common law. In those cases where the contract gives a right of termination they are in effect one and the same.”⁶⁵⁸

From the commercial standpoint, “. . . parties to a contract of this kind, or indeed to any contract, enter into negotiations in the expectation that if the one of them commits a breach which goes to the root of the contract in the sense just described, the other will be entitled to recover damages for the loss of his bargain. The parties may, of course, agree to depart from that position, but that is the point from which they start.”⁶⁵⁹

The exclusion provisions in the current case were provided in Article 10:

“The Contract Price of the Vessel shall be adjusted by way of reduction in the event of any of the contingencies set out in this Article. Such adjustment shall be effected by way of reduction of the amount of the delivery installment of the Contract Price . . . (it being understood by the Parties that any such reduction of the Contract Price shall [be] by way of liquidated damages and not by way of penalties).

The Purchaser shall not be entitled to claim any other compensation and the Seller shall not be liable for any other compensation for damages sustained by reason of events set out in this Article and/or direct consequences of such events other than liquidated damages specified in this Article.”⁶⁶⁰

⁶⁵⁷ *Id.* para. 15.

⁶⁵⁸ *Id.* para. 20.

⁶⁵⁹ *Id.* para. 14.

⁶⁶⁰ *Id.* para. 5.

Also from the commercial perspective, if the contract excluded the Yard's liability for damages at large in the event of a repudiatory breach then "it would mean that the Yard could at any time refuse to perform the contract without any liability other than to refund installments of the price."⁶⁶¹

Moreover, in legal rationale, "[i]t is important to remember that any clause in a contract must be construed in the context in which one finds it, both the immediate context of the other terms and the wider context of the transaction as a whole. The court is unlikely to be satisfied that a party to a contract has abandoned valuable rights arising by operation of law unless the terms of the contract make it sufficiently clear that that was intended. The more valuable the right, the clearer the language will need to be."⁶⁶²

Refusing the Yard's argument that Gearbulk had no right to recover damages for loss of bargain because the effective cause of its loss was not the Yard's breach of contract but its own decision to exercise its contractual right of termination, the Judge held that, "it is clear that in this case the contract proceeds on the footing that if Gearbulk chose to exercise its right, the Yard's breach was to be viewed as the effective cause of the contract's termination."

Article 10.7 reads as follows:

"10.7 Effect of Termination

Upon termination of this Contract by the Purchaser in accordance with the provisions of Article 10 or any other provision of this Contract expressly entitling the Purchaser to terminate this Contract, the Seller shall forthwith repay to the Purchaser all sums previously paid to the Seller under this Contract, together with interest accrued thereon calculated at the rate of 1 month LIBOR per annum from the respective date(s) of payment of such sums until date of refund . . . It is however further expressly understood

⁶⁶¹ *Id.* para. 21.

⁶⁶² *Id.* para. 23.

and agreed upon by the Parties hereto that, if the Purchaser terminates this Contract under this Article, the Purchaser shall not be entitled to any liquidated damages under Articles 10.1, 10.2, 10.3 or 10.4 hereof.”⁶⁶³

The Judge stated that, “Once one accepts that Article 10 does not exclude Gearbulk’s right to claim damages for loss of bargain, there is no good reason to construe Article 10.7 as providing an exclusive remedy of a kind that was intended to take away by the back door rights of potentially considerable value. Lord Diplock’s observation in *Gilbert-Ash v Modern Engineering* comes to mind once again. Taking into account the contract as a whole I am left in no doubt that the parties intended Article 10.7 to provide a remedy additional to those that would ordinarily be available to Gearbulk on termination of the contract.”

From this case, the author is of the view that if a buyer wishes to claim both a return of its money and damages for loss of the bargain, that must be very carefully and precisely expressed. Therefore, the innocent party does not, by exercising a contractual termination right allowed by the contract, unwittingly deprive himself/herself of loss of bargain damages.

Further, the terms of the shipbuilding contract usually include:

i. Method of Payment

In most cases the first installment of the purchase price will be payable before construction starts once the shipbuilder’s refund guarantee has been issued. Subsequent installments will then become due following completion of particular stages of construction with a final installment due on delivery. Normally, completion of a stage of construction (i.e. keel laying, hull completion and launching) would be confirmed by a

⁶⁶³ *Id.* para. 5.

classification society surveyor. One alternative to this is to provide for pre-delivery installments to be paid on particular dates regardless of the stage of construction reached.

ii. Title and Security

The shipbuilding contract will contain detailed provisions dealing with when title in the ship will pass. The parties are, in principle, free to agree whatever they like. However, title normally passes on delivery.

It sometimes happens that the shipbuilder is not able to provide a refund guarantee to secure the return of any pre-delivery installments in the event of non-delivery. In such cases the contract might provide for the progressive transfer of title as the construction progresses.⁶⁶⁴

In order to provide the buyer with security it will also be important for it to obtain a refund guarantee pursuant to which a bank will guarantee the repayment by the shipbuilder of any money that becomes due under the Shipbuilding Contract upon any premature termination thereof.

iii. Plans and Specifications

Agreement of a detailed specification for the ship will be one of the most important and earliest issues to address. It is of particular relevance if the ship is of a non-standard design with particular requirements in terms of its technical capability and performance with which Builders may not be familiar.

In addition to technical issues, other matters that are likely to affect the specification are as follows: (a) intended use of the ship (i.e. commercial or non-commercial) (b) trading patterns (c) Classification required and Classification Society appointed (d) choice of flag and flag state requirements.

⁶⁶⁴ See *Getting the deal through Shipping 2010* at 51 (Law Business Research Ltd, 2010).

iv. Warranties and Limitation of Liability

Builders' warranty clauses are very specific as to what is and what is not covered and as to the time frame of the warranties. The warranty generally covers all defects and damage due to defective workmanship and materials furnished by the builder or its subcontractors or other fault in construction or installation or builder's specifications or drawings. Therefore, specific terms of the warranty should be negotiated carefully by the parties.

It is normal for the shipbuilder to guarantee the materials and workmanship used in the construction of the ship and its appurtenances, components, engines, machinery, equipment and spare parts for a period of at least 12 months from delivery.

Most shipbuilding contracts also contain a clause excluding liability for any consequential damage suffered by the purchase such as damages for loss of use of the vessel.

v. Extras and Change Orders

One of the most common sources of disputes between shipbuilders and buyers is the determination of whether or not an item is an extra or part of a fixed price contract. In this situation, the best way to resolve the problem is for the buyer and builder to have an agreement to continue with the work and sort out the dispute at a later time by either arbitration or litigation.

vi. Completion Dates

Usually, it is important for a purchaser to have a ship completed by a certain date, and it is best to include a liquidated damages clause in the contract specifying the per diem penalty for late delivery.

vii. Insurance

Shipbuilding contracts require the builder to provide insurance to cover the vessel and such parts as shall be constructed and all materials, engines, machinery, outfit and equipment to be installed in or on the vessel, as well as all of the owner's supplied equipment against all risks of loss and damage pre-keel laying and builder's risk insurance for a total loss of not less than 100 per cent of the contract price.⁶⁶⁵ When the vessel is under way for sea trials or at the place of delivery, the contract should also require the builder to insure the vessel for protection and indemnity risks and for hull and machinery risks in the same amounts referred to above.

In the context of U.S. laws, builders are also required to maintain workers' compensation insurance at statutory amounts with Longshoreman and Harbor Workers' Compensation Act coverage endorsement.

viii. Taxes

Unless a tax exemption is being claimed, the shipbuilding contract should normally specify that tax is payable. The most common exemptions to one or more of these taxes are for: ships built for export, ships purchased by commercial fishermen, ships delivered to Native Indians on a reserve, and self-propelled ships in excess of 500 gross tons. However, the exemptions may change from time and time and advice should be sought from the relevant governmental agencies.

For newbuildings, payments of pre-delivery contract price are treated as advances. If the yard fails to complete the construction by the delivery date, or the yard is in breach of the shipbuilding contract the buyer will be entitled to terminate the contract and demand repayment of the pre-delivery installments. Where the shipbuilding contract provides for payment in full by installments on or before the delivery, the buyer will usually finance

⁶⁶⁵ The builder's risk policies generally include institute builder's risk clauses, increased value, institute strike clauses, institute war clauses and coverage against hurricanes, windstorms and earthquakes.

the payments by bank loan. The bank commonly will require the buyer to pay 20-30 percent of the total purchase price of the ship on its own. The bank will fund in tranches to meet the later building contract installments at milestones, for example, keel laying. The loan will commonly not become repayable until after the physical delivery of the vessel when the vessel earnings come into stream. During the construction period, the buyer will be required to assign a package of the shipbuilding contract and the refund guarantee to the financier bank. Indeed, it is of importance for the buyer to ensure that the shipbuilding contract and the refund guarantee are assignable. In contrast, if the vessel is being built on the seller's credit terms, the forgoing is not relevant.

4. Refund Guarantee Deficiencies

As discussed in Chapter IV, Section 6.4 above, the refund guarantee is the financial cornerstone of the shipbuilding project.⁶⁶⁶ However, refund guarantees are often subject to a number of general and specific deficiencies. These deficiencies may well materially affect their practical value to shipowners and their financiers.

Speaking of the scope of the refund guarantee, it almost invariably only covers the builder's failure to repay installments and interest following the buyer's cancellation of the shipbuilding contract under its express terms.⁶⁶⁷ In contrast, the refund guarantee does not normally address the following issues:

1. termination under common law principles (acceptance of the builder's repudiatory breach);
2. total loss; or
3. frustration, for example, war.

⁶⁶⁶ Refund guarantees are uncommon in the case of US shipbuilding contracts. Parent company guarantees, both for the builder and the buyer are common.

⁶⁶⁷ See Simon Curtis, Enforcing the refund guarantee – practical problems.

Regarding the question whether the guarantee is “on demand or not”, in *Rainy Sky v Kookmin Bank*, the refund guarantee was held to be an “on demand” instrument.⁶⁶⁸ It affirms the principles set out in *Gold Coast v Caja de Ahorros*, which involved construction of refund guarantees. The refund guarantee may either be “callable” (i) upon the buyer’s simple demand or (ii) only after the builder’s liability to make the refund has been determined by a tribunal or court.

Regarding the expiry date of the refund guarantee, it is vital to ensure that this provides sufficient “time margin” to permit cancellation under the shipbuilding contract. It will probably be subject to a fixed expiry date.

The buyer should also bear in mind that it must ensure that the guarantor (i) is aware of the true nature of the shipbuilding contract including side letters/collateral agreements, and (ii) has given its consent (in the guarantee or subsequently) before any material variation is made.

5. Ship Registration

International law requires that every merchant ship be registered in a country. This country in which a ship is registered is called its flag state. No vessel may trade the high seas without a national character. The 1958 Geneva High Seas Convention provides that:

“Ships shall sail under the flag of one State only and, save in exceptional cases expressly provided for in international treaties or in these articles, shall be subject to its exclusive jurisdiction on the high seas. A ship may not change its flag during a voyage or while in a port of call, save in the case of a real transfer of ownership or change of registry”⁶⁶⁹

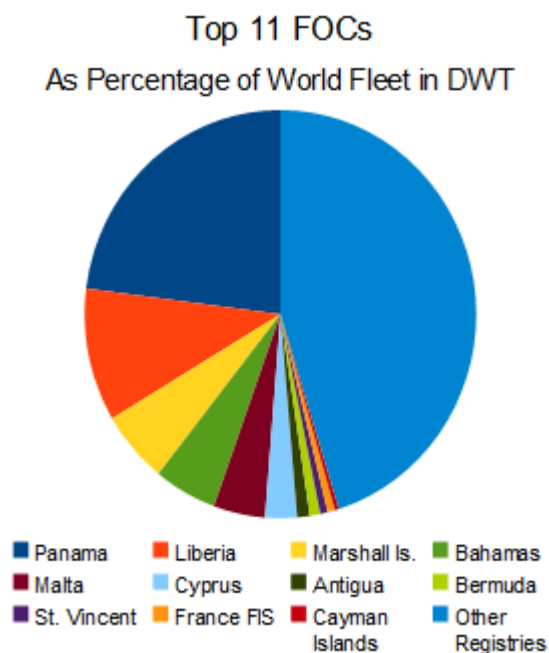
⁶⁶⁸ *Rainy Sky v Kookmin Bank*, [2009] EWHC 2624 (Comm) (U.K.), available at <http://www.bailii.org/ew/cases/EWHC/Comm/2009/2624.html>.

⁶⁶⁹ Article 6 of the 1958 Geneva High Seas Convention.

Depending on the flag state concerned, the flag state does not necessarily have to be the state in which the owner of the ship is registered. Many owners take the form of newly incorporated single purpose companies, or namely, special purpose vehicle, to provide financiers with the comfort that the company has no pre-existing trading liabilities, to minimize the risks of sister ship arrests when unfettered trading is key to cash-flow management, and to achieve anonymity for those behind the owning parent. However, this can also be a double-edged sword, leaving the third parties to deal with a single purpose company with no track record of successful trading and with nothing ostensibly to its name other than a minimal capitalization.

Ship registration is an essential part of the trading process. Every flag state has a ship register entering the particulars of merchant vessels of that flag state. The ship register is open to public inspection. It benefits shipowners as they may prove to third parties that their unencumbered sole ownership of the vessel. Ship registration plays an important role in many aspects, such as: vessel purchases, newbuilding deliveries, financing, vessel leasing, and different priorities of owners and mortgagees.

Ship registries include open/international registers and closed/national registers. For local registers, usually these flags maintain a national restriction by (1) nationality of the individual owner behind the register and (2) nationality of the company as owner. On the other hand, open registers allow registration by non-nationals or Foreign Maritime Entities or their equivalent and offer minimal restrictions on crew nationality. They usually also promote simple registration procedures and offer low or zero taxes. The reasons for choosing an open register are varied and include tax avoidance, the ability to avoid national labor and environmental regulations, and the ability to hire crews from lower-wage countries.



Source: Review of Maritime Transport 2009, Report by the UNCTAD secretariat, on the basis of data supplied by Lloyd's Register - Fairplay

From the figure above, we may want to wonder three questions:

- i. Why is Panama so clearly the biggest register in the world?

According to the UNCTAD report, the largest flag of registration continues to be Panama.⁶⁷⁰ During the World War II the United States allowed U.S. vessels to flag into Panama to circumvent its own neutrality laws. As opposed to registration in the U.S., Panamanian registration obviously had attractions following the end of the World War II of avoiding higher U.S. labor costs, U.S. detailed regulation and U.S. financial liability.

- ii. Why has the Liberian register become so dominant?

A group of U.S. oil companies created this flag and based it first in New York for their tanker service fleets. With this springboard it was difficult for it not to flourish. As

⁶⁷⁰ Review of Maritime Transport 2009, report by the UNCTAD, United Nations, New York and Geneva, page 54.

the world's second largest registry, Liberia is predominantly used by owners from Germany and Greece.⁶⁷¹

iii. Why are there so many other flags worldwide?

In the 1980s, a large number of countries recognized the attractiveness of significant potential revenues from registration and annual fees from foreign companies in registering their tonnage with them. Ship arrest as a result of vessels' widespread movements encouraged separate company formation, separate shipowning and separate registration with the consequence of fees per company or vessel registration.

The Marshall Islands has become the third largest registry in the world, catering for shipping interests from Greece, the States, Germany and so forth.⁶⁷² It is of particular importance for the United States for historic reasons and for the fact that almost 30% of the U.S. controlled tonnage flies the flag of the Marshall Islands.⁶⁷³

The motivations for choosing a foreign flag vary for different countries, vessel types and vessel characteristics. In Europe, the Maltese flag is used by ships from Greece, Turkey and the Islamic Republic of Iran.⁶⁷⁴ In the Caribbean, the registry of the Bahamas caters mainly for owners from Greece, Canada and Norway.⁶⁷⁵

iv. Are open registers a sign of poor quality and national register a sign of good quality?

No quality distinction should be drawn carte blanche between open and national flags.

⁶⁷¹ *Id.* at 56.

⁶⁷² *Id.* at 57.

⁶⁷³ *Id.*

⁶⁷⁴ *Id.*

⁶⁷⁵ *Id.*

Based on pertinent laws and regulations of the key registries, the author summarized their ship registration requirements and procedures respectively, details see Annex 1 Liberia, Annex 2 Bahamas, Annex 3 Cyprus, Annex 4 Malta, and Annex 5 Panama.

Ship registers are also registers of title and ship mortgages, and registration affects the priority of mortgages and other claims. A lender wants to know that the mortgage is valid and constitutes adequate and enforceable security. It wants to ensure that the ship satisfies any requirements of the particular flag state. If there is not the case, the registration of the ship at the relevant registry could be avoided, along with the mortgage. A lender may also want to know how the flag state deals with maritime liens, which could mean a third party may rank ahead of the lender in certain circumstances.

If the ship is to be registered under a different flag once it is sold, the sale and purchase documents and the closing process need to reflect this. Usually, the new flag state requires for evidence showing details that the ship has been deleted from the old registry. The form of deletion certificate varies among flag states.

6. Funds Disbursement Procedure – Disbursement of Advance and Borrower’s Equity

In order to explain the money disbursement procedure, the author sets up a sale leaseback hypo below. In this hypo, the borrower is a Marshall Island SPV (the “Borrower”), which is set up by its parent company, a New York registered private equity company. Bank ABC (the “Bank”) is a European Bank acting through its New York office. The Ship was built and delivered at a Korean Shipyard (the “Yard”). The Yard’s bank is a Korean Bank. The Bareboat Charterer M Shipping Ltd. is a Maltese shipping company and also the buyer from the Yard, and the seller under the MOA to the Borrower (the “Seller”). The Ship will be registered in the ownership of the Borrower in Malta when the Ship is delivered in Korea and will be immediately bareboat chartered to the Charterer. The newbuilding is financed by the loan provided by the Bank and the equity of the Borrower. The Ship will be registered with Maltese flag.

The Borrower has instructed the Bank to disburse the Advance upon the satisfaction of applicable conditions precedent under the Loan Agreement, together with the Borrower’s Equity (as defined below). The Borrower has advised that such disbursements are intended to constitute the Borrower’s payment of the purchase price (the “Purchase Price”) to the Seller under the MOA. Moreover, the Borrower has advised the MOA Purchase Price is \$43,000,000 and that it intends to satisfy such Purchase Price as follows:

Portion of Advance be pre-positioned at the Yard’s Bank	\$24,400,000	
Portion of Advance to paid by Payment Letter at closing	<u>5,600,000</u>	
Bank Advance		\$30,000,000
Borrower’s Equity (to be paid by Payment Letter)		10,000,000
Seller’s Loan		<u>3,000,000</u>
MOA Purchase Price		<u>\$43,000,000</u>

Accordingly, this hypo aggregates the actions necessary for payment of applicable fees, drawdown of the Advance, and the pre-positioning and subsequent disbursement of funds based on the requirements under the Loan Agreement and the instructions provided by the Borrower.

Advance funds will only be released upon (1) satisfaction of applicable conditions precedent under the Loan Agreement, and (2) receipt by the Bank of an email or other written confirmation from the Borrower or its counsel that the Bank may proceed to release funds in such amounts and pursuant to such instructions as set forth below.

Action	Amount
1. Payment Amounts and related Banking Details:	
a. Aggregate fees (the “Fees”) to be paid to the Bank:	\$[760,000]*
i. the Bank’s Banking Details	
b. Equity portion of the MOA Purchase Price (“Borrower’s Equity”) to be deposited with the Bank:	\$[●]*
i. the Bank’s Banking Details	
* [minus Seller’s Loan and \$[●] as first month’s hire under the Charter]	
c. The Bank to disburse the Advance, together with Borrower’s Equity as follows:	
i. Portion of Advance to be pre-positioned at the Yard’s Bank pursuant to a MT199 ⁶⁷⁶ /MT103 conditional SWIFT (the “Conditional SWIFT”) two Business Days prior to release at closing:	\$[24,400,00]
A. Korean Bank’s Banking Details	
	delivery installment

⁶⁷⁶ A swift message type 199 is an interbank message used between two banks to transmit the value of a bond or a free format message engaging both banks.

- ii. portion of Advance and Borrower's Equity to be paid to Seller by irrevocable payment letter ("Payment Letter"): \$[5,600,000] +
- A. Banking Details [Borrower's Equity]

2. Verification of Conditions Precedent relating to Drawdown Notice:

The Bank will confirm that all conditions precedent set out in the Loan Agreement have been met on or before the date of the Drawdown Notice.

3. Drawdown Notice

Borrower will deliver a Drawdown Notice to the Bank not less than [3] Business Days prior to the proposed Drawdown Date (which Drawdown Date is anticipated to be 3 Business Days prior the delivery date of the Ship thereby allowing funds to be pre-positioned in Korea for value 2 business days prior to the delivery date as required by the Construction Contract). The Drawdown Notice will confirm amounts and payment instructions in connection with disbursement of the Advance.

4. Payment of Fees and Depositing of Borrower's Equity:

- a. Borrower will transmit the Fees to the Bank for value not later than 1 Business Day prior to the Drawdown Date; and
- b. Borrower will transmit the Borrower's Equity to the Bank for value not later than 1 Business Day prior to the Drawdown Date.

5. Pre-positioning Advance:

- a. The Bank will transmit the Conditional SWIFT to Yard's Bank on the Drawdown Date as specified in the Drawdown Notice; and
- b. The Bank will pre-position the executed Payment Letter with the Bank's counsel in New York.

6. Verification of Conditions Precedent at closing:

The Bank will confirm that all applicable Conditions Precedent set out in the Loan Agreement have been met on or before the Drawdown Date. Such confirmation will be subject to confirmation by the Bank's Maltese counsel that all necessary documentation for registration of the Ship and the Mortgage in Malta has been tabled and otherwise made available to the Maltese registrar and that nothing will prevent the registration of the Ship and the Mortgage immediately upon delivery.

7. Confirmation of readiness to close:
 - a. All parties will confirm readiness to close.
 - b. The actions set out in Nos. 8 and 9 below shall then take place simultaneously.
8. Delivery of the Ship from Yard to Seller, and from Seller to Borrower, and Release of Pre-Positioned Funds and Payment Letter:
 - a. Yard and Seller will sign the “tabled” Protocol of Delivery and Acceptance in Korea;
 - b. Seller and Borrower will sign the “tabled” Protocol of Delivery and Acceptance in Malta;
 - c. Borrower will instruct the Bank to release the pre-positioned funds by countersigning the Protocol of Delivery and Acceptance;
 - d. All applicable Finance Documents will be released from escrow;
 - e. Yard will deliver its Bill of Sale (and other applicable documents) to Seller;
 - f. Yard and Seller will complete the time in the Protocol of Delivery and Acceptance in Korea;
 - g. Seller will deliver its Bill of Sale (and other applicable documents) to Borrower;
 - h. Seller and Borrower will complete the time in the Protocol of Delivery and Acceptance delivered in Malta; and
 - i. Borrower will instruct the Bank to release the Payment Letter to the Seller’s counsel in New York on behalf of Seller.
9. Registration of the Ship and the Mortgage, delivery of the Ship to Seller as Charterer:
 - a. Borrower/its Maltese counsel will initiate provisional registration of the Ship in Malta;
 - b. The Bank/its Maltese counsel will initiate registration of the mortgage in Malta; and
 - c. Borrower will effect delivery of the Ship to the Seller as Charterer.

7. Closing Meeting Logistics

Traditionally speaking, at the closing meeting representatives of the buyer and seller on board ship are in telephone contact with a meeting ashore of representatives of sellers,

buyers, current and prospective mortgagees and the ship's existing registry.⁶⁷⁷ Further to the sale leaseback hypo above, the author would like to discuss the closing meeting logistics on the basis of the hypo.

Delivery/Closing Time:

Korea	3:00 PM
Malta	8:00 AM
New York	2:00 AM

Pre-Closing

The Shipyard will (a) prepare drafts of the delivery documents required under the shipbuilding contract, (b) make available forms of the Bill of Sale, Builder's Certificate and other related documents to M Shipping Ltd., the Charterer/Seller under MOA and the Borrower for review, comment and pre-approval by the shipping registry in Malta, and (c) arrange for the advance execution and notarization of such delivery documents, as applicable.

M Shipping will send all available conditions precedent to the MOA and the Bareboat Charter to Borrower's counsel in New York. M Shipping will provide ten (10) days notice of the expected delivery date of the Ship. Five (5) days prior to the expected delivery of the Ship, the Borrower will provide the Bank with a drawdown notice in respect of the loan. All parties will agree to the form of an irrevocable payment letter to be issued by the Bank at closing.

Two (2) banking days prior to the expected delivery date of the Ship, the Borrower will instruct the Bank to send US\$24,400,000 to the Korean Bank by MT103/199 SWIFT to be held in a suspense account subject to release instructions contained in the MT103/199 SWIFT. The Borrower will send its equity portion of the purchase price of

⁶⁷⁷ See Martin Stopford, *Maritime Economics* 202 (3rd ed. 2009).

the Ship in the amount of US\$10,370,000 to the Bank to be held with the balance of the loan proceeds. Ship surveyor will confirm to the Borrower that the Ship is in acceptable condition.

Closing Part I –Delivery of the Ship from the Shipyard to M Shipping (to take place simultaneously with Parts II and III)

The closing meeting is to take place at the Shipyard in Korea.

1. The following documents will be tabled at the closing in Korea: (a) Power of Attorney (from M Shipping to its Attorney in Fact); (b) Power of Attorney (from the Borrower to its Attorney in Fact); (c) Power of Attorney (from the Shipyard to its Attorney in Fact); (d) Bill of Sale from Shipyard to M Shipping, duly signed and notarized; (e) Builder's Certificate from Shipyard to M Shipping, duly signed and notarized; (f) Protocol of Delivery and Acceptance between the Shipyard, as seller, and M Shipping, as buyer; (g) Copies of the following documents to be delivered to M Shipping from the Shipyard: (i) Protocol of Sea Trials, (ii) Protocol of Inventory, (iii) Protocol of Stores, (iv) Protocol of Finished Plans, (v) Protocol of Deadweight Experiment and (vi) Declaration of Warranty re: Ship free from liens; (h) Interim Classification Certificate; and (i) Assignment of Warranty of Quality signed by M Shipping, the Shipyard and the Borrower.

2. An irrevocable payment letter from the Bank in favor of M Shipping undertaking to remit US\$15,210,000 to M Shipping will be tabled with the counsels of the Bank and the Borrower in New York.

3. The Shipyard will confirm to M Shipping through M Shipping's representative and to the Borrower through its representative that the Ship is ready to be delivered to M Shipping.
4. The Borrower's representative will confirm to the counsels of the Bank and the Borrower in New York that the documents listed in paragraph 1 above (i) conform to the respective drafts thereof circulated previously, (ii) have been executed, and (iii) have been tabled.
5. The Borrower's Maltese counsel will confirm to all parties that (i) all necessary documentation and fees are in place at the Maltese shipping registry, (ii) the Maltese shipping registry is prepared to register the Ship in the Borrower's ownership upon receipt of the executed Bill of Sale, Builder's Certificate and Protocol of Delivery and Acceptance by email or facsimile and (iii) the registry is prepared to record the Mortgage over the Ship in the Bank's favor.
6. The Bank's Maltese counsel will confirm to the Bank and to all parties that (i) all necessary documentation and fees relating to the registration of the Mortgage are in place at the Maltese shipping registry, (ii) the Mortgage will be registered upon the delivery of the Ship, and (iii) the undated Protocol of Delivery and Acceptance between M Shipping and the Borrower and the undated Mortgage have been executed and tabled in Malta and, in the case of the Protocol of Delivery and Acceptance between M Shipping and the Borrower, with the time remaining to be filled in.
7. M Shipping's representative will confirm that it is ready to accept the Ship from the Shipyard and that it is ready to accept the Ship under the bareboat charter with the Borrower.

8. All parties, including the Bank, will confirm their readiness to close. The Borrower or its counsel will then confirm to the Bank and its counsel by email that the Bank should release the funds by instructing that the Protocol of Delivery and Acceptance between the Shipyard and M Shipping be countersigned by the Bank's representative at the Shipyard.
9. The Bank will instruct its representative at the Shipyard to countersign the Protocol of Delivery and Acceptance between the Shipyard and M Shipping.
10. The Shipyard's representative and M Shipping's representative shall complete the time in and sign the Protocol of Delivery and Acceptance from the Shipyard to M Shipping and the Bank's representative shall countersign the Protocol of Delivery and Acceptance from the Shipyard to M Shipping.
11. Immediately upon the signing of the Protocol of Delivery and Acceptance from the Shipyard to M Shipping (i) the Bank's representative at the Shipyard shall instruct the Shipyard's Bank to release US\$24,400,000 to the Shipyard's account and (ii) the Bank's New York counsel will release the irrevocable payment letter in New York to M Shipping's counsel in New York.
12. Simultaneously with No. 9 above, the Shipyard's representative shall release the documents listed in paragraph 1(d) through 1(h) above to M Shipping's representative.
13. Simultaneously with No. 9 above, M Shipping's representative shall release the Assignment of Warranty of Quality to the Borrower's representative.

14. Immediately upon release thereof, M Shipping's representative will email the (i) Bill of Sale, (ii) Builder's Certificate, and (iii) Protocol of Delivery of Acceptance to the Borrower's Maltese counsel.

15. M Shipping's representative will email all of the documents listed in paragraph 1 above to all parties.

16. The Borrower's representative at the Shipyard will email a copy of the Assignment of Warranty of Quality to the Borrower's counsel in New York.

Closing Part II – Delivery of the Ship from M Shipping to the Borrower under the MOA (to take place simultaneously with Parts I and III)

The closing meeting is to take place at the Maltese Shipping Registry.

1. The following documents will be signed and tabled at the closing in Malta:

- (a) Power of Attorney (from M Shipping to its Attorney in Fact)
- (b) Power of Attorney (from the Borrower to its Attorney in Fact)
- (c) Four (4) original, notarized Bills of Sale from M Shipping to the Borrower
- (d) Commercial Invoice from M Shipping to the Borrower
- (e) Protocol of Delivery and Acceptance between M Shipping, as seller, and the Borrower, as buyer
- (f) Confirmation from M Shipping that the Ship has not been registered under any flag
- (g) First Priority Maltese Statutory Mortgage

2. Simultaneously with No. 7 in Part I above, M Shipping will (i) release the original Bills of Sale, (ii) release the Commercial Invoice, (iii) complete the time and date in and release the Protocol of Delivery and Acceptance and the Borrower will (iv) register the Ship under the Maltese flag, (v) inform the Bank's Maltese counsel that the Ship has been registered under the Maltese flag, and (vi) date, execute and release the Mortgage to the Bank's Maltese counsel.

3. The Bank's Maltese counsel will record the Mortgage simultaneously with the registration of the Ship.
4. Written confirmation of the registration of the Ship and the recordation of the Mortgage will be provided to all parties.
5. Email copies of the (i) Bills of Sale, (ii) Commercial Invoice, and (iii) Protocol of Delivery and Acceptance will be sent to all parties.

Closing Part III – Delivery of the Ship under the Bareboat Charter (to take place simultaneously with Parts I and II)

1. The Protocol of Delivery and Acceptance pursuant to the Bareboat Charter shall be tabled at the closing in Malta. Contemporaneously with the Ship's registration under the laws of Malta and the recordation of the Mortgage, Protocol of Delivery and Acceptance pursuant to the Bareboat Charter will be executed between the Borrower, as owner, and M Shipping, as bareboat charterer.
2. An email copy of the fully executed Protocol of Delivery and Acceptance will be circulated to all parties.
3. The Maltese legal opinion relating to the MOA and bareboat charter will be released.

Post-Closing

As soon as possible after the closing, email copies of the Transcript of Registry and the Mortgage will be sent to New York counsels by the Maltese counsels.

6 JUDICIAL SALE

While most of us have confidence in the shipping finance outlook, some commentators expressed their deep concerns, as Steve Matthews said on Lloyd's List:

“Shipping finance is looking increasingly daunting from a variety of perspectives. Depressed vessel earnings and values, together with limited options for raising new funds for investment or refinancing, are posing major challenges for chief finance officers. This is in the context of increasingly worrying global economic indicators. Recoveries are stalling in many key consuming countries, including the US, while China and India are trying to bear down on inflation and sovereign debt problems mount in some of the eurozone countries in particular. As more shipping companies struggle to break even at present earnings levels, more are running into financial trouble, seeking bankruptcy protection and having ships repossessed by lenders.”⁶⁷⁸

Some sources highlighted the issue of German banks arresting and selling vessels, noting that the banks' unwillingness to grant deferrals of repayments to the same extent as they did in the past two years is ending.⁶⁷⁹ For example, two German-owned vessels⁶⁸⁰ have been up for sale at auction in Malta, adding to the list of vessels coming under the auctioneer's hammer this year after being arrested by banks as owners struggle to meet mortgage repayments.

According to Lloyd's List, this latest sale at auction follows the auction in August 2011 in Singapore of two arrested general cargo vessels owned by insolvent German company Scanscot Shipping. Also, bankrupt German owner Beluga Shipping has had its fleet sold at auction as several banks moved to recoup money owed.

Also, due to the reason of loan-to-value ratio affected by the reduction of ship value, the current value of some ships is far below the liabilities to banks, the banks therefore

⁶⁷⁸ Steve Matthews, Global economic indicators paint a worrying picture for ship finance, July 20, 2011, available at: <http://www.lloydslist.com/ll/sector/finance/article375621.ece>.

⁶⁷⁹ Hal Brown, Two more arrested German vessels go to auction, Sept. 2, 2011, available at <http://www.lloydslist.com/ll/sector/containers/article379002.ece>.

⁶⁸⁰ The two vessels, both owned by German company Reederei Andre Wiczorek Schiffahrt, according to Lloyd's List Intelligence, are being sold by banks Deutsche Schiffsbank Aktiengesellschaft and Commerzbank Aktiengesellschaft.

have started to turn up the heat on their customers, namely, the shipowners.⁶⁸¹ Market observers expect that the number of forced sales of ships will increase in the later part of 2011.⁶⁸² There have been several recent bankruptcy filings in the U.S. and numerous ship arrests as banks have also begun to recognize the futility of continuing default waivers as ship values continue to decline.⁶⁸³

According to Dagfinn Lunde, member of the Board of managing directors at Germany's DVB Bank and responsible for shipping finance, shipbuilding capacity is about 2.5 times bigger than necessary for the immediate replacement of tonnage. He expressed his view that, "We expect China and [South] Korea to continuously put ships into the market. Prices for newbuilds will further decline. The oversupply is killing the shipping markets."⁶⁸⁴

He pointed out that for the rest of 2011 and well into 2012, shipowners and banks will face restructuring as a key topic. The reason is "[t]hose shipowners who bought very expensive vessels at the high end of the market are clearly facing problems on the liquidity side at the moment. Some fire sales and foreclosures might occur, especially if the bank involved does not extend the loan. It is always the lack of liquidity which kills a company."⁶⁸⁵

⁶⁸¹ Paul Slater, Shipping is still mired in a global recession, available at: <http://www.lloydslist.com/ll/sector/finance/article379187.ece>.

⁶⁸² Patrick Hagen, Banks force HCI Capital fund to sell tanker, Sept. 5, 2011, available at: <http://www.lloydslist.com/ll/sector/finance/article379159.ece>.

⁶⁸³ Paul Slater, Shipping is still mired in a global recession, available at: <http://www.lloydslist.com/ll/sector/finance/article379187.ece>.

⁶⁸⁴ Steve Matthews, Overcapacity crisis to last 18 months, says Lunde, Sept. 6, 2011, available at: <http://www.lloydslist.com/ll/sector/finance/article379255.ece>.

⁶⁸⁵ *Id.*

7 CLASSIFICATION SOCIETY

Classification society has very close relationship with the shipping industry, from ship sale and purchase to cooperation with Port State control.⁶⁸⁶ The classification societies are the shipping industry's internal regulatory system. They give classifications to ships by surveying their structural soundness, equipment quality, etc.

Classification rules are developed to contribute to the structural strength and integrity of essential parts of the ship's hull and its appendages, and the reliability and the function of the propulsion and steering systems, power generation and those other features and auxiliary systems which have been built into the ship in order to maintain essential services on board for the purpose of safe operation of the ship.⁶⁸⁷

Major international Classification Societies have participated into International Association of Classification Societies (the "IACS"). To put it simply, purchasing a second hand ship has the similar risk as buying a second hand car, notably, the hidden or irreparable quality problems. However, due to the survey run by the classification society, purchasing a second hand ship is better than the latter.

Also, in a vessel delivery closing meeting at the shipyard, before the shipyard and the buyer proceed, the classification society will board the vessel, inspect the vessel, make surveys and issue confirmation of class certificate. After the buyer is assured and satisfied with the vessel's quality, both parties will sign the protocol of delivery and acceptance, the lender will countersign the protocol and release the fund to the shipyard, and the vessel will be simultaneously registered in the ownership of the buyer.

⁶⁸⁶ See Philippe Boisson LLD, Classification Society Cooperation with Port State Control: a Move Towards the End of Substandard Practices.

⁶⁸⁷ Classification Societies – what they do and do not do. See www.iacs.org.uk.

Practically, one minute afterwards, the mortgage will be recorded in favor of the lender by the buyer/borrower.⁶⁸⁸

Classification societies today not only serve private and public law functions, but have also expanded their services to other industries. With conventions like MARPOL and SOLAS, measures like the ISM and ISPS Codes, contracting states have to inspect vessels to ensure compliance. States appoint classification societies to act on their behalf in these matters.

When a ship is first classed, the relevant classification society will issue a certificate recording the character or class rating assigned to the ship. Then the classification society will survey the vessel at regular intervals to determine whether the vessel still complies with the rules and requirements of the class. If a shipowner fails to comply with the requirements or violate the class rules, the classification society could decide to suspend or to withdraw the ship's classification with immediate effect or after a certain period of time. If a ship's classification is withdrawn or cancelled for reason of non-compliance, the ship's international ship certificates will become invalid and the ship will no longer comply with the flag state's requirements.

Also, from a financing standpoint for the banks, the insurances and charter need the class status information, and the bank will usually require any ship (which secures the loan) to be classed with a classification society approved by the bank, maintained in class without any overdue conditions or recommendations, and kept under periodical survey. The bank will also require the shipowner to send a written authorization letter to the classification society enabling the bank to inspect class records to obtain copies of class certificates and inform the bank of any negative changes to the class status.

⁶⁸⁸ It is based on the author's practice experience from attending closing meetings.

Classification society has also been victims of judicial analysis in the debate relating to the tort of negligence.⁶⁸⁹ Classification societies are not guarantors of safety of life or property at sea or the seaworthiness of a vessel because the classification society has no control over how a vessel is operated and maintained in between the periodic surveys which it conducts. Like other professional entities, classification society will also make mistakes. In the 1972 case of *The “Tradeways II”, Great American Insurance Company, et al v. Bureau Veritas*, classification society Bureau Veritas did not find any problems in the annual survey, however, the charterer later found out defects during the on hire survey, which was overlooked during the annual survey. BV cancelled the ship class accordingly. After repairs, the class was reinstated. Unfortunately, the vessel eventually sunk near Antwerp. The Hull & Machinery Insurer paid the owner and then sued BV on the ground of negligence. In *Otto Candies LLC v. Nippon Kaiji Kyokai Corporation*⁶⁹⁰, NKK was held liable, on the basis of negligent misrepresentation, for economic losses suffered by a buyer. It is difficult to succeed on claims for negligent misrepresentation as claimants have to prove that the defendants knew that the statements were false or were reckless in their belief as to the truth of those statements, the defendants knew that the claimants would be relying on the statements and the claimants actually relied on the statements. The court emphasized the need for actual knowledge of the third party reliance, without which no duty of care arises.

The mere imposition of a duty of care does not automatically make classification societies liable for all maritime incidents. Breach of duty and causation must exist. However, on the other hand, imposition of a duty of care will make the classification

⁶⁸⁹ See Philippe Boisson LLD, Classification Society Cooperation with Port State Control: a Move Towards the End of Substandard Practices.

⁶⁹⁰ 346 F 3d530 (5th Cir 2003).

societies more diligent and careful with their tasks, enhancing the safety of life and property at sea.

8 ALTERNATIVES & IMPROVEMENTS FOR CHINESE SHIPPING FINANCE

With the development of ship financing, problems arise from the operation, such as issues with respect to contract, compensation, recourse and so on. Chinese regime should be amended or added as soon as possible. Here are some suggestions by the author as follows:

1. The qualities of the U.S. regime could be emulated by China

a) Tax-oriented financing

Leveraged lease financing offers significant tax and economic advantages that are not obtained in the usual secured financing. The structure of a leveraged lease allows them to be tailored to best meet the tax needs of the parties involved. By making the tax benefits incidental to ownership available instead to lending or other institutions agreeing to act as owner and lessor, the lessee is able to participate in these tax benefits through a reduction in rentals made possible by the tax savings realized by the lessor. The owner-participants will be entitled to considerable tax benefits from the deductions and credits obtained by virtue of their ownership of the vessel.

By investing as little as 20 percent of the vessel's cost, the owner participants will be fully entitled to accelerated depreciation deductions and investment tax credit based upon 100 percent of the vessel's cost and, since the long-term bonds will have been repaid by the end of the charter term, 100 percent of its residual value as well. The smaller the investment that is made by the owner participants, the larger will be their return in terms of tax benefits, which remain the same regardless of the amount invested. This trade-off ideally produces an attractive rate of return for the lessor and financing for the lessee at a cost below the lessee's normal borrowing rate.

Therefore, the leveraged lease financing could be introduced to China. To utilize this popular method used in the United States and other developed shipping countries, exempt or reduce the custom and value-added tax to foreign advanced vessels and reduce the capital cost of Chinese shipping companies in order to accelerate renovation of Chinese fleets.

b) Ship credit rating system.

Learning from credit rating operation in the United States, the Chinese ship financial leasing organizations should improve themselves to be more professional, strengthen the cooperation with China Classification Society (hereinafter as CCS) and shipbrokers; establish and make perfect the project credit rating system, so that China's own system of ship credit rating and ship security and mortgage could be set up, including but not limited to, the evaluation and mortgage of ship under construction and ship under operation; evaluation and trading system of secondhand ship.

c) Export-Import Bank

Eximbank is an agency of the United States that has as its purpose the expansion of exports of U.S. goods and related services by making credit available to exporters, foreign purchasers and domestic and foreign lending institutions through direct loans, guarantees and insurances. Eximbank offers a variety of assistance programs, tailored to meet different requirements and needs of exporters, foreign purchasers, U.S. lenders and foreign lenders.

Offering shipowners the export buyer's credit from Eximbank is currently a popular financing method. It is important for China to perfect its ship export financing regime in order to increase the financial support of ship export. Buyer's credit has the characteristics of long period and low interest. Also, the debt risk can be controlled better.

Chinese Eximbank should learn more about the type and scope of the U.S. Eximbank assistance programs such like financial guarantees and guarantees of export debt obligations. The commercial risks covered by Eximbank under its guarantee are insolvency of the foreign purchaser and any failure by it to pay when due any amounts under the guaranteed obligations. Political risks covered include transfer delays in converting local currency payments, cancellation of local import licenses and losses due to war, revolution or civil disturbance.

2. The qualities of Japanese and Korean regimes could be emulated by China

a) Government finance

The rapid development and acceleration of shipbuilding in Japan and Korea is inseparable with their tremendous government finance. Governments offer favorable buyer's credit and guarantees to shipyards, and favorable revenue to shipping and shipbuilding corporations. As well, governments provide subsidized interest to commercial loans to shipping companies and favorable shipbuilding loans. Shipping companies can also get research and development subsidy. Japanese government established shipbuilding public entity speaking for ships to different companies and then rent them to shipping companies. The charter hire can be used to order more ships. This method could be emulated by China. Further, the system of planning for shipbuilding stated above also has the value of being introduced to China.

b) Floating charge for mortgage of vessels under construction

According to the CMI report, Japan has established the regime of mortgage for ships under construction without registry in a very early time, in order to accelerate ship's export. In the case of newbuilding for foreign customers, the yard may obtain finance directly from the Export and Import Bank of Japan; such loans will be secured by a

hypothec on the ship under construction (without usually registering it), by a hypothec on the yard and by a pledge of the construction insurance policy. The floating charge should be led to China in order to better resolve the current practical problems for ship under construction.

Furthermore, we should also pay attention to the aspects below:

1. Ship mortgage. To amend the definition of ship mortgage and assort with the definition in Article 33 of *The Guarantee Law of the People's Republic of China*; to add regulations about perfection of mortgage in advance; to properly modify the stipulations of maritime liens in CMC by adding parties investing in ship projects and other creditors into the scope of the main body.

2. Registration for ship lease financing. It is necessary to establish a new-type registration for ship lease financing, and thereby make perfect the ship's registration regime. The registration of ship's ownership and lease financing should be separated. When registration for financial lease is terminated, the previous registration for ownership becomes effective automatically. There have been some positive developments. On July 20, 2009, the Finance Lease Registration System was introduced by the Credit Reference Centre of The People's Bank of China (PBOC) and the International Finance Corporation (IFC). It is an online registration system which (i) is regarded as a unified public platform to announce a lessor's ownership over the leased assets, (ii) reduces credit risk and the operational risk for leasing companies, and (iii) provides transparency and protection for the owners of the security interests.⁶⁹¹

3. In the judicial practice, judicial organs could, based on mediation, recombine parties to and debt of ship financing project and continue working on the project during the process

⁶⁹¹ See generally *IFC's role in China's Financial Sector Transformation*, November 2012.

of dealing with the compensation dispute cases in respect of ship financing. With the consent of shipyard, buyer could transfer the rights and interests of the shipbuilding contract to the lender.

4. To make the ship financing under CMC be regulated under the scope of lease financing field and to utilize current contract law rationale or theory to stipulate ship financing, like what is operated in the United States.

5. Conditions of credit and loan. Shipping companies should gain much favorable credit conditions. The period of repaying the debt should be extended. China should take a lower interest rate or an interest rate consistent with those of developed shipping countries.

6. Risk protection. The applicable risks associated with lease financing are credit, interest rate, liquidity, transaction, and compliance. Countermeasures should be made to protect the benefits of all parties concerned, and to prevent the risks associated with operation, financing, politics and natural disaster.

3. Current Restrictive Factors in and Suggestions to Ship Finance in China

3.1 Commercial Bank Loans

● Restrictive Factors

As for environment, the current credit system of China (including the credit system of commercial banks) has not fully taken into account the fact that the development of the shipping industry and the operation of shipping enterprises are special, instead it treats the shipping industry as an ordinary service industry and uses general credit standards to rate shipping enterprises for granting credit or loans. Since the government is strictly controlling the total amount and purpose of credit and restricting foreign investment in this sector to a certain extent, it is not good for the long-term development of the market if China refuses to open it entirely, and it makes it hard for capital intensive shipping enterprises, which have special operating risks, to get ship financing loans.

The current Chinese legal system does not permit the formation of ship financing companies (SPV-special purpose vehicle) and the mortgage on ships under construction.⁶⁹² The governmental organs relating to ship financing, such as the maritime departments and the administrative departments for industry and commerce, are not aware of the importance of service, and cannot provide information about shipping companies or ships to the public. These have considerably restricted the development of ship financing loans.

As for institutions, Chinese-funded commercial banks do not know well about the ship construction (market), the operation of shipping enterprises (the freight rate market) and the second-hand ship trading (market), are not able to assess ship financing projects, and lack industry professionals, technology, information, experience and assistance from

⁶⁹² The author attended ship finance conference in China and learnt that some SPVs can be established in Hong Kong.

specialized auxiliary institutions. Therefore, only a few large Chinese-funded banks can enter into the market.⁶⁹³ As restricted by the current credit and legal systems, Chinese-funded banks treat ship financing loans as ordinary company loans, and apply general credit standards to rate shipping enterprises for granting credit or loans.⁶⁹⁴ In practices, Chinese-funded banks usually work on their own, and barely participate in any “international exchange” activities, so the concentrating effect cannot be brought into play even if they are gathered together.⁶⁹⁵ In addition to that, auxiliary institutions such as ship financing brokers companies, ship valuation companies, ship trading brokers companies, shipping enterprise credit rating companies, law firms and accounting firms are very insufficient in the market.⁶⁹⁶

As for the products, as restricted by the credit and legal systems and the fact that financial institutions and auxiliary institutions do not know well about the market, the loan products of commercial banks are simplex in Shanghai, merely including loans to shipping enterprises and letters of guarantee for repaying advances.⁶⁹⁷

● Suggestions

As for the legal environment, Chinese government may work out guiding opinions on loans to local shipping enterprises and shipping construction enterprises on the basis of the *Guiding Opinions of the People's Bank of China and China Banking Regulatory*

⁶⁹³ These banks include China Export & Import Bank, China Development Bank, Bank of China, Bank of Communications, Industrial and Commercial Bank of China, China Minsheng Bank, Agriculture Bank of China and so forth.

⁶⁹⁴ The author had a chance to review a Chinese Bank's credit policy to shipping industry during the author's internship in Shanghai.

⁶⁹⁵ It is based on the author's practice experience.

⁶⁹⁶ It is based on what the author learnt from her internship with Ince & Co Shanghai office in winter 2009.

⁶⁹⁷ It is based on the author's phone interview with an officer in Bank of Communications Shanghai headquarter.

Commission on Further Adjusting the Credit Structure to Promote the Rapid yet Steady Development of the National Economy (2009), provide guidance for Chinese-funded commercial banks to fully understand the particularity of the shipping industry and shipping enterprises, encourage banks to grant loans for purchase or building of ships to shipping enterprises and ship-making enterprises, and finally set up a credit system facilitating the development of the shipping industry. Ways to encourage them include providing convenience for market access, creating favorable conditions for business operations, granting fiscal and tax discount/preferences, reducing or exempting administrative cost, offering free trainings, consultations and guidance, and granting governmental subsidies. As turned out in practices, the most effective way is to provide fiscal and tax preferences, such as exempting banks from business tax payable for granting ship financing loans or providing them subsidies after they pay taxes.

China may consider forming guarantee companies funded by the local governments in addition to national guarantee companies funded by the Central Government to provide guarantees for the ship financing of shipping enterprises and shipping construction enterprises, small and medium enterprises in particular, solve the problem of insufficient guarantees, and set up suitable credit assessment and guarantee systems for the shipping market.

China may, on the basis of the *Company Law* (2005 amended), *the Maritime Law* (1992), *the Ship Registration Regulation* (1994), *the Guarantee Law* (1995), *the Real Right Law* (2007), *the International Ocean Shipping Regulation* (2001) and other relevant laws, regulations and policies, cooperate with the Ministry of Transport, the State Administration for Industry and Commerce and the Maritime Safety Administration, make local laws and regulations, form ship financing companies (SPV) at the Yangshan

Port experimental zone⁶⁹⁸ or Tianjin Economic and Development Area⁶⁹⁹ (“TEDA”), and permit the mortgage financing of ships under construction at Shanghai or Tianjin on a pilot basis. Mortgage registration can be made in two forms: first is to register the mortgage over ships under construction directly under *the Maritime Law* (1992) and *the Ship Registration Regulation* (1994); second is to register in the form of “floating mortgage of property” under the Real Right Law (2007). If conditions permit, China can set up an “open” international ship’s nationality registration agency of China at the Yangshan Port experimental zone or TEDA as a supplement to the establishment of SPV so as to grant SPV more freedom to run their own business and offer them more favorable tax policies. The purpose of setting up an international ship’s nationality registration agency of China is to permit Chinese-funded enterprises to register their ocean transport ships inside China and to fly the national flag of China, instead of being restricted by the relatively rigid shipping, company, tax and employment laws of China.

China may draw lessons from the practices of the world shipping powers in establishing specialized shipping advisory agencies. The government may fund the establishment of shipping and financial research institutions and build shipping and financing information platforms to provide shipping enterprises, financial institutions, intermediary agencies and governmental organs with information and advices about the shipping and financial service markets, agencies, products, talents, trainings, technologies, contracts, tax, law and dispute solutions free of charge. Based on Shanghai’s current legal system for talent introduction, Shanghai may, with assistance from colleges, universities and research institutes, set up a shipping and financial talents division under Shanghai International Financial Talent Service Center to introduce,

⁶⁹⁸ Yangshan port is a deepwater port for container ships in Hangzhou Bay south of Shanghai.

⁶⁹⁹ It was formed in late 1984 and currently has more foreign businesses in it than all of Shanghai.

cultivate and train high-level talents specialized in shipping, finance, insurance, brokerage, law, accounting and technology. The above-mentioned two suggestions are hereinafter referred to as “building information platforms and setting up talent centers”.

China may improve the service awareness of governmental departments in charge of industry and commerce, maritime affairs, foreign exchange and other matters related to ship financing, and work out measures making it easy for the public to inquire about shipping companies, ships and letters of guarantee for repaying advances.

China may also reinforce the dispute settlement system. For instance, Shanghai can, at the same time when ensuring that the Maritime Court of Shanghai openly, fairly and impartially perform its judicial duties, promote the arbitration services of Shanghai Arbitration Commission to the shipping sector and the financial sector, particularly the services of Shanghai International Financial Court of Arbitration and Shanghai International Shipping Court of Arbitration subordinate to Shanghai Arbitration Commission, encourage the Commission and the Courts to provide consulting and mediation services, and use the non-litigant arbitration approach (ADR-Alternative Dispute Resolution) to solve disputes arising from ship financing loans and other shipping financial issues so as to realize the harmonious development of shipping financial services.

As for institutions, China may lead and encourage Chinese-funded commercial banks to fully understand the particularity of the operation of the shipping sector and shipping enterprises, apply suitable and easy standards to rate shipping enterprises for granting credit or loans, actively provide loans for purchase or making of ships to shipping

enterprises and ship-making enterprises, and pay attention to the follow-up services after loans are granted⁷⁰⁰.

China may, based on the current banking laws and in light of the actual situations of the shipping sector and the financial sector of China, encourage the formation of banks with Chinese funds, the introduction of banks (branch banks or departments) exclusively engaged in ship financing loans from foreign countries, and the formation of ship financing brokers companies, ship trading brokers companies, ship valuation companies, ship classification societies, ship inspection and evaluation companies, specialized credit rating companies, maritime law firms, specialized accounting firms and other auxiliary institutions. The above-mentioned suggestions are hereinafter referred to as “encouraging the formation and introduction of Chinese and foreign financial institutions and auxiliary institutions”.

As for products, China may encourage Chinese-funded commercial banks to provide real ship financing products, which means to grant loans to ship financing companies (SPV) under guarantees (plus additional security). In some cases, banks would reasonably require an “additional security” such as the mortgage of ships under construction, pledge of (SPV) stocks, personal security by the shareholders or directors of SPV, or security by the parent company of SPV, which are all universally accepted forms of security for ship financing.

China may also encourage Chinese-funded banks to take the initiative to cooperate with specialized ship financing banks of foreign countries, introduce their mature ship financing products, and develop new products with them at both domestic and overseas markets.

⁷⁰⁰ From conferences that the author attended, the author learnt that some banks visit their clients within 2 months after ship delivery as a required internal policy.

3.2 Derivatives of Commercial Bank Loans

- Restrictive Factors

As for environment, the current credit system of China (including the credit system of commercial banks) has not fully taken into account the fact that the development of the shipping industry and the operation of shipping enterprises are special, and as a result Chinese-funded commercial banks are not properly driven to provide ship financing products, let alone developing and providing derivative products. The government has rigid control over the total amount and purpose of credit, and still restricts foreign investment in this sector to a certain extent. It is not good for the long-term development of the market if China refuses to entirely open it.

For institutions, Chinese-funded commercial banks and other financial institutions “are unconcerned about” loan derivatives for three reasons: 1. although banks do not know well about the shipping market, they prefer to rely on their own in the ship financing sector; 2. they have not fully realized the magnificent role of syndicated loans in spreading risks, increasing competitiveness and creating a collaborative atmosphere; and 3. they lack of talents, technologies, information, experience and assistance from specialized service providers. Moreover, very few specialized service providers such as ship financing brokers companies, ship valuation companies, ship trading brokers companies, ship enterprise credit rating companies, law firms and accounting firms are available in the market.

As for products, since Chinese-funded banks do not know well about the shipping market and are less motivated to provide ship financing products, loan derivatives are barely available in the market.

- Suggestions

As for environment, China may, on the basis of the Interim Measures for Syndicated Loans (1997), the Guidelines for Syndicated Loan Business, the Guidelines for the Financial Innovation of Commercial Banks and other laws, regulations and policies, make local regulations, encourage Chinese-funded banks to sufficiently utilize the national inter-bank funding market, actively develop, design, offer and trade derivatives of ship financing loans, simplify the examination and trading formalities, reduce costs as many as possible, and try to set up a secondary market for loan derivatives.

China may select two or three competitive, experienced and reputable banks as the leading or organizing banks of syndicated loans for ship financing, and encourage them to communicate with other banks to exchange and share technologies, talents and information, jointly develop the market, form syndicates and achieve the ultimate goal of synergetic development.

Moreover, China can build information platforms and set up talent centers. As for institutions, we may lead Chinese-funded commercial banks to fully understand the magnificent role of syndicated loans and other loan derivatives in spreading risks, increasing competitiveness and creating a collaborative atmosphere, and encourage them to actively provide such products for shipping enterprises and ship-making enterprises.

In addition to that, China can also encourage the formation and introduction of Chinese and foreign financial institutions and auxiliary institutions.

As for products, we may encourage Chinese-funded banks to introduce syndicated loans, Mezzanine loans, negotiable securities loans, shared interest loans and other mature loan derivatives of foreign countries under the current legal systems for the financial and

banking sectors, and encourage them to cooperate with specialized ship financing banks of foreign countries to develop new products at both domestic and overseas markets.

3.3 Financing of Ship Exporters

- **Restrictive Factors**

As for environment, the current credit system of China has not fully realized the particularity of the ship-making industry and the importance of the financing of ship exporters to the development of ship-making enterprises, and has not fully understood the importance of non-governmental lending (including entrusted loans) to the development of ship-making enterprises. As a result, Chinese-funded companies and their partners in the banking sector treat financing loans for the export of ships as financing loans for the export of ordinary goods and thus apply general financing indexes to those projects. As the government has certain control over foreign trade and restricts foreign investment in the financing lease sector to a certain extent, it is not good for the long-term development of the market if it is not entirely open. Under the current legal system, loans between companies (including entrusted loans) are under rigid control, and loans between individuals and companies are limited in non-commercial areas.

As for institutions, Chinese-funded trade companies do not know well about ship making (market) and ship trading (market), are unable to assess ship export financing projects, and lack talents, technology, information, experience and assistance from specialized auxiliary institutions. Therefore, only a few trade companies have access to the export financing sector, and they are merely willing to serve as ship export financing agents. Moreover, the business (including the selection of ship factories and banking

partners) of trade companies is actually restricted in their own particular geographical market. In addition to that, very few auxiliary institutions such as ship valuation companies, ship trading brokers companies, maritime law firms and specialized accounting firms are available in the market.

As for products, due to lack of knowledge about the market, Chinese-funded trade companies treat financing loans for the export of ships as financing loans for the export of ordinary goods, so loans are granted merely in the model of “common seller”. Although there are attempts to replace ship export financing loans with entrusted loans and the aforementioned “Taizhou Model”, the legal status of these two alternatives has not been determined yet.

● Suggestions

As for environment, China may, on the basis of the Plan on Adjusting and Revitalizing the Ship Industry (2009) and the Several Opinions of the State Council on Accelerating the Revitalization of the Equipment Manufacturing Industry (2006), encourage competitive trade companies and their banking partners to seek for cooperation with ship manufacturing enterprises, shipping enterprises and ship equipment manufacturing enterprises in ship export financing, even to form joint ventures.

China may make local regulations according to the Guiding Opinions on the Pilot Operation of Small-sum Loan Companies, the Regulation on Lenders which is under the deliberation of the State Council and other relevant laws, regulations and policies, and relief restrictions on non-governmental lending (including loans between companies and loans between individuals and enterprises) on a pilot basis. More particularly, China can try to determine the legal status of entrusted loans and “Taizhou Model” in ship export

financing, take in deposits of the private sector (deposits of enterprises and individuals) via small-sum loan companies, and lend them to shipyards for certain specific ship construction projects in the form of direct loans or entrusted loans.

Moreover, China can build information platforms and set up talent centers. As for institutions, China may lead and encourage Chinese-funded foreign trade companies and their banking partners to fully understand the particularity of ship export financing and apply appropriate and easy standards to provide financing support for ship construction projects.

China may guide and reinforce the role of small-sum loan companies in trade financing, and establish specialized non-governmental lending companies on the basis of that.

In addition to that, China may also encourage the formation and introduction of Chinese and foreign financial institutions and auxiliary institutions.

As for products, China may encourage Chinese-funded foreign trade companies to cooperate with shipyards and banks, introduce mature ship export financing products from foreign countries, such as back-to-back ship export financing and joint ship export financing, and encourage them to cooperate with specialized financial institutions of foreign countries to develop new products at both domestic and overseas markets.

3.4 Policy-based Ship Export Loans

● Restrictive Factors

As for environment, the relevant governmental departments have not realized the importance of policy-based ship export loans to the development of the advanced equipment manufacturing industry, the shipping industry and other relevant industries in

China, so they only delegate the Export-Import Bank of China (CEXIM) the power to grant policy-based loans for ship export, and provide sufficient financial support for them. The government exercises rigid control over CEXIM in the granting of policy-based ship export loans, which is actually inconsistent with China's status as a super shipbuilding giant.

As for institutions, since only CEXIM can provide policy-based loans for ship export, insufficient competition is not good for the long-term development of the market. Due to the rigid control of the government, CEXIM cannot independently decide the amount of loans, how to grant loans, terms of loans and receiver of loans. CEXIM does not necessarily have a good understanding of shipbuilding (market) and ship trading (market), is not fully capable to assess ship export financing projects, and lacks talents, technology, information, experience and assistance from specialized auxiliary institutions. Moreover, very few auxiliary institutions such as ship valuation companies, ship trading brokers companies, maritime law firms and specialized accounting firms are available in the market.

As for products, due to the rigid control of the government and its limited knowledge about the shipbuilding industry, the policy-based loan products provided by CEXIM are simplex, merely including loans for shipyards and refund guarantee, and it barely provides buyer's credit.

● Suggestions

As for environment, China may, under the Plan on Adjusting and Revitalizing the Ship Industry (2009) and the Several Opinions of the State Council on Accelerating the Revitalization of the Equipment Manufacturing Industry (2006), cooperate with CEXIM and its Shanghai Office or a commercial bank, and use the balance of the local

governments to provide policy-based ship export loans or similar loans through the Shanghai Office of CEXIM or the said commercial bank so as to support the ship manufacturing industry of Shanghai and the surrounding areas.

Moreover, China can build information platforms and set up talent centers.

As for institutions, China may lead and encourage competitive commercial banks to develop ship export policy-based loans or similar products to increase their competitiveness and development impetus in the market, lead and encourage the Shanghai Office of CEXIM and other commercial banks which provide policy-based loans or similar products to fully understand the particularity of shipbuilding enterprises and vigorously provide policy-based loans to shipbuilding enterprises, and, if conditions permit, turn the Shanghai Office of CEXIM into an office exclusively providing policy-based loans or set up a ship financing office of CEXIM at Shanghai.

In addition to that, China may also encourage the formation and introduction of Chinese and foreign financial institutions and auxiliary institutions.

As for products, China may encourage the Shanghai Office of CEXIM and other commercial banks providing products similar to policy-based loans to learn from the mature experiences of foreign countries, actively provide buyer's credit products, and introduce mature policy-based lending products from foreign countries, such as loan products to sellers turned into buyers. In the meantime, China may encourage them to cooperate with specialized financial institutions of foreign countries to develop new products at both domestic and overseas markets, e.g., providing policy-based loan products to international transport ships not made for export.

3.5 Ship Financing Lease

● Restrictive Factors

As for environment, the current credit system of China has not fully understood the difference between ship financing lease and loan, but treats them as similar financial services and applies almost the same credit standards. The current credit system has not become aware of the importance of ship financing lease to the development of shipping enterprises, small and medium ones in particular. The government restricts foreign investment in the financing lease sector. It is not good for the long-term development of the market if it is not entirely open. The current laws (such as the Measures for the Administration of Finance Leasing Companies (Revised 2007)) set a pretty high threshold for the formation of financial lease companies, and as a result those able to invest in financial lease companies are mostly large Chinese-funded commercial banks. This actually impedes free competition in the market.

As for institutions, financial lease companies do not know well about shipping (market), ship financing lease (market) and second-hand ship trading (market), and it is very difficult to independently and freely operate the financing lease business as they are also restricted by the credit standards applied to their parent companies (commercial banks).⁷⁰¹ In addition to that, financial lease companies lack the ability to assess and run ship loan projects, and also lack talents, technology, information, experience and assistance from specialized auxiliary institutions. Therefore, only a few financial lease companies can operate the ship financing lease business. Insufficient competition is not good for the long-term development of the market. As restricted by the credit standards of their parent companies (commercial banks), financial lease companies usually treat ship financing lease as loans and handle the two businesses almost the same way. Moreover,

⁷⁰¹ For example, Bank of Communications, Commercial and Industrial Bank of China, China Merchants Bank all have their respective leasing arms.

very few auxiliary institutions such as ship financing brokers companies, ship valuation companies, ship trading brokers companies, shipping enterprise credit rating companies, law firms and accounting firms are available in the market.

As for products, financial lease companies only provide traditional ship financing lease products due to restrictions from the current credit system and the credit standards of commercial banks.

- Suggestions

As for environment, China may, on the basis of such laws and policies as the Measures for the Administration of Financial Lease Companies (amended 2007), cooperate with the China Banking Regulation Commission, make local laws and regulations, lead financial lease companies to fully understand the particularity of the development of the shipping sector and the operation of shipping enterprises, and encourage them to apply reasonable credit standards different from those applied to loans to assess ship financing lease projects and more actively provide financial lease products to shipping enterprises.

China may consider forming guarantee companies funded by the local governments in addition to national guarantee companies funded by the Central Government so as to provide guarantees for the ship financing lease of shipping enterprises, small and medium enterprises in particular, solve the problem of insufficient guarantees, and set up suitable credit rating and guarantee systems for the ship financing lease business.

China may also permit financing lease companies to raise funds by borrowing money from banks, borrowing money at the inter-bank market or issuing bonds with the scope permitted by law so as to improve their operating abilities.

Moreover, China can build information platforms and set up talent centers.

As for institutions, China may lead and encourage competitive financial institutions, shipping companies, foreign trade enterprises and ship factories to separately or jointly form specialized ship financing lease companies to increase market impetus, and encourage them to apply appropriate credit standards and vigorously provide financing lease products to shipping enterprises.

In addition to that, China may also encourage the formation and introduction of Chinese and foreign financial institutions and auxiliary institutions.

As for products, China may encourage ship financing lease companies to introduce mature ship financing lease products from foreign countries and to provide leaseback services and bareboat financing lease services (long-term bareboat lease). In the meantime, China may encourage them to cooperate with specialized financial institutions of foreign countries to develop new products at both domestic and overseas markets, such as financing lease products (structural financing products) in combination with ship financing securitization, private placement of the equity of shipping companies, shipping investment funds and shipping trust.

3.6 Ship Financing Securitization

- **Restrictive Factors**

As for environment, the current credit system of China has not fully considered the fact that the development of the shipping industry and the operation of shipping enterprises are special, and as a result Chinese-funded commercial banks are not properly driven to provide ship financing products, let alone developing and providing securitization products. The government has strict control over securitization products,

and restricts foreign investment in this sector to a large extent. Existing products are primarily issue of bonds whose “basic assets” are mortgaged real estate, and the design, examination, issue and trading of products are very complicated. Under the current legal systems of China (such as the Administrative Measures for the Securitization of Credit Assets (2005) and the Measures for Supervising and Administering the Pilot Securitization of Credit Assets (2005)), only a minority of financial institutions such as banks may issue and trade credit assets securitization products. The only place to issue and trade such products is the inter-bank bond market. It is not good for the long-term development of the market if it is not entirely open.

For institutions, Chinese-funded commercial banks and other financial institutions “are unconcerned about” ship financing securitization products for three reasons: 1. the government’s rigid control over this sector throws cold water on their enthusiasm to develop their own products; 2. they have not fully understood the essence of securitization products and their magnificent role in spreading risks, increasing competitiveness and creating a collaborative atmosphere; and 3. they lack of professionals, techniques, information, experience and assistance from specialized auxiliary institutions. Moreover, very few specialized service providers such as ship financing brokers companies, specialized securities companies, specialized securities middleman companies, specialized credit rating companies, maritime law firms and specialized accounting firms are available in the market.

As for products, since Chinese-funded banks and other financial institutions do not know well about the shipping market and are less motivated to provide ship financing products, ship financing securities products are barely available in the market.

● Suggestions

As for environment, China may, on the basis of such laws and policies as the Administrative Measures for the Securitization of Credit Assets (2005) and the Measures for Supervising and Administering the Pilot Securitization of Credit Assets (2005), rely on the Shanghai Stock Exchange and the National Inter-bank Bond Market, and cooperate with the China Banking Regulatory Commission to guide and encourage Chinese-funded commercial banks and other financial institutions to make attempts in developing and providing bond and stock products which take prepaid principals and interests of loans as the “basic assets” and are secured by the mortgage of ships under construction, mortgage of ships or transfer or mortgage of prepaid freight charges and to actively participate in the development of other ship financing securitization products.

China may try to set up a secondary market for securitization products at the National Inter-bank Funding Market or the Shanghai Stock Exchange, allow big financial institutions and non-financial institutions to participate in the issuance and trading of ship financing securitization products, and reduce the links and costs of the development, design, listing and trading of products as many as possible.

China may consider permitting, leading and encouraging Chinese-funded banks and other financial institutions to separately or jointly transfer, issue and sell (including the issuing of bonds and stocks) ship financing securitization products at securities markets outside China.

Moreover, China can build information platforms and set up talent centers.

As for institutions, China may lead Chinese-funded commercial banks and other financial institutions to fully understand the essence of securitization products and their magnificent role in spreading risks, increasing competitiveness and creating a collaborative atmosphere, and encourage them to provide such products for shipping enterprises and ship-making enterprises.

China may also guide and support the formation of securities companies and securities brokers companies specialized in ship financing securitization, and encourage such companies to try to develop and provide securitization products. In addition to that, China may also encourage the formation and introduction of Chinese and foreign financial institutions and auxiliary institutions.

As for products, China may encourage Chinese-funded banks and other financial institutions to introduce mature securitization products of foreign countries into China under the current financial, banking and securities laws, provide bonds and stocks which take prepaid principals and interests of loans as the “basic assets” and are secured by the mortgage of ships under building, mortgage of ships or transfer or mortgage of prepaid freight charges, actively participate in the development of other ship financing securitization products, and cooperate with specialized financial institutions of foreign countries to try to develop new products at both domestic and overseas markets.

9 CONCLUSION

Shipping is the bloodline of trade, growth and welfare.⁷⁰² Also, the global shipbuilding industry is fundamental to international trade because it produces the oceangoing vessels that are the only practicable and cost effective means of transporting large volumes of many essential commodities and finished goods around the world.⁷⁰³

However, Shipping cannot ignore global economics as the vast majority of world trade is carried by ships. According to Lloyd's List, "Shipping shares have been trading downwards since mid-June [2011] and will continue to decline in all sectors as freight markets show no signs of recovery and analysts and brokers reveal fears of a continuing oversupply of ships that have been obvious for several years."⁷⁰⁴

As Martin Stopford described, "shipping cycles roll out like waves hitting a beach. From a distance they look harmless, but once you are in the surf it's a different story. No sooner has one finished than another starts and, like surfers waiting for a wave, shipowners cluster in the trough, paddling to keep afloat and anxiously scanning the horizon for the next big roller."⁷⁰⁵ The basic features of shipping cycles from boom through to bust have big implications for the principal participants in the ship financing decision.

The banks deal shipping loans almost exclusively during boom periods and create overcapacity and dampen the freight market. The main characteristics are that freight rates are unpredictable and volatile. The shipowners keep ordering. In the market

⁷⁰² H.E. Haralambides, S.D. Tsolakis and C. Cridland, 12 Shipping Economics-Research in Transportation Economics 65 (2005).

⁷⁰³ See Report on ship financing, OECD Council Working Party on Shipbuilding (WP6), page 3, available at www.oecd.org/dataoecd/55/6/47128870.pdf.

⁷⁰⁴ Paul Slater, Shipping is still mired in a global recession, available at: <http://www.lloydslist.com/ll/sector/finance/article379187.ece>.

⁷⁰⁵ See Martin Stopford, *Maritime Economics* 93 (3rd ed. 2009).

downturn, they come in and buy in more ships at a low price. Then there is more over capacity. If shipowners could decide between them who to order and when, and how much, then the shipping world would be a better place. But the question remains, would they? Most importantly, could they?

Both of the borrowers and the lenders should take into account the phases of the shipping cycle in which the financing decision is made and be aware of the consequences if they fail to do so.

In this thesis, the author has discussed how the shipping finance evolves through the cycles with more finance methods and approaches. The author started by reviewing the history of the ship finance and discussed the types of finance available to the industry. The author then illustrated the secured lending, sources of security to the banks and lease financing, and analyzed the ship financing regimes in China and United States in details, and in United Kingdom, Korea and Japan. The author studied the ship mortgage regimes in China, the United States, Liberia and The Marshall Islands and the importance of the mortgages as a source of bank security. From a more practical perspective, the author discussed the ship construction, sale and purchase, judicial sale, classification society, and respective ship registration requirements in Liberia, Bahamas, Cyprus, Malta and Panama. Finally, the author, a native of China, made suggestions that the Chinese shipping finance regime should learn and borrow from the U.S., Korean and Japanese shipping finance regimes in areas which they excel. A better shipping finance regime and a constructive transactional work will help minimize or prevent litigations, which is the last frontier when governmental, business or personal relationships are in need of resolutions. A healthy and vibrant shipping finance regime will enhance the shipping industry in general and indirectly stimulate the global economy.

Annex 1 - Liberia
REPUBLIC OF LIBERIA
REGISTRATION ON THE LIBERIAN FLAG

Eligibility

- Liberian Corporation
- Foreign Maritime Entity (“FME”).

Company Formation

- Liberian Code of Laws revised 1976 (Business Corporation Act);
- Minimum of three directors;
- President, Secretary and Treasurer;
- No annual returns;
- LISCR Trust Company of Liberia (“LTC”);
 - no disclosure of officers;
 - maintain a registered agent in Liberia;
 - payment of fixed annual tax.
- FME:
 - Under the provisions of Chapter 13 (as amended) of the Liberian Business Corporations Act;
 - an application to be an FME must include name, jurisdiction in which the entity was created, date of creation, address of principal place of business, persons vested under law with management of the FME, address of resident agent in Liberia (this is provided through the LTC).

Taxation

- There are no assessed corporate or individual taxes in Liberia.

Registration

- Submit the following documents in triplicate:
 - application for official number, call sign and registration of the vessel;
 - authority of agent or officers;
 - bill of sale, builder’s certificate or other proof of ownership;
 - confirmation of class;
 - for vessels over 15 years old, a status report of the special survey from the class society;
 - permission to transfer or delete;
 - proof vessel is free from recorded liens;
 - application for radio station license.

Bareboat charter registration

- bareboat charter registration is permitted;

- foreign bareboat charter registration is also permitted;
- all certificates of registry and radio licenses must be surrendered to the appropriate office for the duration of the foreign bareboat charter registration.

Vessel Eligibility

- Age restriction of 20 years;
- Class;
- Safety inspection.

Crewing

- No nationality restrictions.

Mortgages

- Five original counterparts;
- The mortgage instrument must state:
 - The date of maturity and relevant liabilities;
 - In the case of revolving credit, the maximum amount;
 - All parties.
- The following additional documents must be presented with the mortgage at the time of recording;
 - Evidence of authority;
 - Memorandum of particulars.

Annex 2 – Bahamas

THE BAHAMAS REGISTRATIO ON THE BAHAMIAN FLAG

Eligibility

- Foreign Owners;
- No “local participation” requirements.

Company Formation

- Companies Act 1992 or International Business Companies Act 1989 for International Business Companies (“**IBCs**”);
- IBC – a company which does not carry out business with persons resident in the Bahamas, nor owns real property in the Bahamas (may hold bank accounts, retain local professional services, etc.);
- IBC:
 - May hold shares in Bahamian Corporations;
 - Two shareholders (normally Bahamian companies must have 5 shareholders);
 - Registered office;
 - No general meeting (required for normal Bahamian companies);
 - One director, no residency requirement (normally Bahamian two required for Bahamian companies);
 - No requirements to file annual return (normal Bahamian companies must do so annually);
 - No exchange controls.
- Memorandum of Association must be provided to the Registrar of Companies, Articles of Association may be filed later;
- Normally incorporation takes 24 hours;
- A branch of a foreign company may be established in the Bahamas under the Foreign Companies Act.

Taxation

- No direct taxes of incorporation, income or profits;
- Exemption to IBCs for most indirect taxes including capital gains;
- Foreign owned ships are exempt from custom duties and stamp duties if they exceed 150GRT;
- Double taxation treaties apply.

Registration

- Usually takes place in Nassau, London or New York;
- Provisional Registration usually obtained first for 6 months (* below

- indicates that the document must be produced for provisional registration);
- Submit the following documents/information for permanent registration (there are additional requirements depending on whether the ship is a Passenger or Cargo Ship):

Name of Ship*
 Former Tonnage Certificate*
 Former Survey Certificate and/or copy of Certificate of Registry*
 Former SOLAS Certificate*
 Number of Passengers (if any)*
 Number of Crew Berths (including master)*
 Application for Safe Manning Certificate*
 Bill of Sale or Builder's Certificate (new ship)*
 Declaration of Ownership*
 Certificate of Company Incorporation and Certificate of Good Standing*
 Managing Owner*
 Authorized Officer Declaration*
 Oil Pollution Certificate (Tankers only)*
 Registration Fee*
 Annual Fee*
 Particulars of Radio Equipment Installed*
 Radio Accounting Authority Identification Code (AAIC)*
 Maritime Mobile Service Identity Number (MMSI)*
 Release from Foreign Register
 Declaration of no Liens on Foreign Register
 Carving note returned duly completed
 Survey and First Nautical Inspection satisfactorily completed

Bareboat charter registration

- Bareboat charter registration is permitted;
- Documentation from the original country of registration is required notifying the Bahamas of any encumbrances and all requirements of provisional and permanent registration must be met;
- Foreign bareboat charter registration is also permitted;
- The consent of the owner, a copy of the bareboat charter and consent of the mortgagee is required to charter out of the flag.

Vessel Eligibility

- Age restriction of 12 years (at time of first registry);
- 1,600 or more NRT and engaged in "foreign going trade";
- Discretion for vessels less than 1,600 NRT or older than 12;
- Surveys;
- Safety inspection before ship is put into service and annual inspection.

Crewing

- Merchant Shipping Act;
- No minimum wage, trade union recognition discretionary;
- Officers on Minimum Safe Manning Certificate.

Mortgages

- Executed on the Bahamian form;
- Third party witness;
- Priority according to date recorded.

Annex 3 - Cyprus CYPRUS SHIP REGISTRATION ON THE CYPRIOT FLAG

Eligibility

- A ship may not be registered on the Cypriot flag unless more than one half of the shares of the ship are owned by:
 - A corporation established in Cyprus and operating under the laws of the Republic;
 - A specifically authorized corporation incorporated outside Cyprus in which the controlling interest is vested in Cypriots.

Formation

- Shipping companies registered in Cyprus belonging exclusively to non-residents are accorded non-residential status (Cyprus shipping company).
 - Cyprus shipping companies are registered as private limited companies with limited liability under the provisions of Cyprus company law.
 - Share capital may be nominal or actual.
 - Different classes of shares can apply.
 - Minimum 2 shareholders.
 - No nationality or domicile requirements for shareholders or directors.
 - General meetings and board meetings may be held abroad with written resolutions.
 - One or more directors must be disclosed.
 - Company secretary of any nationality.
 - Annual returns and annual accounts must be filed and the names of shareholders must appear therein. These are to be filed with the Registrar of Companies and are open to inspection.
 - Registered address in Cyprus.
 - Incorporation takes 3 days (urgent applications permitted).
 - Memorandum and Articles of Association (in Greek) must be registered with Registrar of Companies.
 - Incorporation is evidenced by a certificate of incorporation issued by the Registrar.

Taxation

- No tax payable on profits.
- No capital gains tax is payable on the sale or transfer of a ship or the shares in a shipping company.
- No State duty payable on the inheritance of shares in a shipping company.
- Double taxation treaties apply.

Registration

- Provisional registration at any Cypriot embassy or consulate.
- Application submitted through the Registrar of Ships for permission to register together with the following documents by letter, telex or cable:
 - Classification Society confirmation that the ship has been registered and that statutory certificates will be issued on behalf of the Cypriot government;
 - Accounting authority confirmation that a contract has been signed to settle the ship's accounts.
- Once the application has been approved by the Registrar, provisional registration may proceed.
- The following further documents must be provided for provisional registration:
 - Bill of Sale;
 - Certificate of Deletion;
 - Certificate of Provisional Registration valid for 6 months (renewal available for additional 3 months).
- Permanent registration must be effected by the Registrar of Cyprus ships within 9 months.
- The ship need not be present in a Cypriot port at the time of permanent registration.
- Originals of the following additional documents must be submitted to the registrar of ships in Cyprus for permanent registration:
 - Cypriot or international tonnage certificate;
 - Certificate of survey;
 - Application for registration;
 - Deletion Certificate;
 - Copy agreement signed with the vessel's Radio Accounting Authority.
- In practice most documents may be submitted in English.

Bareboat charter registration

- Parallel registration permitted with more than 20 flag states.
- Two years.
- Age limits apply.
- Effected by bareboat charterer.
- The following documents must be submitted to the Registrar of Cyprus ships:
 - Bill of Sale;
 - Certificate of Deletion;
 - Certificate of Provisional Registration valid for 6 months (renewal available for additional 3 months).

- Original application for parallel registration in;
 - copies of the memorandum, articles of association, and certificate of incorporation of the bareboat charterer;
 - copy director's resolution resolving to bareboat charter the vessel and register the vessel in to the Cypriot register;
 - original power of attorney;
 - copy memorandum of appointment of ship's husband; - copy Bareboat Charterparty;
 - copy certificate of management of the vessel;
 - certified written consent of the owner for parallel registration in; - certified written consent of all mortgagees;
 - original certificate of encumbrances from the foreign register; - copy crew list;
 - original application for license to install and work wireless telegraphy onboard the ship under the Cyprus flag;
 - confirmation of class;
 - confirmation that a recognized radio traffic accounting authority will settle the ship's radio maritime account;
 - confirmation from the master as to the marking of the vessel.
- During the period of bareboat registration the ship's foreign registration will be suspended.
 - Ship will fly the Cypriot flag and the name of the ship and her Cypriot port of registry shall be marked on her.
 - Cypriot ships may be parallel registered out of the registry into a foreign register for up to 3 years (renewals may be permitted) subject to the approval of the minister of communications and works.
 - Documentary requirements for parallel registration out of the registry are similar to those for parallel registration into the registry. An original common declaration by the owner and bareboat charterer is also required. This is an undertaking that during the ship's parallel registration Cypriot law will be respected and the vessel will continue to meet the same international conventions that apply to Cypriot ships.

Vessel Eligibility

- Age not exceeding 15 years.
- Merchant Shipping legislation applies.
- Vessels over 15 years may be registered in the Cyprus register of ships under additional conditions.
- Automatic undertaking that an owner or bareboat charterer of the vessel registered under the Cyprus flag will cause the vessel to be inspected by its

own surveyors as a result of the identification of deficiencies or alleged serious violation of international conventions at the request of the department of merchant shipping.

Crewing

- Governed by the Merchant Shipping (Masters and Sea Laws) 1963 to 1997
- Provisions in the law that 15% of the crew must be of Cypriot nationality (this requirement is not strictly upheld due to the limited availability of Cypriot seamen).
- Bilateral agreements with the labor supplying developing countries.
- Master must have an employment agreement with the shipowner and every seaman onboard must enter an agreement with the Master.
- Certificates of competency issued by the government of Cyprus (or one of the 46 countries whose certificates have been recognized by the government of Cyprus).

Mortgages

- No stamp duty.
- No certificate of deletion issued unless all registered encumbrances have been discharged.

Annex 4 - Malta
MALTA
SHIP REGISTRATION ON THE MALTESE FLAG

Eligibility

- Subject to the below, wholly owned by Maltese citizens or bodies corporate established under the laws of Malta and having their principal place of business in Malta.
- Note the recent changes in Maltese company law.

Company Formation

- Companies whether Maltese or not may form a body corporate under the Companies Act 1995 (single member companies as limited liability companies, partnerships and trusts are now permitted for “licensed shipping organizations”).
- An International Trading Company (“ITC”) may be set up this is the company deriving income for non-Maltese investments.
- Registered office in Malta.
- Shares may be subscribed on a nominee basis.
- Directors need not be Maltese citizens or resident in Malta.
- A company secretary is required but need not be Maltese or resident in Malta.
- An annual general meeting of the shareholders is required but may be held anywhere worldwide.
- An annual return naming the shareholders and directors of the company must be filed with the Registry of Companies every year.
- Audited accounts must be filed with the annual return.

Taxation

- Onshore companies are subject to corporate tax of 35% on profits.
- Tax incentives for foreign shareholders of ITC’s because of double taxation agreements for registration.
- Vessels are registered provisionally for a period of six months (extendable to one year) during which time permanent registration documentation must be finalized.
- The following documentation must be submitted to the registrar in Valletta (or if arrangements have been made at the office of a Maltese Consul).

Registration

- application for registration
- change of name (where applicable)
- photocopy of international tonnage certificate
- proof of qualification to own a Maltese ship i.e. memorandum and articles of association
- declaration of ownership
- evidence of seaworthiness
- application for a safe manning certificate.

The following original documents must be submitted to the Registrar in Valletta for permanent registration:

- in the case of a new vessel the builder's certificate, otherwise, a bill of sale or any other document by which the vessel is transferred to the applicant for registry
- cancellation of registry certificate from the last country of registration
- proof that the ship has been issued with such valid certificates required by international conventions ratified by the Government of Malta
- certificate of survey
- copy of the tonnage certificate
- evidence that the vessel is marked in accordance with Maltese law
- Crew Lists.

Bareboat Charter Registrations

- Bareboat charter registration is permitted.
- Vessels bareboat registered in Malta enjoy the same rights and privileges and have the same obligations as other ships registered in Malta.
- Matters regarding title are governed by the underlying registry.
- Operation of the vessel is within the jurisdiction of the Maltese registry.
- Registration is for the duration of the bareboat charter or until the expiration of the underlying registration whichever is the shorter.
- Maximum period of registration for 2 years.
- Compatible registry.
- Charter to a Maltese body corporate.
- The following original documents must be produced with an application for bareboat registration into the Maltese registry:

- Application for registration
- Declaration of bareboat charter accompanied by the charter agreement
- International tonnage certificate
- Transcript or extract of the underlying registration
- Consent in writing of the underlying registry, owners and any mortgagees
- Evidence of seaworthiness of the vessel.
- Maltese law also provides for bareboat registration of Maltese ships under foreign flag providing it is to be registered at a compatible registry. The following documents must be produced for bareboat charter registration out of the Maltese registry:
 - Application for bareboat charter registration and the foreign registry
 - Written consent of all mortgagees
 - Written undertaking by the owner to surrender the ship's certificate of Maltese registry to the registrar within 30 days from the ship's bareboat charter registration under a foreign flag
 - Written undertaking not to fly the Maltese flag during the period of bareboat charter registration
 - Photocopy of the bareboat charterparty.

Eligibility

- Ships of over 15 years but under 20 years must pass an inspection by an authorized flag state inspector before or within 1 month of provisional registration.
- Ship of over 20 years but under 25 years must pass an inspection prior to provisional registration.
- Ships of 25 years and older do not qualify for registration.
- Prior to registration vessels must be classed with an approved classification society.
- Regular flag state inspections are carried out by Maltese authority inspectors throughout the world. The costs of these inspections are borne by the Malta Maritime Authority except when a second or subsequent inspection must be undergone to ascertain if reported deficiencies have been corrected.

Crewing

- Maltese ships are subject to the provisions of the Merchant Shipping Act and ancillary regulations concerning competency of officers and seafarers.
- IMO Convention SCCW 1978 as amended.

- Certificates of competency are issued on examination.
- No restrictions on the nationality of the master, officers or crew engaged on Maltese ships (however the employment of Maltese seafarers is promoted so far as possible).
- Minimum safe manning certificate.
- Contract of employment between the master and the seamen.

Mortgages

- Statutory form of mortgage used for the registration of all ship mortgages.
- No restriction on mortgaging ships registered in Malta to foreign nationals.
- Priority is established according to the date and the time of the registration of the mortgage.
- Subsequent mortgages are permitted with the prior written consent of the existing mortgagees.
- Mortgagees' consent to deletion required (notarized and legalized).

Annex 5 - Panama PANAMA

REGISTRATION ON THE PANAMANIAN FLAG

Eligibility

- Any corporation irrespective of nationality.

Company Formation

- Offshore Companies:
 - Two shareholders;
 - Incorporate by filing a Public Deed containing Articles of Incorporation (including name, objectives, capital, names and addresses of officers and directors);
 - Three directors of any nationality;
 - President, Secretary and Treasurer (one person may hold more than one office);
 - Shares of nominal and/or no par value;
 - Shares issued in nominative or bearer form;
 - No requirements to file annual return or accounts;
 - Stock book and minute book
 - Shareholder's proxy and meetings may be held anywhere in the world providing that the Articles permit this;
 - No registered office required;
 - Based on Delaware company law.

Taxation

- Corporations only taxed on sources of income which derive from within Panama.

Registration

- Three stages:
 - Provisional registration ("enrolment"):
 - Present the following original documents to the Shipping Department of a Panamanian Consulate:- Application Form, Power of Attorney, Acceptance of Sale, Tonnage Certificate, Deletion Certificate;
 - Provisional Patente and Provisional Radio license are usually issued within 24 hours;
 - Registration of Title:
 - Present the following original documents to the Public Registry Office in Panama:- Builder's Certificate or Bill of Sale and Certificate of Cancellation or Deletion.
 - Permanent Registration:

- Present a notarial document evidencing registration of title in the Public registry. If all fees have been paid and the Shipping department is satisfied that all supporting documents have been provided a Permanent Patente will be issued for 2 years.

Bareboat charter registration

- Bareboat charter registration is permitted;
- Dual registration for two years providing foreign registry content (renewal permitted);
- The following documentation must be presented to the Shipping Department in Panama or through a Panamanian Consulate abroad:- Charterparty, Consent of Owner, Certificate of foreign registry indicating the name of the owner and any encumbrances, Certificate of foreign register, power of attorney for the charterer;
- Foreign bareboat charter registration is also permitted;
- Panamanian vessels may charter out of the flag for a period of two years.

Vessel Eligibility

- No age restrictions (vessels over 20 years old subject to inspection);
- Annual inspection;
- Surveys by recognized surveyors or classification societies only;
- Vessels over 20 years old will be subject to additional inspection during their Provisional Patente.

Crewing

- Minimum Sage Manning requirements (certificate required);
- Officers and crew of any nationality;
- Seamen's certificates of competency may be obtained in Panama or at authorized consulates;
- Additional annual inspection for vessels engaged in transportation of cargo or passengers.

Mortgages

- Ownership of title recorded simultaneously;
- In Panama or at consulate;
- Preliminary registration available for 6 months;
- Bilateral contract;
- Signatures notarized and legalized;
- Document must be translated into Spanish for permanent registration;
- Mortgage must be registered to be effective against third parties.

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44.	Regulation on Lenders (Draft)

BIOGRAPHY

Han Deng earned her Bachelor of Law degree in International Economic Law from Dalian Maritime University (PRC) in 2005. She received her Master of Laws degree in Admiralty and Maritime Law from Tulane University in 2006. She was a visiting student at University of Texas at Austin in the fall semester of 2005. In 2007 she joined the doctoral program in Shipping Finance at Tulane University. Han has been the recipient of numerous honors and awards including the Harry F. Stiles Scholarship, the Institution of International Education (IIE) Award for Excellent Asian Students, Tulane Maritime Law Center Most Outstanding Case Note Award, 2010, The Second Place Winner of the American Bar Association Admiralty & Maritime Law Committee 2010 Law Student Writing Competition and Excellence Prize, 7th "Challenge Cup" Legal Writing Competition, Liaoning Province, PRC, 2005. While pursuing her doctorate degree, Han was an Editor of Tulane Maritime Law Journal and interned with Chinese, American and British law firms. Han is currently a full time associate attorney at Watson, Farley & Williams in New York City. Additionally Han has published her research in the Tulane Maritime Law Journal, University of San Francisco Maritime Law Journal, Annual of China Maritime Law and so forth.