Ship Finance in China: Key Developments and Challenges

China’s shipbuilding industry has developed rapidly over the past few years partly due to strong demand for newbuilding vessels from Chinese shipowners. China had set its sights on becoming the world’s biggest shipbuilder by 2009, and by 2010/2011 China will have contributed to a massive 150m dwt deliveries, doubling the 75m dwt delivered in 2006. This article will be of interest to banks and financial institutions who are attracted by this booming market. Set out below are certain key developments and associated issues and risks involved in structuring a ship finance transaction in China.

Pre-delivery Financing for Vessels Being Built in China

If pre-delivery financing is required for vessels to be constructed by a Chinese shipyard, the usual form of security for financiers is

- The assignment of the shipbuilding contract (principally the right to call on the shipyard to finish construction)
- The assignment of any refund guarantees that have been issued as security for the shipyard’s obligation under the shipbuilding contract to refund the pre-delivery instalments, should the vessel be deficient or never be completed.

This latter assignment provides the right for the financier (as assignee) to step into the shoes of the shipowner and call on the refund guarantor following a default by the shipyard. Normally, the refund guarantor is a PRC bank, in which case it is important to ensure that:

- The PRC refund guarantor’s “quota” will not be exceeded as a result of providing the refund guarantee. This relates to the requirement that the total of the PRC refund guarantor’s contingent liability under all foreign exchange guarantees and its own direct foreign exchange liabilities should not exceed 20 times the amount of its own foreign exchange funds;
- Although the PRC refund guarantor does not require approval from the State Administration of Foreign Exchange of China (SAFE) to issue the refund guarantee, for such refund guarantee to be valid, it must be registered with the relevant local branch of SAFE;
- The refund guarantee should be re-registered with the relevant SAFE office upon assignment of the same in favour of the financier to ensure that it remains valid and is in full force and effect. The effect of the re-registration is to record the change of beneficiary from the shipowner to the financier. Although the financier only becomes a payee if the shipowner defaults, it will become the beneficiary of record as China does not distinguish between an assignee by way of security and an assignee by way of sale.
Unless a right to assign is clearly stated in the refund guarantee, it has become standard market practice that the PRC refund guarantor will only consent to the assignment of the refund guarantee provided that the right for making any demand for payment remains with the assignor (i.e. the buyer under the shipbuilding contract). To address this issue, the refund guarantee assignment would normally include a mechanism so that the financier can make a demand under the refund guarantee as attorney-in-fact on behalf of the buyer pursuant to a power of attorney clause contained in the refund guarantee assignment. In the notice of assignment to the PRC refund guarantor, there should be a statement informing the refund guarantor that the financier has been appointed as attorney-in-fact on behalf of the buyer with the sole and exclusive right to make any demand under the refund guarantee.

Unless the PRC refund guarantor can be persuaded to consent in writing to this substitution of roles (usually in the acknowledgement attached to the notice), it is prudent to prepare demand notes in advance and to ensure that the owner signs these. They can then be held undated in escrow by the financier in the event that the PRC refund guarantor rejects a demand signed under the power of attorney.

Due to rising newbuilding prices and increasingly tight order books, certain Chinese shipyards encounter difficulties in arranging refund guarantees to be provided by their banks. One of the alternatives is that such refund guarantee be provided by an associated company of the shipyard with financial substance. If this is an acceptable arrangement, it is important to review the articles of association of such refund guarantor to ensure that the issuance of any refund guarantees falls within its scope of business and to ensure that authorisation is given by its board of directors to issue such refund guarantees. An opinion letter from a qualified PRC law firm would be the preferred method of satisfying these tests.

**PRC Ship Mortgages**

With China opening up Renminbi (RMB) lending businesses to foreign banks, a new market is emerging for foreign banks to compete for the first time (through their branches in China) with local Chinese banks in RMB ship finance. If financed in RMB, the vessel should fly the PRC flag, hence a PRC ship mortgage would be the principal security for the financier. However, it is suggested that financiers should consider the risks involved in taking a PRC ship mortgage, including:

- **Approvals** – the requirement for approvals is cumbersome and time consuming. There are special restrictions on the maximum percentage of foreign ownership in PRC companies engaged in international shipping. Inland transportation is still a restricted business, and various government departments impose restrictions for sensitive cargoes (such as oil) and coastal trade.

- **No central ship registration** – there is no central ship registration system in China. Registration is effected at the relevant local branch of the Maritime Safety Administration (MSA) where the vessel is registered (there are currently 24 ports in China where the vessel can be registered). Without physically checking the register itself, it can be difficult to obtain proof with respect to the ownership and security on the vessel being financed;

- **Mortgage registration** – completion of the mortgage registration is time consuming during which the financier’s priority could be compromised. It should be noted that the registration rules allow seven
days for the MSA to complete the registration – it follows that the mortgage registration process should commence well in advance of the proposed drawdown date to ensure that the financier is secured on Day 1. Priority is determined by the date of application of the mortgage registration, provided that all the documents supporting the application are complete and are acceptable to the local branch of the MSA;

- Enforcement – enforcement of PRC ship mortgages in China remains a major concern to financiers, as the law is largely untested. Different rules may apply according to the port where the vessel is lying and some ports are relatively inexperienced. Security has to be put up by the arresting bank. There is no right of forfeiture under PRC law, and assuming the case is brought to a successful conclusion, SAFE consent is required to remit the sale proceeds out of China.

**Long Term Charter Structures**

Until some momentum is created in foreign bank lending and/or the above enforcement concerns are resolved, the current practice is to register the vessel outside China (say Hong Kong) and to charter the vessel to a PRC company. The “long term charter structure” for traditional US Dollar ship finance minimises country risk and reduces bureaucratic controls. If the Hong Kong flag is used, it also offers economic advantages to the shipowner in the form of reduced port charges when the vessel calls at PRC ports.

Relying upon revenue from a charterer rather than the shipowner operates in the following manner:

- The PRC shipping company sets up an offshore special purpose vehicle (SPV) to be the borrower and owner of the vessel;
- The SPV will then enter into a long term time charterparty with its PRC parent;
- The SPV will use the periodic charterhire (received from its PRC parent) to service the debt; the charterhire amount should be structured so that it is sufficient to make all principal repayments and payment of interest under the facility, as well as bank and legal fees.

The time charterparty will be documented on a “hell or high water” basis. This means that the PRC parent’s obligation to pay charterhire under the time charterparty is absolute, unconditional and without any set-off irrespective of whether the vessel suffers a total loss or its quiet enjoyment of the vessel is interrupted for any reason; such payment obligation will continue until all the amounts owing to the financier under the facility have been repaid in full.

Following a default, the preference of international financiers has been to resort to the courts in their own country. This enables them to litigate any dispute in their own language and to obtain a judgment that they can enforce in China. However, it is not a simple matter to enforce a foreign judgment as there are few countries that enjoy reciprocity of court judgments with the PRC. Instead, financiers are invited to rely upon arbitration as a forum for mediating disputes because the PRC will enforce arbitration awards instead.

As an example, pursuant to a letter of confirmation dated 25 October 2007 from the Supreme People’s Court of the People’s Republic of China, arbitration awards made in Hong Kong are enforceable in China, subject to the proviso in Article 7 of the “Arrangement Concerning Mutual Enforcement of Arbitral Awards Between the Mainland and the Hong Kong Special Administrative Region” (the proviso in Article 7 largely reproduces the well-established and limited New York Convention grounds for resisting the enforcement of awards). On this basis, it is suggested that any dispute arising from contracts involving a PRC party (e.g. the time charterparty) be resolved not through the courts but by arbitration. This will ensure that such arbitral award will be recognised and enforceable against the PRC parent in China.

**Leasing - A New Business for Chinese Banks?**

Leasing business is in its infancy in China but may become a new tool for Chinese banks to achieve higher profits and diversify into non-interest income. Under this structure, the leasing arm of the bank would set up an SPV to be the owner of the vessel. The SPV would then charter the vessel to a shipping company who will be responsible for the entire operation of the vessel during the charter period. The traditional form of lease would follow a “bare-boat” style, where the charterer takes over an empty ship and assumes the benefits and burdens (including maintenance, repairs, the provision of crew and the insurances of the vessel).

The major difference between a traditional ship finance structure and a leasing structure is that the Chinese bank is itself the owner of the vessel - it takes
on to its books the vessel’s asset risk which, in a rising market, affords benefits by getting an upside at the end of the charter period (i.e. profit from disposal of the vessel with a market value exceeding the residual value in the books of the bank). However, if the SPV owner is an offshore company and the bareboat charterer is a PRC shipping company, the following will need to be taken into account:

- The bareboat charter might be regarded by SAFE as a finance lease requiring registration;
- The assignment of insurances by the bareboat charterer would require SAFE registration;
- The bareboat charter (irrespective of whether it contains a purchase option/obligation) would give rise to a deemed import into China of the vessel on Day 1 resulting in an import duty and VAT in China. As the aggregate rate of import duty and VAT is in the region of 25% of the amount of charterhire payable over the term of the bareboat charter (the actual rate of import duty depends on the type of the vessel being financed), the use of offshore SPVs has not proved economic.

To address the above concerns, a two-tier structure will normally be required so that

- The vessel will first be bareboat chartered to an offshore SPV (which is a wholly-owned subsidiary set up by the PRC end-user in say, Panama, Liberia or Hong Kong)
- The SPV bareboat charterer (as disponent owner) will then enter into a time charterparty with the PRC shipping company.

Conclusion

The PRC has taken enormous strides and made known its ambitions in the shipbuilding arena, but has only recently started to make corresponding efforts to develop its ship finance industry. Funding by credit loans at low rates of interest is becoming less profitable due to the high cost of newbuildings and the long period of time it takes to recoup the capital. Providing for easier access to international financiers may avoid China’s growth becoming restricted and strategic opportunities being missed.

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