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Security under shipbuilding contracts in international practice

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The shipbuilding contract may be classified as a contract whereby the Builder undertakes to sell and deliver agreed subject matter. This is the case in Denmark², France³, Norway⁴, Sweden⁵, United Kingdom⁶ and United States⁷.

In other jurisdictions the shipbuilding contract is classified, not as a contract of sale, but as a contract for work and materials. This is the case, inter alia, in Germany⁸, Italy⁹, Japan¹⁰, and Korea¹¹.

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² Sale of Goods Act 1980

³ Law 3.1.1967 and other references in the Civil Code

⁴ The Sale of Goods Act 1905

⁵ Law 1987:822 governing international sales, based closely on United Nations Convention on Contracts for the International Sale of Goods (1980) and Law 1990:931 governing other commercial sales

⁶ Hill, Maritime Law (2nd Edition 1985), p. 74 but see also Hyundai Heavy Industries Co. Ltd v. Papadopoulos [H.L. 1980 2 All. E.R. 29, 34] where a different approach was implied.

⁷ State law applies. See anyway Golden Lane, Inc. v. Bobben Fabrications, Inc. 1977 A.M.C. 2006 in which the argument that the contract was one of sale, was rejected and the contract was classified as a contract for work.

⁸ Articles 631 and following of the Civil Code.

⁹ Article 241 of the Code of Navigation states that, unless otherwise provided in the Code, shipbuilding contracts are governed by the rules in the Civil Code relating to contracts for work and materials (*appalto*) and found in Articles 1655 and following of the Civil Code. Very few rules of law for shipbuilding contracts are found in the Code of Navigation itself.

¹⁰ Prevailing view is in this sense unless, when the contract is made, work has already commenced: Article 632 of the Civil Code.



Although many systems of law afford a legislation on shipbuilding, it is a world wide practice that the relation between a Builder and a Buyer is accurately regulated by a contract. In the shipbuilding industry it is frequent to adopt standard form of contracts originated from the industry practice along decades.

The most common standard forms used are the Shipbuilding Contract of the Association of West European Shipbuilders (AWES 1972), the Shipbuilding Contract of the Shipowners Association of Japan (SAJ) and the Shipbuilding

Contract of the Maritime Subsidy Board of the United States Department of Commerce Maritime Administration (MARAD).

The People Republic of China recommends, through the Advisory Board of the China maritime Arbitration Commission (CMAC), a standard form of shipbuilding contract (which they refers as "Model Contract").

As substantial amount of money are at risk when ships being built, the parties to the contract, builder and buyer, are each concerned to ensure that, in the event of the other's insolvency or non performance, their own loss will be kept to a minimum. Moreover, this concern is shared by those who finance the construction of ships by lending money to either the builder or the customer and who thus seek to ensure the priority of their debt over the debts of other creditors.

Registration

The first form of guarantee in a shipbuilding contract is the possibility to register the ships under construction and the rights acquired in such ships in a Special State Register within the jurisdiction where the ship is built. Some jurisdictions afford this possibility or even make it

¹¹ Article 567 in practice cancels the relevance of the classification of the contract providing that the rule of law governino the contract of sale apply also to contracts for work and materials.



compulsory. This is the case for Argentina¹², Italy¹³, Germany¹⁴ and France¹⁵.

In other countries registration is possible but not compulsory (Canada¹⁶, Norway, Sweden and any country adopting the 1967 Convention) or required only when the ship under construction can be safely identified and reach a minimum established tonnage (Denmark¹⁷). Registration is not compulsory also in Portugal¹⁸, Greece, Netherlands and Spain, although possible.

The effect of registration of ships or those of mortgages or hypothecs on ships under construction is determined by the law of the place of registration.

It is generally true that the registration of the ship under construction enables the subsequent registration of mortgages on that ship, while it is still under construction. Moreover, the Buyers' rights in the ship may be upheld against third parties if the ship has been registered. This includes often protection from risks related to yard's bankruptcy and enhanced security for those financing the Buyer or yard's customer.

Transfer of property rights

In a number of countries it is not possible to register a ship under construction. These include Japan, South Korea¹⁹, the United Kingdom

¹² Article 59 of the Navigation Act (No. 20094)

¹³ Article 238 of the Code of Navigation provides that the shipbuilding contract must be registered in the register of ships under construction, failing which the ship is presumed built on the account of the builder, unless proof is given to the contrary. Registration is made in the Harbour Master's Office of the place where the yard is located.

¹⁴ Registration required only if the owner of the ship under construction wishes to mortgage the ship. Registration is made at the Court of First Instance of the place where the yard is situated.

¹⁵ The builder of any ship of more than 10 gross tons, whether on his own account or for a customer, must declare it to the competent administrative authority (Decret n. 67-967 of 27.10.1967, Articles 5 and 6).

¹⁶ Section 4 (1) Canada Shipping Act 1970

¹⁷ Ship Registration Act, Sect. 4.1

¹⁸ Regulation on Commercial Registration, Articles 1, 76 and 84 and Decree No. 42.644, Articles 4 and 12

¹⁹ I am not aware of the procedural regulations having been made to enact article 874 of the South Korean Commercial Code providing for registration of ships of more than 20 GT for the purposes of hypothecation.



and the United States²⁰. I have been advised that this is the case also in Ukraine.

In these countries the interest of those concerned with the proper performance of the shipbuilding contract have been secured by other means.

The contract usually provides for the payment of the purchase price by instalments at key points during the construction. The instalments are usually expressed as a percentage of the total purchase price and are usually payable on signing the contract, on laying the keel, on launching the ship and on delivery, with perhaps a few further instalments payable after the erection of 25 per cent, 50 per cent and 75 per cent of the steel work.

The Buyer's security for the amount of the instalments, which he has paid during construction, lies in the fact that these instalments are so arranged that the amount paid at any given time during the course of construction is approximately equal to the value of the work performed at that stage (and materials received) and in fact the contract often provides that the property in the ship, but not the risk, passes to the Buyer as the ship is constructed.

The Buyer is sometimes given the right, in the event of the insolvency of the builder, to enter upon the builder's premises and complete the ship, using the builder's labour and equipment, or to remove the ship and complete it elsewhere if this is possible.

The provisions relating to the passing of property usually extends to materials in the builder's yard intended for the ship and appropriated to the ship by being marked with its yard number.

If the contract is properly drafted this would give the Buyer some protection against the unsecured creditors of an insolvent builder.

Equally the builder may ensure that under the contract he retains ownership of what has been built at least to the extent that he has not received proportionate instalment payments.

²⁰ Validity of a security interest in a vessel is governed exclusively by Federal Law of United States: see *Alberto v. Maryland national bank* [1987] A.M.C. 2409, 2412-2413 (3rd Circuit, 1987) and cases cited.



In AWES, Article 8 (b), three alternative versions are offered. The first version provides that during construction the ship shall be the builder's property and the builder undertakes not to dispose of the vessel and not to allow any mortgage or lien being registered on the vessel except with the buyer prior written consent. On delivery the property is transferred upon the buyer together with all appurtenances. The second version provides for property of every part of the ship (including materials supplied and appropriated to the ship) passing upon buyer during construction but builder to retain a lien. A third version provides that every part of the ship under construction, including materials and appurtenances, being property of the buyer but only as security for instalments paid by buyer to the builder.

In SAJ, Article 7 (5), is expressly provided that title to and risk of loss of the Vessel shall pass to the Buyer only upon delivery and acceptance thereof having been completed.

In MARAD, Article XXIV, is provided that title to the ship and to all work and material performed upon or installed in the vessel or placed on board the vessel shall vest in the Buyer. The same applies to the material at builder's

shipyard or located elsewhere, for use in the performance of the contract work, to the extent that the buyer and the Board have paid.

Performance Bonds

A second possibility is that the builder be required to provide a performance bond or the Buyer a bank guarantee, such as a banker commercial credit, to ensure performance.

Refund Guarantees

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 (acceptable to the Buyer) will guarantee the repayment by the Builder of any money that becomes due under the Shipbuilding Contract upon any premature termination thereof (e.g. any instalments that are to be repaid as a result of a termination of the Shipbuilding Contract due to the Builder's default, including if the Builder runs into financial difficulties or following a total loss, or any penalty payments due which are not deducted from the final purchase price).



Accordingly, agreeing the identity of this bank and the terms of the Refund Guarantee will be an important part of the negotiation process.

The Parties should note the following points when agreeing the terms of the same:

(a) The Builder and its bank will usually insist upon a cap of liability under the Refund Guarantee. This would normally be for the amount of all paid pre-delivery instalments plus interest.

(b) Where the Buyer obtains some security through ownership of the Vessel during the course of her construction the Builder might argue that the Refund Guarantee should only cover the earlier pre-delivery instalments and not all of them. However, since this "security" is often difficult to rely on requests of this nature should normally be resisted.

(c) The procedure for paying claims under the Refund Guarantee should also be agreed. Ideally, the Buyer will be seeking a form of on-demand guarantee whereby the relevant bank is required to pay upon receipt of a demand (complying with the terms of the guarantee) regardless of whether or not the Buyer has established that it is entitled to the refund at law. The

alternative is for the guarantee to provide that in the event of a dispute no payment will be made until the dispute has been settled or determined in accordance with the Shipbuilding Contract (e.g. by expert determination, arbitration or through the courts). In these circumstances the Buyer needs to ensure that any date of expiry referred to in the Refund Guarantee is extended to allow for the dispute resolution procedure to be completed.

(d) A Buyer would normally wish to have a right of approval over the identity of the bank giving the Refund Guarantee and where a series of new buildings

is being ordered may wish to specify that more than one bank is involved. In these circumstances the Buyer should also require some provision that would allow it to withdraw its approval of any bank where there has been a material deterioration in the bank's financial condition before the Refund Guarantee is issued. Normally, this would be done by reference to a change to the bank's credit rating.

(e) The Buyer, in turn, may be required to provide a Performance Guarantee from a bank acceptable to the Builder guaranteeing the performance by the Buyer of its various payment obligations under the



Shipbuilding Contract. Such a guarantee would normally depend upon the Builder's claim to such instalments being established rather than being of an on demand nature. The requirement for such a guarantee will obviously also depend on the financial standing of the Buyer.

For larger corporations a guarantee may not be required or a parent company guarantee or the obligations of a subsidiary may be accepted.

Where there are concerns over the financial standing of a Buyer, a Builder may also agree to forego a guarantee if the instalments are weighted so that more is paid in advance of delivery to reduce the Builder's exposure to unrecoverable costs.

A brief mention should be made to the Chinese industry practice concerning refund guarantees as the PRC is currently the third-largest ship building nation in the world, after South Korea, which recently took the No.1 slot, and Japan, now No.2.²¹

For PRC new buildings, it is usual, certainly within a sellers'/yard's market, for the refund guarantee to be issued by a PRC bank within the PRC. In turn, there are a number of additional regulatory requirements that should be noted, and, ideally, reflected from the outset in the shipbuilding contract.

PRC law regulates foreign currency guarantees issued by PRC financial institutions. Specifically, at the moment, not all PRC financial institutions have the requisite authority from the Chinese Banking Regulatory Commission to issue foreign currency guarantees.

Further, for the foreign currency Refund Guarantee (provided for new buildings) to be valid, the Refund Guarantee must be registered with the PRC's State Administration of Foreign Exchange ("SAFE") by the issuing Bank.

To register the Refund Guarantee, the issuing Bank will usually enter the primary details of the refund guarantee (e.g. beneficiary, date of guarantee, amount of guarantee, etc.) into a Schedule, which it prepares monthly for all

²¹ China's ship completions rank third in the past 10 consecutively years and the shipbuilding capacity also increased from 3.462 million DWT of 2002 to 12 million DWT of 2005. According to statistics, from 2006 to 2010, the total demand of ships will reach 31 million DWT, and the annual demand will be 6.2 million DWT on average. In 2005, the cumulative sales revenue of Chinas shipbuilding industry amounted to RMB 110.85 billion, up by 42.6% over the year of 2004, and the profits amounted to RMB 4.29 billion, far more than that of 2004, which was RMB 1.64 billion. The export is also promising and the earnings broke through USD 4 billion in 2005.



of the foreign currency guarantees it has issued. The Schedule is then filed with and signed ("chopped") by SAFE in Beijing, or the local branch with jurisdiction over that Bank. Unless that procedural step is complied with, recent PRC guidelines on the area state that within the PRC the refund guarantee is not valid and therefore unenforceable.

Accordingly, buyers are recommended to request evidence from the yard to show that the Refund Guarantee has been duly registered with the SAFE, with prudence dictating that evidence being a pre-condition to the buyer's obligation to make the payment intended to be covered by the relevant Refund Guarantee. Usually, a copy of the Schedule with both the Bank and SAFE's chops (stamps) will suffice.²²

Builder's lien

Whether or not such a right is given by the contract itself, the builder may have a possessory lien on the ship²³. This is the lien of the unpaid Seller, enabling him to keep the ship as security until all instalments of the price have been paid by the Buyer. Possessory liens are linked to

²² The CMAC Model Contract of Shipbuilding provides:

6. SECURITY FOR PAYMENT OF INSTALMENTS BEFORE DELIVERY:

The Buyer shall, concurrently when this Contract being signed, deliver to the Seller an irrevocable and unconditional Letter of Guarantee in the form annexed hereto as Exhibit "B" in favour of the Seller issued by a first class international bank (hereinafter called the "Guarantor") acceptable to Bank of China and the Seller. This guarantee shall secure the Buyer's Obligation for the Payment of all 2nd, 3rd and 4th instalments of the Contract Price.

7. REFUNDS

All payments made by the Buyer prior to delivery of the Vessel shall be in the nature of advance to the Seller, and in the event this Contract is rescinded or cancelled by the Buyer, all in accordance with the specific terms of this Contract permitting such rescission or cancellation, the Seller shall refund to the Buyer in United States Dollars the full amount of all sums already paid by the Buyer to the Seller under this Contract, together with interest (at the rate set out in respective provision thereof) from the respective payment date (s) to the date of remittance by telegraphic transfer of such refund to the account specified by the Buyer. As security to the Buyer, the Seller shall deliver to the Buyer, concurrently with this Contract being signed, a Refund Guarantee to be issued by the Bank of China, Head Office, Banking Department, Beijing, the People's Republic of China in the form as per Exhibit "A" annexed hereto.

However, in the event of any dispute between the Seller and the Buyer with regard to the Seller's obligation to repay the instalment or instalments paid by the Buyer and to the Buyer's right to demand payment from Bank of China, Head Office, under its, guarantee, and such dispute is submitted either by the Seller or by the Buyer for arbitration in accordance with Article VIII hereof or for appeal or appeals in accordance with the English laws, Bank of China shall withhold and defer payment until the arbitration award between the Seller and the Buyer is published. Bank of China shall not be obligated to make any payment unless the arbitration award orders the Seller to make repayment and any right of appeal available to the Seller under English laws is waived or is not exercised by the Seller in accordance with English laws. If the Seller fails to honour the award or judgment, then Bank of China shall refund to the extent the arbitration award (or any court judgment) orders.

²³ In France, Germany, Korea (Articles 320 and 322 of the Civil Code), Norway, Sweden, United Kingdom, United States, Argentina, Denmark and The Netherlands. In Argentina the validity of the lien is dependent on the registration of the shipbuilding contract in the National Ships Register. In USA see for example, *Peninsular Savings & Loan Assn. v. o/s Seismic Sea*, [1984] A.M.C. 2635. However, it has been held that, because shipbuilding contracts and associated supply contracts are not maritime contracts (*Thames Towboat Co. v. The Schooner Francis McDonald*, 254 U.S. 242 (1920)), no maritime lien can attach for equipment installed on a ship during construction and prior to completion: *Nilo Bare Line Inc. v. m/v Bayou Dularge* [1980] A.M.C. 750 (8th Circuit, 1978).



possession. This means that the lien exists until the builder remains in possession of the ship. Eventually, if he remains unpaid, the builder will be entitled to sell the ship, whether completed or not, in order to recover any loss that he might have sustained. Such a sale will not extinguish his right to prove in the liquidation of an insolvent Buyer in respect of any loss not covered by the sale.

In common law countries this is simply an “application of the common law possessory lien conferred for work on a chattel. There is no distinction, for this purpose, for example between a repair of a ship or a car”²⁴.

In other countries, like in Italy, the builder gets no possessory lien on the ship in his yard. But he will insert in the contract a right to retain title the ship sufficient to ensure security.

Charges

Although it may not be possible to create a mortgage on the ship under construction, the lender to the Buyer may, of course, obtain security by way of mortgage on other ships in the ownership of the Buyer (collateral securities). In Japan it has been common for the Buyer to have a banker’s commercial credit opened in favour of the builder and, if the issuing bank requires security, to offer mortgage cover on the Buyer’s existing ships. These may be regulated by the shipbuilding contract as, for example, in MARAD Standard Form, Article XXII (b).

The builder, on the other side, may borrow against security of a mortgage on his yard, in accordance with the law of real or immoveable property

There are also kinds of security or charge which look more specifically to the ship under construction itself.

In Canada a security interest in a ship under construction may be registered under the Personal Property Security Act 1970, if it is any one of, inter alia, “(i) a chattel mortgage²⁵, conditional sale, equipment

²⁴ Jackson, *Enforcement of Maritime Claims* (London 1985). Sale of Goods Act 1979 Sec. 41

²⁵ A chattel mortgage is a mortgage where a loan is granted against the value of movable personal property, as opposed to real estate.



trust, floating charge, pledge, trust deed²⁶ or trust receipt²⁷, and (ii) an assignment, lease or consignment intended as security²⁸.

In Ireland, as in the United Kingdom, a fixed or floating charge²⁹ may be created on the ship.³⁰

In Italy security is possible that does not depend on registration of the ship. Article 2762 of the Civil Code provides for a Machinery vendor's lien, according to which vendor has a lien for the unpaid purchase price on the machinery sold and delivered, even if such machinery is built in or joined to an immovable owned by the builder or buyer or a third party. The lien is conditional upon the registration of documents, witnessing the sale and the claim, in the register kept by the tribunal having jurisdiction over the place where the machine is located³¹. The lien last for a period of three years from the date of the sale, and is effective as long as the machinery is in possession of the builder or buyer in the place where the registration was made, except in the case in which it has been fraudulently taken away. The rule is in theory applicable to the seller (supplier) of machinery installed in the ship under construction.

In Korea the registration of ships under construction is not permitted. However, the creditor of the owner and the owner himself may register a charge in accordance with Article 28 of the Real Property Registration Act.

In United Kingdom a fixed charge may be registered under the Bills of sale Acts 1878-1891, but this cumbersome device is less likely to be used than a floating charge. A floating charge may be created, without

²⁶ A formal document which outlines the terms of a trust agreement.

²⁷ Receipt of goods that have to be held in trust or the lender.

²⁸ Tetley, *Maritime Liens and Claims* (London 1985)

²⁹ A floating charge is a security interest over all of the assets of a company, which 'floats' until an event of default is triggered or until the company goes into insolvent liquidation, at which time the floating charge crystallises and attaches to all of the assets of the company. Floating charges can only be granted by companies. If an individual person or a partnership was to purport to grant a floating charge, it would be void as a general assignment in bankruptcy. Floating charges take effect in equity only, and consequently are defeated by a bona fide purchaser for value without notice of any asset caught by them. In practice, as the chargor has power to dispose of assets under a floating charge, this is only of any consequence in relation to disposals after the charge has crystallised.

³⁰ Section 99 of the Irish Companies Act 1963

³¹ Article 1524 Civil Code



formality, on any assets of the borrower.³² This security ensures that the charge has priority over other creditors who takes subsequent security, provided the charge prohibits the creation of later charges and, together with its terms, is registered in accordance with the Companies Act 1985, sections 395 and following.³³

In United States a security interest may be registered under section 9-101 and following of the UCC and may be granted by the builder who has title to the ship under construction. On delivery this security must be replaced by a preferred ship's mortgage.

Assignment of the contract

A lender may also require the borrower to assign the benefit of the shipbuilding contract together, in the case of a loan to the customer/buyer, with an irrevocable letter of instruction to the builder to hold the ship to the order of the lender. If the contract provides that the builder must provide bankers' refund guarantees to ensure the repayment of instalments in the event of default by the builder, the benefit of these too must be assigned by the customer/buyer to the lender.³⁴

The contract may also insist that the contract cannot be assigned without the consent of each party (as in AWES, Article 18; MARAD, Article XXVIII; SAJ, Article XIV), although it may also provide that consent is not to be unreasonably withheld.

In some countries lenders require security which are remote from the shipbuilding contract, such as a series of promissory notes drawn to coincide with the instalments due and which, when paid in full, will discharge the borrower's obligations.³⁵ In other jurisdictions it is common for builders to

rely on personal guarantees provided by the beneficial owners or directors of the buyer company.³⁶

Insurance

³² To enable the borrower to use or deal with the assets in question they are not identified individually but are referred to generically and may include ships under construction.

³³ Pennington, Company Law (6th Edition, London 1990), ch. 12

³⁴ Assignment is not found in practice in Denmark but is found in the United Kingdom.

³⁵ This is the case for example in United Kingdom

³⁶ This is the case of Italy, France and Korea.



A lender will also look to insurance cover against loss or damage to the ship during construction, a matter for contractual arrangement between the builder and the buyer. In particular very frequent are loss payable clauses, whereby the sums payable under the insurance policies are payable to the lender in any circumstances in which his security might be at risk. When is possible to do so the policy shall have to be taken out in the joint names of the builder, the buyer/customer and the lender.

Many thanks for your attention.

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