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## A study on the legal issues of ship finance lease in China

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**WORLD MARITIME UNIVERSITY**

Dalian, China

**A STUDY ON THE LEGAL ISSUES OF SHIP  
FINANCE LEASE IN CHINA**

By

**SUN LEI**

**The People's Republic of China**

A research paper submitted to the World Maritime University in partial  
fulfillment of the requirements for the award of the degree of

**MASTER OF SCIENCE**

**(MARITIME SAFETY AND ENVIRONMENTAL MANAGEMENT)**

2015

## **DECLARATION**

I certify that all the material in this research paper that is not my own work has been identified, and that no material is included for which a degree has previously been conferred on me.

The contents of this research paper reflect my own personal views, and are not necessarily endorsed by the University.

(Signature):           Sun Lei

(Date):                 June 29, 2015

**Supervised by:**

Guo Ping

Professor

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## **ACKNOWLEDGEMENTS**

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## **ABSTRACT**

**Title of Research Paper:**        **A Study on the Legal Issues of Ship Finance Lease in China**

**Degree:**                                **Msc**

As a special financing way of financing and leasing-assets integrated, ship finance lease in the world especially in China is developing rapidly in recent years. Since the object of finance lease ship has certain particularity itself, ship finance lease is governed by both the legislation of maritime affairs and financial lease legislation at the same time. Therefore, the relevant legal issues derived from ship finance lease could not be solved simply by a specific law, but should be treated according to various comprehensive legal laws. In China, there is no specific provision for ship finance lease in the domestic maritime laws and the control of finance lease including ship finance lease is relatively chaos in the field of finance law. Overall, the situation in China is lack of unified legislation of finance lease to regulate the behavior of ship finance lease.

This paper tries to introduce the origin of ship finance lease, specify meanings, characteristics and contents of the ship finance lease contracts and discuss the situation of the existing registration system, the necessity to establish the ship finance lease registration system and problems to focus on in China, in combination with the development status of ship finance lease business worldwide and in China. Then, the author analyses the possible problems related to the ship finance lease, including arrest and auction of finance lease ship and the risk study of finance lease ship collision in which different measures should be chosen to take in the specific situations. Finally, for the problems imperfect and urgent to be solved existed in ship

finance lease in China currently, such as decentralized laws and regulations and the confusion of management, the paper intends to find the corresponding solutions and put forward legislative proposals of ship finance lease in China.

**KEYWORDS:** Ship finance lease, Contract, Registration, Arrest, Collision

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## **LIST OF ABBREVIATIONS**

BUNKER	International Convention on Civil Liability for Bunker Oil Pollution Damage, 2001
CBRC	China Banking Regulatory Commission
CLC1969	International Convention on Civil Liability for Oil Pollution Damage, 1969
CLC1992	Protocol of 1992 to amend the International Convention on Civil Liability for Oil Pollution Damage of 29 November 1969
HNS	International Convention on Liability and Compensation for Damage in Connection with the Carriage of Hazardous and Noxious Substances
IMO	International Maritime Organization
MOFCOM	Ministry of Commerce of China
NPC	National People's Congress of China
NPCSC	Standing Committee of the National People's Congress of China
OPA	Oil Pollution Act
RRS	Regulations for Registration of Ships of the People's Republic of China
SMPL	Special Maritime Procedure Law of the People's Republic of China
SPC	The Supreme People's Court of the People's Republic of China
UCIFL	UNIDROIT Convention on International Financial Leasing

## **CHAPTER 1 Introduction**

### **1.1 Background of research**

In recent years, the global shipbuilding center of gravity transfers to Asia especially Japan, South Korea and China, while ship finance markets around the world also gradually shift to Asia. As a new way of financing, ship finance lease has got rapid development worldwide in recent decades. Affected by the financial crisis, many European and American ship owners come to China to seek funding support after financing blocked abroad. In addition, with the situation of ocean shipping enterprise lack of funds, financial institutions are involved in the development of the shipbuilding industry by ship finance lease which appears as a new and effective way to solve problems of shipbuilding and shipping company funds shortage ( Zhang, 2012 ) . Therefore, choosing the ship finance lease legal issues in China as research topic is mainly based on the following aspects:

1) To cope with the rapid development of the world's emerging ship financing and application. Ship financing by the way of financing lease is quite common and effective in the developed countries of shipbuilding industry, while in China the enterprise to carry out the ship finance lease business is less and the supply is not high. Since China's shipbuilding industry is in a critical period of development now, difficulty of financing has restricted the leap-forward development of the industry.

2) To respond to the complicated legal problems in the ship finance lease in China. Ship finance lease looks for a reliable investment channels for bank capital and provides low cost and high quality supply of funds for shipping companies. However, many heavy and complicated legal issues are followed at the same time. To study the related law of ship finance lease in China will benefit to help provide a better legal environment of ship finance lease for Chinese shipping industry.

## **1.2 Purpose of research**

Studying the problems faced by the ship finance lease in China is realistic and concrete, because it is directly related to the comprehensive revitalization of the shipbuilding industry and shipping industry. Meanwhile, referring to the ship finance lease law relationship inevitably involves many financial issues and legal issues of cross effect in legal departments, which needs to be done on the basis of the corresponding theoretical support.

### **1.2.1 Theoretical significance**

Firstly, it is helpful to comb the issue of legal application for ship finance lease in China. Ship finance lease law in China is relatively fragmented and has no specific legislation to regulate. There are related provisions in different laws, for example, the provisions of the charter party in the Maritime Code of the People's Republic of China (hereinafter referred to as the "Maritime Code"), the provisions of financial leasing companies operating, financing in the Finance Leasing Company Management Approach promulgated by CBRC and other regulations in the Contract Law of the People's Republic of China (hereinafter referred to as "Contract Law") and UCIFL, etc. In dealing with disputes in the process of ship finance lease in China, it needs a comb to quote the laws.

Secondly, it is practical to innovating ship finance lease law system in China. Ship finance lease relationship has the general characteristics of financing lease, and the legal norms of ship and the financing leases legal relationship also cross at the same time. Moreover, it is also closely related with the property law, international finance law, maritime law and company law that make the ship finance lease legal relationship more complicated. The study, tries to simplify heavy and complicated issues in the process of ship finance lease in China to the problem of property rights, contract, the administrative registration and other major problems through research.

### 1.2.2 Practical significance

Firstly, the ship finance lease is the era subject of China's economic reform and development. China's shipbuilding and shipping industry are in its critical period and the revitalization cannot do without the financial support in the current post-financial crisis world. Ship finance lease can solve problem of funds shortage in China's shipbuilding and shipping industry through the involvement of financial institutions. Thus, the research on ship finance lease issue bears on revitalization of China's shipbuilding and shipping industry that matters stable and sustainable development of its economy.

Secondly, it has direct application value for construction of related law in China. At present, the research on the related system of ship finance lease is still in a rough introduction of foreign ship finance lease model and relevant legal provisions, and there exist many shortcomings and blanks in the scope and content of the legal application and adjustment of ship finance lease. Under the circumstance of so demanding financing lease system by shipping industry, research on legal issues of ship finance lease China has important application significance at the time of change and development of Maritime Code, RRS and other relevant laws and regulations.

## **1.3 Methodology of research**

### 1.3.1 Literature review

In order to further understand the history, the international and domestic legislation situation and the feature of ship finance lease, the content of the financing lease contract and the characteristics of ship registration system, the author has read a lot of Chinese and foreign articles and visited the database of CNKI, Westlaw database, database BIMCO Lloyds legal report through the school library and finally found a large number of Chinese and English literature and material to support the present research.

### 1.3.2 Experience learning

On the basis of the literature, the author summarized the process of development and status quo of ship finance lease, introduced the content and character of the ship finance lease and ship finance lease content. Since the system and laws of the ship finance lease in China is not comprehensive enough, many issues may be come out with the ship finance lease business. Two specific issues were selected and explained under the background of China's current legal system and shipping circumstance. The paper also gave some advices to promote the ship finance lease in China, including modifying and perfecting legislation, establishing ship finance lease registration system and strengthening the support of ship finance lease business, etc according to the characteristics of the ship finance lease and the present situation of the development of Chinese domestic shipping.

### 1.3.3 Case study

The author engaged in domestic ship registration himself and has certain practical experiences of applying China's domestic ship registration law, including ownership

and financing lease registration of ship. However, based on the registration of ship finance lease according to the practice of bareboat charter registration in general in China, the existing registration system of ship finance lease is not effective and the author will explore the necessity of establishing ship finance lease registration system by comparing. As a result, it can not only protect the interests of the parties in the contract for financial leasing but also eliminates responsibility which registration personnel should not have. The legal relationship can be adjusted mostly by both the lessor and the lessee.

## **CHAPTER 2 Summary of Ship Finance Lease**

### **2.1 Introduction of financing lease**

#### ***2.1.1 Emergence and development of financing lease***

Lease includes two aspects: rent-out and rent-in. "Rent-out" refers to the lessor lending content (property) to others and earning profits while "rent-in" refers to the lessee renting other's items and paying the rent. So, it can be defined respectively from the viewpoints of both lessor and lessee: lease is the behavior that the lessor transfers the use of an object rights and benefits in order to obtain the corresponding rental income or the lessee achieves the right to the use and yield of a content at the expense of paying the rent in a certain period of time.

Financial leasing is the combination of traditional and credit financing. Compared with the traditional leasing, the particularity of financing lease is to achieve the purpose of financing in the form of leasing-assets. The lessor buys rental equipment according to the choice of the lessee, which has the connotation of advancing funding, while the lessor withdraws the funds with interest advancing to the lessee before by the form of charging rent, which shows the characteristics of debt financing (Wang, Zhu, & Hu, 2014).

Since financing lease was born in the United States, it was widely accepted by other countries enterprises rapidly. Western European countries, Japan, Canada and other



developed countries founded their own leasing company by learning experience from the United States. Financing lease was known to many countries in the aspect of promotion and financing function gradually and formed a large demand leading to the rapid development of global finance market. According to statistics from World Leasing Yearbook, financing lease sales around the world was 40 billion dollars in 1978, 500 billion dollars in 2000 and more than 880 billion dollars in 2013, with an average annual growth rate of over 30% (White, 2015). Judging from the rental market penetration (ratio of total rent to the total amount of investment in fixed assets), financial leasing has become the third largest financing mode after the capital market and bank credit.

### ***2.1.2 Definition of financing lease***

Although the financing lease is common with large size all over the world, there is no uniform definition for financing lease.

In the UK, British Accounting Committee defined finance lease as: if at the beginning of the lease the lessee for at least 90% or more of the equipment of the present value of future payment obligation, it is the financing lease, otherwise it is an operating lease. The important features of the financing lease in Britain is that the lessor always possesses the ownership of lease item and does not transfer while the lessee does not get purchase option of lease at the end, or it will make financing lease change into hire purchase, leading that the parties cannot enjoy the corresponding preferential tax on the financing lease.

The International Institute for the Unification of Private Laws (1988), an international organization, defines financing lease as "*in which one party (the lessor), (a) on the specifications of another party (the lessee), enters into an agreement (the supply agreement) with a third party (the supplier) under which the lessor acquires*

*plant, capital goods or other equipment (the equipment) on terms approved by the lessee so far as they concern its interests, and (b) enters into an agreement (the leasing agreement) with the lessee, granting to the lessee the right to use the equipment in return for the payment of rentals. "* in paragraph 1 of article 1 of UCIFL. The statement under paragraph 3 of article 1 is: *"This Convention applies whether or not the lessee has or subsequently acquires the option to buy the equipment or to hold it on lease for a further period, and whether or not for a nominal price or rental."*

From the description of the convention, it confirms the independent financier's status of lessor in the financing lease, namely, it emphasizes the financing lease the typical form of trading with three parties and two contracts in the financing lease. At the same time it does not take it as the necessary conditions of financing lease whether the lessee enjoy the purchase option of the lease item and maintains an open mind on the disposal of the lease item at the termination of tenancy. It reconciles the conflict at this point between Anglo-American law system and continental law system (Wu & Li, 2001).

In Wikipedia, a finance lease or capital lease is a type of lease. *It is a commercial arrangement where: a) The lessee (customer or borrower) will select an asset (equipment, vehicle, software); b) The lessor (finance company) will purchase that asset; c) The lessee will have use of that asset during the lease; d) The lessee will pay a series of rentals or installments for the use of that asset; e) The lessor will recover a large part or all of the cost of the asset plus earn interest from the rentals paid by the lessee; f) The lessee has the option to acquire ownership of the asset (e.g. paying the last rental, or bargain option purchase price)* (Finance lease, n.d.).

Finance leasing in China experiences a long journey. The earliest Chinese regulation

to regulate the meaning of the financing lease is Interim Regulations on Management of Chinese Finance Leasing released by the state council on May 19, 1986. The regulations defined: "finance lease is the leasing transaction that the lessor financing to provide the required equipment for the lessee with functions of both financing and leasing-assets. It mainly relates to three parties - the lessor, the lessee and the supplier and consists of two or more contracts. The lessor concludes a purchase contract with the supplier and makes payment according to the requirements and choices of the lessee, and then enters into a lease contract with the lessee and leases the equipment to the lessee. The lease term shall be not less than two years. During the period of the lease, the lessee pays the rent to the lessor by installments as stipulated in the contract. The ownership of the leased equipment belongs to the lessor while the lessee enjoys the right to use the device. When the lease expires, the equipment can be purchased or renewed by the lessee or returned to the lessor as stipulated in the contract".

Contract Law does not define financing lease but defined the financing lease contract as: "*financial leasing contract is the contract that the lessor buys the lease item from the seller according to the lessee's selection to the seller and the lease item and provides for the use of the lessee, the lessee pays the rent*". The definition states the features of financing lease only from the perspective of contract.

The Financing Lease Law (draft)(ED3) in 2006 defined "*finance lease refers to the trading activities that according to selection of the lessee and supplier the lessor gets the lease item from the supplier, rents it to the lessee and collects rent from the lessee. When the lease expires, the lessee can renew, purchase or return the lease item. The shortest lease term for the first time is one year, and the lessor shall be limited to enterprise which obtains the status of financing lease business.*"

The "Administration Procedures of Financial Leasing Companies" newly revised in

2007 stipulated in article 3: *"finance lease refers to the trading activities that according to the lessee's choice or recognition of the lease item and the supplier the lessor rents the lease item from the supplier's place to the lessee to possess and utilize as contracted to and collects rent from the lessee."* The definition is close to the regulations in article 1 of UCIFL.

Comparing the above concept, although the understanding angle of financing lease is different, the basic transaction characteristics of three parties concerned are all reflected in the financing lease. The author considers that according to China's current situation, expression on the financing lease in the Financing Lease Law (draft) (ED3) should be more comprehensive and accurate, for it contains all principal elements of the finance leasing behavior.

### ***2.1.3 Characteristic of financing lease***

Financing lease is a special way of lease combining financing and leasing-assets as one, and typical financing lease has the following characteristics generally:

- 1) A financing lease will contain at least three parties and two contracts. The lessor, the lessee and the supplier link together through the contract on sales of goods and the financial leasing contract.
- 2) The financing lease has the dual nature of financing and leasing-assets. Financing lease is a way of combining financing and leasing-assets on the basis of separation of the ownership and right of use which not only satisfies the need of the tenant for financing but also makes use of the lessor's idle capital efficiently.
- 3) The investment decision-makers and investors are devised. For selection of the item for lease, investment decision-maker is not the lessor but the lessee. The lessee is lack of enough money to buy the needed equipment, so the choice to the lease item

is completely according to the lessee's own needs and as a sponsor the lessor only bears the financing service (Finance lease, n.d.).

4) The feature of non-termination. Since the lease item is selected by the lessee, the lessor buys equipments according to the lessee's option. Therefore, during the validity period of the lease contract, no matter if the lessee claims to cancel the contract or not, the lessee should pay the rent to the lessor unconditionally and have no right to terminate the contract ahead by returning the lease item unless the fault is caused by the lessor.

## **2.2 Content of ship finance lease**

### ***2.2.1 Origination and development of ship finance lease***

As the ship industry including shipbuilding and ship operations belongs to the capital-intensive industry which needs a large number of capital investment and high financial support while the carrier's own funds is limited, methods like bank financing are required to raise the required funds. In the past, the owner's financing source to build a ship was mainly borrowing money from commercial banks and banks engaged in the ship mortgage. However, most of the ship's lending institutions have taken strict lending evaluation criteria and some banks tighten and even cancel the ship loans in recent years. With the booming of the shipping market, the demand of ship financing market for money is becoming much bigger and the funds provided by the traditional financing way are increasingly inadequate.

In May 1952, first enterprise that used the way of financing lease to conduct equipment leasing business in the world was founded in California of the USA, marking the birth of financing lease. This new brand of lease quickly applied to shipping industry. The emergence of ship finance lease made the capital market

combine with the shipping market conveniently to faster and better development of shipping market while capital was found a way to get higher returns. Combining with the characteristics of the trading patterns, many countries issued relevant laws and policies in order that financing lease play a positive role to promote shipping market.

Financing lease in China began with the establishment of China Orient Leasing Company in 1981. As of June 2014, there were 25 financial leasing companies approved by CBRC with normal business operation, more than 1200 foreign investment and financing leasing companies approved by MOFCOM and 123 domestic pilot financial leasing companies approved by MOFCOM and State Administration of Taxation. Compared with a total of only over 100 in 2009, the amount has increased by several times in past years. This provides unprecedented opportunities for ship's financial leasing industry (Wang, 2009).

### ***2.2.2 Definition and characteristics of ship finance lease***

As a kind of financing lease, ship finance lease should have the basic characteristics of financing lease. Therefore, it can be defined that ship finance lease is a finance lease that the lessee selects the ship and vendor, or shipbuilder and technical standards for ship construction, the lessor signs a Financing Lease Contract with the lessee and a Ship Sale and Purchase Contract with seller or a Shipbuilding Contract with the shipbuilder respectively, then the lessor lease the ship to the lessee and the lessee pays the rent.

From the definition, it is evident that the ship finance lease has the basic features of financing lease - at least two contracts including a Financing Lease Contract and a Ship Sale and Purchase Contract or a Shipbuilding Contract, and three parties involves: the lessee, the lessor and the seller or shipbuilder. The lessee has the option on lease shipping seller or builder. During the lease, the lessor possesses ownership

of ship but free from warranty liability whether finance lease ship defecting or not and obligation of tenant to pay the rent is absolute and irrevocable. When the lease expires, the lessee has the right to purchase, renew or return the ship.

Ship finance lease has stronger property rights compared with the general financing lease. In general financing lease, the lessor has the ownership of the lease item during the lease term and the lease item is not within the scope of the liability assets of the lessee. In the 242nd regulation of Contract Law, "in case the lessee enters into bankruptcy the lease item does not belong to bankruptcy property and the lease should not be used to pay off the debt of the third party in the normal operation of the lessee." Although ship finance lease is not specially regulated in Maritime Code, arrest of ship system in Maritime Code makes it possible that lessee's ships in financing lease way be detained for a wide range of maritime claims as the subject matter for the ship is adjusted by Maritime Code. On the basis of the provisions of the scope of arrest of ship in SMPL, the maritime claimant can arrest the lessee's ships. The lessee is in a position similar to the shipowner factually through the judicial process.

### ***2.2.3 Category of ship finance lease***

#### **1) Direct lease**

In this way, after the lessee chooses ship or shipyard according to the need, the lessor and the seller sign the sale and purchase contract while the lessor and the lessee sign the leasing contract. Then the seller delivers the ship to the lessee and gets payment from the lessor. The lessee uses the ship, profits and pays the rent regularly.

#### **2) Sublease**

Sublease is a kind of financing lease that lease in and then rent out, and the ownership of the lease item belongs to the first lessor. The lease item lease

companies provide to the lessee is not purchased from the seller but leased from another lease company. The main difference between sublease and direct lease is that the former receives financing lease facility from the lease company while the latter gains directly from the banks, financial institutions in the traditional credit financing way.

### 3) Leaseback

The substance of leaseback is that the lessee transfers the ownership of the ship to the lessor, obtains corresponding funds in the form of loans and amortizes the lease debt to the lessor in the form of rent.

### 4) Trust lease

Trust lease is the combination of trust with financing lease. It is the behavior that the client entrusts the use right of monetary fund properties to the trustee on a basis of trust in the trustee and then properties are used and disposed in the form of financing lease in the trustee's own name according to the client's will for the benefit of the trustee or a specific purpose.

### 5) Leveraged lease

Leveraged lease, refers to that, when investing in a financing lease business, the lessor only offers a small amount of money and other funds required for lease business (accounting for 60 to 80 percent of the funds required for purchasing the lease item) are offered as non-recourse loans by the third person in agreement with the guarantee of beneficial right of the lease term and rent.

### 6) Joint lease

Joint lease is also the combination of trust with financing lease. The way is that one financing lease company finances lease as the lessor but part of the lease funds



comes from one or more other financing lease companies.

## **2.3 Ship finance lease contract**

### ***2.3.1 Basic principal of ship finance lease contract***

The basic subjects of the ship finance lease contract include the lessee, the lessor and the ship seller or builder. To the lessee, the seller or builder, laws in China have no special restrictions, but there is a market access system to the company allowed to do financing lease business, namely qualification as a "lessor".

### ***2.3.2 Main content of the ship finance lease contract***

In a ship finance lease, the lessee and the shipbuilder or the seller agree to build or trade one ship, then the lessor signs a shipbuilding contract or a ship sale and purchase contract with shipbuilder or seller selected by the lessee. After that, the lessor and the lessee sign the financing leasing contract. Therefore, the ship finance lease contract is a kind of collection contract, constituted by the financing leasing contract, a shipbuilding contract or a ship sale and purchase contract.

#### **2.3.2.1 Main content of shipbuilding contract**

General clauses contain 10 items: instructions and classification, contract price and payment term, adjustment of contract price, supervision and inspection, trial, the matter of delivery, quality assurance, insurance, liability for breach and dispute resolution.

Besides, there is the special clause. The function is that the rights of lessor under the shipbuilding contract can be transferred to the lessee and the shipbuilder responses to the lessee directly, including ship construction standards, supervision and inspection, trial, quality assurance and other rights. The lessor, as nominal ownership, only bears payment obligation.

### 2.3.2.2 Main content of the ship sales and purchase contract

The terms of a ship sale and purchase contract include: basic situation of the ship, conformity of property rights and management rights, price and buyer's payment time and way, ship checking and delivery time and place, spare parts on the ship and remaining fuel belonging, seller's commitment and guarantee, liability for breach and dispute resolution on both sides.

In addition, a special agreement will also be made in the ship sale and purchase contract - rights in the contract are transferred to the lessee while the buyer only bear the payment obligation.

### 2.3.2.3 Main content of financing lease contract

#### 1) Description of leased ship

A leased ship is the core problem in the ship finance lease as it ties the lessor, the lessee and shipbuilder and relates to rights and obligations of parties. Generally speaking, the explanation terms of the leased ship shall be same as the indicators of ship listed in the shipbuilding contract.

#### 2) The lease term and rent

The term of ship finance lease is commonly 5 to 10 years, because a chief characteristic of financing lease is that if the lease term is too short the lessee has to pay a lot of rent in the short term which is not conducive for the financing to fully play, and if the lease period is too long the investment risk of lessor will be aggravated. The average calculation standard of rent is:  $(\text{ship price} + \text{commission} + \text{other expenses}) / \text{times of rent payable} + \text{interest}$ .

#### 3) Delivery and inspection of ship

In the ship finance lease business, the shipbuilding contract generally stipulates that the subject matter will be delivered to the lessee directly by the shipyard rental and the lessor does not undertake the obligation to receive the ship. In the terms of the

delivery of the ship, it should be stated that the rent ship is selected by the lessee and also the lessee is responsible for the acceptance of the vessel. If the ship quality is found defective, the lessee shall claim to the shipyard directly and the lessor assists.

#### 4) The use and insurance of ship

Generally the lessee operates, uses, maintenances, repairs the ship and bears the corresponding risks during the period of lease. Infringement to a third party in use shall be the responsibility of the lessee and the lessor is not liable. Moreover, the lessee needs to adequate insurance for the ship, including hull insurance and joining mutual insurance association, etc.

#### 5) Non-termination clause in midway

Commonly, the term regulates that ship damage does not affect the obligations of lessee paying the rent. If the ship is lost or unable to repair, the lessee shall pay all unpaid rent to the lessor.

#### 6) Ownership of the ship after the expiry of lease

This clause generally provides, after the expiry of the lease, the lessee may renew, cancel or buy the ship at a symbolic price or directly own it under the condition of paying all the rent.

#### 7) Liability for breach and dispute resolution

Usually it states the responsibility when the lessee refuses to perform the obligation of paying the rent, as well as the way of relief the lessor may take, for example, repossessing leased ship and asking for compensation or requiring the lessee to pay all the rent in advance. Dispute resolution clauses generally concern way to settle the dispute and choosing the applicable law and jurisdiction of the court.

Above are the main clauses of the ship finance lease. Additionally, the parties may agree on some other terms, such as financing lease guarantee, transfer of the lessor's right, etc.

## **2.4 Legal issues in the ship finance lease**

Since ship finance lease belongs to both financial business and shipping business, its uncertainty is bigger than that of ordinary business. Therefore, with the risks widespread, all kinds of controversies and disputes will inevitably occur in the ship finance lease activities. Uncertain factors may make costs and benefits of the ship financing lease change at any time, causing deviation of the expected results of the lessor or the lessee, and a variety of legal issues would appear in the ship financing lease.

From the ship finance lease itself, after financing and spending huge funds to buy a ship, the shipowner completely delivers the ship to the lessee who is unable to be directly intervened and controlled for use, which is the internal cause of the risk in the ship finance lease. The lessor only possesses the ownership of the ship, but he/she does not exercise the right of use. Moreover, the cycle of ship finance lease business is long that makes the rent repayment face unforeseen difficulties. Looked at external factors of the ship finance lease, the default of parties because of problems in the operation and the change of factors such as the economy, politic and the ship itself, all can cause great risks and results in the ship lease business. Additionally, current relevant laws and regulations in China are not perfect, which is the regularity risk for the further development of ship financing lease. A financing lease business may involve the financing lease contract, sale and purchase contracts, loan contract and guarantee contract. When a single contract is implemented, it is likely to be involved in disputes. Disputes in each kind of contract will even influence each other, resulting in the interests of all parties impaired (Bian, 2010).

Due to its complexity, a legal issue seemingly small in the ship finance lease could be involved in several areas. So, many laws and provisions need to be referred to solve the problem properly. This paper will analysis some specific legal issues in the

ship finance lease in detail in the next three chapters, including the ship finance lease registration, the arrest and auction of the financing lease ship and collision risk research of finance lease ship.

## **CHAPTER 3 Ship Finance Lease Registration System**

### **3.1 Ship registration**

Ship registration refers to the legal fact that people owning some rights with the ship, apply to state's authorized ship registration authorities and submit relevant documents, then the authorities approve, register for ships conform to the statutory conditions and issue corresponding certificates in the name of the nation. Although Ship belongs to movable property, it is managed as the real estate in China's legal system. "The establishment, modification, transfer and lapse of the right to property in respect of water-crafts, aero-crafts and motor vehicles without first being registered, shall not affect any bona fide third party." Thus, the establishment, transfer and elimination of ownership and jus in re aliena are applicable to registration system of special moveable property in the principle of public summons of right in rem. Article 9 and article 13 of Maritime Code and article 25 of RRS respectively regulates that ownership, the mortgage and demise charter of ship need to be registered in the ship registration authorities.

The implementation of ship registration, not only benefits to the flag state government supervision and management to the ships, but also provides various benefits of registration country for registered ships. More importantly, applicable law can be determined by the ship registration. From the perspective of private international law, the nationality of ship is an important connection point. The

acquisition, transfer and disappearance of the ownership as well as set, transfer and elimination effect of the mortgage and lease of a ship in the maritime law takes flag state law as applicable law.

### **3.2 Necessity of establishing shipping finance lease registration system in China**

Property rights relationship in ship finance lease is a new type. The basis of legal relationship of ship finance lease is the lease relationship with rights of possessing, using and owning the ship separately, but it is different from traditional leasehold relation.

Ship finance lease is similar to bareboat charter in the performance of the external form. They both appear that the lessor delivers the ship to the lessee and the lessee gets entire operation right, mans the ship and responses for the maintenance himself. Therefore, in the practice, ship finance lease registration is generally mutatis mutandis and applies for bareboat charter registration provisions.

However, compared to bareboat charter, ship finance lease has more strong property right features:

- 1) The lessor has the ownership but is a weakening ownership because the lessee enjoys the possession, use and earnings of the ship in ship finance lease. The aim of the lessor occupying the ownership is to get financing guarantee simply.
- 2) The rent the lessee pays is calculated by standard of lessor's total investment cost plus reasonable profit, not the consideration to possess and use the ship;
- 3) The lessee enjoys expired claims of lease ship's ownership (Guan, 2007).

Therefore, ship finance lease registration with the method of bareboat charter registration, strengthens the lessor's ownership in ship finance lease essentially,

which may damage the lessee's interest. For example:

In ship finance lease, the lessor has a nominal ownership and shall not establish the mortgage of the ship without prior written consent of the lessee during the bareboat charter period. However, it is not specified that the lessor cannot transfer the ownership. If ship finance lease registered in accordance with bareboat charter, the lessor may apply transfer registration to temporarily transfer to bona fide third parties in the financial need and thus financing lease right of the lessee would be under great interference.

When the lessor goes bankrupt, the financing lease with bareboat charter registration will have serious problems in confrontation. One of the characteristics ship finance lease different with traditional lease is "non-termination midway". Even if bankruptcy comes out, the lessor shall not affect rights of the lessee under finance lease contract and bankruptcy administrator shall not terminate the financing lease contract. Only the expected rental income can be listed as creditor's rights into the bankruptcy property. But financing lease with the bareboat charter registration can be a reason to the termination of contract due to the bankruptcy fact of the lessor, because bankruptcy administrator can apply for nullifying registration in accordance with regulations of bareboat charter registration. In this situation, the financing lease of the lessee is lost against a third party (Yang, 2002).

Visibly, registration of ship finance lease according to the provisions of bareboat charter is unable to cover the characteristics completely and fully show the credibility and valid of ship finance lease registration. Thus, establishing a system of ship finance lease registration is one of the problems that need to be solved in the ship finance lease industry.

Ship finance lease registration system can make right condition of the lease item to



the public to protect the lessor, the lessee and the third party in good faith effectively. After the publication of right by registration, on the one hand, the lessor gets protection to establish the priority of ownership. On the other hand, the third party can know the right change of the lease item from registration state before trading to protect interest and transaction security. Additionally, ship finance lease registration can also confirm the priority of relevant rights. The 190th article of Property Law specifies the solution principle of the lease and the mortgage right conflicts: *If a mortgagor leases the mortgaged property before the execution of mortgage contract, the original contract of lease continues in effect. If a mortgagor leases the mortgaged property after the establishment of right of mortgage, the lease may not defend against registered right of mortgage.* But, it is lack of reliable foundation when the lease is determined. The establishment of ship finance lease registration system could provide dependable basis for the time of determining the lease relationship.

### **3.3 Suggestion on setting up ship finance lease registration system in China**

#### ***3.3.1 Principle of registration separation of ownership and ship finance lease***

Based on ship finance lease contract, the ownership of the lessor and the financing lease registration of the lessee registered separately. If the financing lease registration of and ownership registration belong to different countries, the lessor should be allowed to register the ownership in the country of familiar ownership protection mechanisms. Since the lessor has already fulfilled almost all of the obligations after he/she completes the sale and purchase contract in ship finance lease, it is necessary to protect the lessor from the design of the regime. It should be indicated in the Certificate of Ship Ownership Registration and the ship Register Book that it is a finance lease (Feng, 2012).

### ***3.3.2 Formal examination adopted in ship finance lease registration***

The lessor and the lessee reach a ship finance lease business and then sign the ship finance lease agreement. This is the embodiment of "autonomy" principle in private law. The registration authority has no right to intervene and should not use administrative power to substantively exam the financing lease contract. As long as the state of right content in the financing lease is recorded in the Certificate of Ship Ownership Registration and the ship Register Book and published, and the third party can inform the fact of the state, the purpose of financing lease registration is achieved. The compensation liability of registration department, due to registration error, omission and false, may decrease under the method of formal audit (Peng, 2014). Meanwhile, the manpower and time cost reduces and the running speed of each administrative process improves, which also satisfies the principle of economic benefit and efficient administration.

### ***3.3.3 Limiting cancellation registration of ship finance lease***

"Non-termination midway "is the salient feature of ship finance lease different from traditional leasing. Therefore, cancellation registration should not be allowed in principle unless the ship finance lease contract expires or the lessor and the lessee reach a written agreement. Any one-side reason from the lessor or the lessee, for example the lessee proposes that his/her contract purpose cannot reach for the ship defective delivery caused by the lessor's negligence, cannot become the factor of cancellation registration for ship registration authorities, because the ship registration department is not the referee organization and in ship finance lease the main content that one party breaching leads to termination of the contract should not judged by the ship registration department.

#### ***3.3.4 Limiting registration of transference, alteration of the ownership and the mortgage in financing lease***

In ship finance lease, the lessor only retains the nominal ownership as a creditor's rights guarantee, but still appears as owner of the lease ship in legal. The weakening of ownership does not reflect on the certificate of ship ownership registration. From the perspective of protecting the lessee, it is needed to have restrictions on disciplinary right of the ownership of the lessor. Unless prior written consent of the lessee, the lessor is not permitted to transfer, change the ownership and establish the mortgage.

#### ***3.3.5 Extending validity of certificate of temporary nationality***

Since ship finance lease term is long in general which can even reaches the economic life of the ship, validity of the certificate of temporary nationality for finance lease ship according to one year of the temporary nationality registration or two years of the bareboat charter registration will bring inconvenience to the lessee's daily operations. From the perspective of the lessee's convenience, the validity period should be consistent with the certificate of nationality.

#### ***3.3.6 Broadening strict registration system***

In order to promote the development of ship finance lease in China, requirements of domestic capital ratio and crew proportion in the financing lease should be appropriately relaxed. The entry of the foreign capital is also good for foreign financing lease experience and regime at the same time.

In conclusion, the finance lease ship should be registered according to law to indicate the status of the ownership and use and obtain the effectiveness of against a third party. Only after perfection and complementary of current ship finance lease

registration system is it beneficial to the financing of the ship (Guo & Guan, 2012).

## **CHAPTER 4 Arrest and Auction of Finance Lease Ship**

### **4.1 Arrest of finance lease ship**

#### ***4.1.1 Brief Introduction of arrest of finance lease ship***

In ship finance lease transactions, the lessor needs to give the possession, use and earning rights of the ship to the lessee and keep disciplinary right only. The article 242 of Contract Law regulates the reclaim right of financing lease item, and the base in the ship finance lease business manifests the separation of the ship's ownership and possession, use and earnings rights. Nevertheless, the situation of arrest and even judicial auction of ship will be encountered in the maritime practice. Once the finance lease ship auctioned, the shipowner loses the ownership and also the reclaim right of the ship, which contradicts with the article 242 of Contract Law (Cai & Zhang, 2014).

Could finance lease ship be arrested? There is no perfect rule in China and only article 23 of SMPL proposes the provisions of demise charter ship arrested: the maritime court may arrest the ship concerned in the circumstance that the demise charterer of the ship is liable for the maritime claim and is the demise charterer or owner of the ship when the arrest is affected. There are various different kinds of ship finance lease and some forms of lease are not in conformity with the conditions of demise charter, so different situations should be distinguished to decide whether or

not arrest the ship.

#### ***4.1.2 Analysis of arrest of finance lease ship***

Since whether the finance lease ship can be arrested is based on the difference of the ship lease form, the diverse manifestations of ship finance lease must be specified firstly. In the Chapter 2, the six kinds of ship finance lease have been listed. In terms of arrest of finance lease ship, there should be no dispute for direct leasing and leaseback mode. Because the two modes conform to the provisions of arrest of the demise charter ship:

- a. the lessee is liable for the maritime claim;
- b. the lessee is the demise charterer or owner of the ship when the arrest is effected;
- c. there is demise charter agreement between the lessee and the shipowner, or the sublease is after the owner's written consent.

However, the way of sublease should be specially treated. In accordance with the provisions in article 150 of Maritime Code, if the ship was sublet under demise charter, the consent of the lessor in writing must be necessary. Without the consent, the subletting should be null and void. At the moment, the arrest of the involved ship in the form of demise charter is wrong and the applicant should be responsible for all losses of the ship arrested. If the lessor agrees sublease in the form of demise charter in writing, theoretically arrest is uncontroversial. In this situation, the lessor should and could foresee the potential danger of arrest of the ship by the maritime court due to the maritime claims caused by the lessee of sublease in the process of possessing, use and operating the ship, because the parties should undertake the corresponding legal responsibility for the consequences they can predict. Besides, the rent the sublease charterer pays to the lessor comes from the income of possession,

use and operation of the ship indirectly, so the lessor should bear the risk of profit when enjoying the benefits (Feng J.J, 2013).

In the entrusted lease, the trustee-trader signs the financing lease contract with the lessee in its own name and the client as the real owner pays to the trustee-trader. That is, in the ship finance lease business, the trustee-trader enjoys the rights and obligations directly and there is no client no financing lease agreement between the client and the charterer, which does not conform to the provisions of SMPL. Therefore, ship of entrusted lease shall not be arrested.

In the leveraged lease, only a small amount of the funds needed for purchasing the ship are paid by the shipowner and the other is provided by a third party. Fundamentally, leveraged lease and joint lease are both the combination of trust with financing lease. According to the provisions article 23 of SMPL, the finance lease ship shall not be arrested.

Thus, according to the provisions of the demise charter ship arrested in SMPL, theoretically, ships of direct lease, leaseback and sublease may be arrested while ships of turse lease, leveraged lease and joint lease shall not be arrested. It is expected that specific provision on arrest of finance lease ship can be made when amending Maritime Code or developing Financing Lease Law in the future. The arrest by the court could be carried out strictly and the arrest application of maritime claimant would be treated in accordance with the law (Feng J.R, 2013).

#### **4.2 Auction of finance lease ship**

Arrest of ship and forced auction of the arrested ship are different on purpose - the former does not lead to the latter necessarily. Arrest of ship as a judicial coercive measure is mainly the mean to force the shipowner or the demise charterer

responsible for maritime claims to provide maritime security to the maritime claimant.

Forced to sell the ship is a very severe civil coercive measure, which deprives the ownership of the shipowner. The impact to the shipowner is bigger than arrest of ship. Therefore, conditions of auction of the ship should be set properly and accurately from inherent characteristics of forced to sell the ship, in order to avoid error of application for forced auction of ship and protect the legitimate interests of the shipowner or demise charterer.

Article 29 and other provisions of SMPL made a relatively strict rule on conditions of auction of a ship. Forced auction of a ship shall meet the following conditions:

- a. the court sealed and arrested the ship of the person against whom a claim is made in the procedure of litigation preservation;
- b. the person against whom a claim is made shall be the defendant in the lawsuit or the respondent in the arbitration case, and responsible for the maritime claims except for maritime claims that involves the mortgage, ownership of the ship, possession or maritime liens;
- c. the person against whom a claim is made fails to provide security on the expiry of the time limit for arrest of a ship, and it is not appropriate to keep the ship under arrest,
- d. the maritime claimant starts a maritime action or applies for a maritime arbitration (Deng, 2008).

On the basis of the above provisions and article 3 of Provisions on Several Issues concerning the Application of Law in the Arrest and Auction of Ships by the SPC (2015<sup>a</sup>) "When ship is arrested for demise charterer responsible for maritime claims



and the maritime claimant applies for auction of the ship to pay off debts related to the ship management of demise charterer in accordance with the provisions of article 29 of SMPL, the maritime court shall give permission", the arrested financing lease ship can be judicially auctioned. Obviously, the ship cannot be operated during arrest period and it is difficult to achieve its use value. Instead, a great amount of supervision and maintain cost is needed and repayment ability of the ship is reduced, which will produce adverse effects on interests of the claimant and the person against the claim. Therefore, the auction of arrested financing lease ship can ensure the interests of both parties in some extent.

However, the auction of demise charter ship would damage the interest of the lessor (shipowner), because the purpose of forced auction of the ship is to continue the arrest by saving the proceeds of the ship and repay the debt with saved proceeds after entity dispute gets solved. The ship under demise charter is not owned by the demise charterer in the arrest and auction, but the preserved shipping price is used to repay the debt of operating the ship by the charterer and the innocent shipowner loses the ship. So, under the situation that ship may be arrested and auctioned, the shipowner in the ship leasing shall add sufficient guarantee clauses to avoid the risk of auction due to the debt during ship operation maximally.

Therefore, in terms of the current legislation, according to regulations on forced selling ship in China, financing lease ship can be forced auction. In the Ten Model Cases regarding Arrest and Auction of Vessels by Maritime Courts in China published in by SPC (2015<sup>b</sup>), the demise charter ship HOI CHI was forced auction for the debt of the charterer Hainan Longzhu Shipping Co., Ltd, and the legitimate right of creditor was guaranteed through the auction. In this situation, the demise charterer can be restricted not to get out maritime claims after violating the interests of the maritime claimant for the excuse of possessing no ownership of the leased ship.

Moreover, it is just stated in the context of article 29 "may apply for auction of the ship to the maritime court ", and it should not be concluded that the ship may be forced to sell as long as the applicant applies for auction by the content of the clause. Eventually whether auction of the ship could happen shall be executed by the court in accordance with the provisions of the law.

### **4.3 Conclusions**

To sum up, arrest of the financing lease ship is affected by the manner of financing lease. In the author's view, according to the provisions of Special Maritime Procedure Law on the involved demise charter ship arrested, ship could be arrested under the way of direct lease, sublease and leaseback, but it is not allowed for the turse lease, leveraged lease and joint lease. Furthermore, the arrested financing lease ship can be auctioned under current rules. Arrest and auction of financing lease ship are complex issues in maritime practice, and the feasibility of above analysis needs to be affirmed or corrected by future legislation.

## **CHAPTER 5 Risk of Collision of Finance Lease Ship**

### **5.1 Liability subject of collision in ship finance lease**

Maritime Code makes clear that the responsibility of a collision is afforded by the fault party. If the fault party is finance lease ship, cost and related responsibility of oil pollution disposal, wreck salvage and ship repair under the collision should be borne by the lessor or the lessee, or shared by both parties, there is not corresponding regulation explicitly in Maritime Code.

Whether shipowner, demise charterer and employer such as the ship operator and manager should be responsible for the faults of their employees and become the subject of collision liability in the case that the responsibility is made by collision of the ships they own because of employee's error within the scope of duty?

The article 130 of Summary of the Second Foreign-related Commercial and Maritime Trials Meeting (hereinafter referred to as "Meeting Summary") regulates "the shipowner is responsible for the collision, unless the ship is demise charter and registered in accordance with law. The operator or manager of the ship who is faulty for collision are jointly and severally liable with the shipowner or demise charter, but it does not affect the responsibility main body recovery. The shipowner refers to the body registered as the shipowner lawfully and the actual possessor of the ship if it is without registration in accordance with the law." (Qu, 2010).

When taking all of the above subjects as the main liability of a collision, it would

have both advantages and disadvantages for assuming liability from collision in practice. The advantage is that if the shipowner is a one-ship company or a company without solid financial strengths, the feasibility of compensation is small in the event of a collision which takes the owner as the main subject of compensation. Hence, when all of the above subjects are compensation subjects and the compensation ability of shipowner is insufficient, the collided subject could claim compensation against the other subjects so that interests of the collided can be effectively protected. Nevertheless, the disadvantage is that each subject may shirk its compensation liability to others in the name of no compensation ability itself and if the lawsuit is filed against the above all or part of the subjects cost of the infringed party would increase as there are various different liability subjects (Xiong, 2007). When the liability subject is limited to a single subject, it is convenient for the infringed party to look for specific compensation subject and when there are many liability subjects they will buy insurance in order to lower their liability risk which is an additional burden for company operation costs.

In ship finance lease, when a collision occurs, the lessee is likely to be the main responsibility for collision, and may also be the injured party. According to the provisions of article 130 of "Meeting Summary" and article 4 of Provisions on Some Issues about the Trial of the Cases of Ship Collision Disputes, the legally registered demise charterer shall bear the responsibility of the collision (SPC, 2008). But the lessor or the lessee of which should claim to the infringer for compensation if the ship on the voyage is collided by other ships? The author thinks that it should be the lessee. As the lessee has obtained rights of possession, use, actual operation and earning of the ship, he/she is entitled to acclaim against collision liability to pay compensation if the ship is collided by others. Actually, after the ship collided by the infringer, the specific creditor relationship of the infringer and the lessee, instead of

the real right, is formed. According to the principle of debt relativity, the charterer is entitled to acclaim against the infringing party for damage compensation.

Based on the provisions of Tort Liability Law of the People's Republic of China, the owner of subject shall require the tort liability to compensate for damage. The owner of subject here cannot be simply understood for the ownership. The possessor, manager and user of subject actually controlling the item shall all have the right to be the main body to file tort compensation (Ma, 2005).

Therefore, in the ship collision accident, the lessee not only has the right of claim against the infringer for damage compensation but also has to take the other claims if the lessee violates the interests of others in the shipping.

## **5.2 Oil pollution disposal under the ship collision**

Accomplished with the ship collision is likely to be oil spills from ship causing the fact of environmental damage. In such circumstances, whether the liability subject of collision or leakage should be attributable to the liability of the oil disposal is quite controversial.

In the oil spill accidents of collision, there will be two legal relationships of collision and oil pollution damage caused by ship oil spill. Since the oil spill is caused by the ship collision, collision is the reason for oil pollution damage legal relationship. But the two legal relationships should be applied to different legal bases. The fact of pollution damage is resulted from the fact of ship oil spill and not directly caused by the ship collision. The collision only causes ship damage and loss of the goods, which is applicable for laws and regulations of adjusting legal relationship of the collision.

Part of ship oil spill losses is loss of the items caused by oil spill of the owner of the

oil, and another part is loss for compensation because of pollution damage facts. The subjects to claim compensation and assuming liability of the two partial losses are different.

Article 130 of "Meeting Summary" regulates that the owner of the collision ship should assume proportion liability for compensation to the losses of owner of the spilled oil. The ship collision will not necessarily lead to marine oil pollution damage liability. Because if the leakage of the collision ship is water or other liquid without polluting there should be no oil pollution damage, and oil pollution damage is caused by the polluting property of the leaked oil itself. Thus, there is no direct relationship between ship collision and oil pollution, so the adjustment for the two different kinds of loss is required different laws and regulations, which could also avoid the occurrence of chaotic compensation claims.

It is universally recognized in international opinion that, time charterer and voyage charterer should not be the main responsibility for oil pollution damage in ship leasing, but opinions differ from country to country on whether the demise charterer should bear the responsibility or not.

CLC1969 adopted by IMO in November 1969 stipulates in paragraph 1 of article 3: "except as provided in paragraphs 2 and 3 of this Article, the owner of a ship at the time of an incident, or where the incident consists of a series of occurrences at the time of the first such occurrence, shall be liable for any pollution damage caused by oil which has escaped or been discharged from the ship as a result of the incident." (IMO, 1969). But the provisions at paragraph 4 of article 4 in CLC1992 states: "no claim for compensation for pollution damage under this Convention or otherwise may be made against: (c) any charterer (howsoever described, including a bareboat charterer), manager or operator of the ship".

BUNKER has come into force on China in 2009 and the Law Committee of IMO ascribes bunker oil pollution liability to the party of ship in the convention. But there are a lot of controversies about that "the party of ship" is the shipowner or the operator or any other actual managers of the ship. Some proposed that the shipowner shall be responsible for it, as the CLC1992 and HNS have made same provisions on it and the compulsory insurance can be guaranteed to carry out effectively.

However, other arguments consider the ship manager, ship operator and demise charter as the civil liability. In the management of ship nowadays, shipowners of registration often do not participate in the ship management and it is unfair for them to assume civil liability, which is not in conformity with the principle of "polluter compensation". The actual control of the ship shall assume the oil pollution liability. In order to claims of the claimant could be achieved, BUNKER defines registration owner of the ship, ship operator ship manager and demise charterer as civil responsibility, who is jointly and severally liable for oil pollution damage (IMO, 2001).

OPA 1990 of the USA also defines civil liability for ship owners, ship operators or demise charterers. This would make it easier for the operator or demise charterer to reduce the damage losses at the moment of oil pollution. The lease form of demise charter is different with time charter. The lessor rents the ship without manning to the lessee, and the manning, the safekeeping of the ship and equipment maintenance are all taken charge by the lessee while the lessor (shipowner) does not participate in the actual operation and management of the ship (Hu, 2011). In such cases, the lessee is equivalent to the actual shipowner, and the rights of the lessee during the lease term are strictly protected, excluding infringement of the lessor and the third party. When the oil pollution damage occurs, the lessee, as actual controller of the ship, is granted for liability and the occurrence of oil pollution damage should have direct

relationship with shipping operation. As the actual user, the lessee should check if oil is leaked before the ship departs and timely repair leaking section to prevent further spread of the oil pollution if there is a leakage in the process of shipping.

Under the finance lease relationship, the ship is in the actual control and use of the lessee all the time. In the event of the oil spill damage compensation, the lessor is required to bear relevant liability to pay compensation, in which fairness for the lessor is questionable. UCIFL specifies in paragraph 1 of article 8: "the lessor should not with the lessor's identity and the equipment to a third person for death, personal injury or property damage caused by the responsibility."(Du & Yang, 2000)

The same provision is in article 246 of Contract Law: "during the possession of the lease item, the lessee, the lease item caused personal injury or property damage to a third party the lessor is not liable." In the Financing lease law relationship, the ownership of ship tends to belong to the lessee after the expiration of the lease, so the compensation liability of oil pollution damage during the lease term shall be assumed by the lessee. According to the above two rules, the lessee of ship finance lease should be one of the liability subjects of oil pollution damage. In this way, the lessee can be urged to exercise the reasonable duty of care in the use of ship, and also the infringed party may start treatment of compensate issues with the infringer (the lessee) as soon as possible after the fact of oil pollution damage, in order to avoid the situation of which the lessor takes non-participation in the actual operation and management of ship as justifications and shirks its liabilities when the claimants prosecute in court (Diao ,2006).



## **CHAPTER 6 Suggestions on Ship Finance Lease Legislation in China**

Although the ship financing lease industry in China develops quite rapidly, there comes with a lot of legal issues in the ship finance lease business. The pervious several chapters only select and discuss a few legal issues in it, and more things needs to holistic consideration and effective implementation. Since finance leasing in China is still in the start stage, its healthy development can not simply rely on promotion of market forces and more actions from government such as the legal construction, preferential policy, regulatory measures are needed.

### **6.1 Improve relevant laws of ship finance lease**

#### ***6.1.1 Make special financing lease law***

Although the policy of Contract Law in 1999 ended the history of no legal basis of Chinese financing lease, the chapter of Financial Lease Contract in the law is a total of only 14 articles which are mostly the principled provisions and a lot of legal problems in financing lease is not involved, such as the qualification of the lessor, liability for defects of the lease item, termination of the financing lease contract halfway and so on. That is, the concrete operability of the terms about the financing lease in the Contract Law about is insufficient. In order to define the financing leasing positioning, standardize lease market and help the ship finance lease develop rapidly, corresponding financing lease law and the relevant detailed rules for the implementation and management approach must be issued as soon as possible.

In 2003, NPCSC listed finance lease legislation as the year's NPC legislation plan. The Finance Lease Law (draft), after several years of brewing and three revises, contains 6 chapters and 63 articles. The draft specifies legal characteristics different from the traditional lease that the lessor is not liable for warranty of defects of lease subject, non-termination midway in the finance lease contract and the lease item without registration shall not counter the third party bona fide. The draft details provisions of the nature, registration and business scope of the lease company, the rights and obligations of the lessor and the parties concerned, the applicable scope and public registration of the lease subject, the liability for breach of contract, the supervision of finance lease and so on, covering all or most of the finance lease business (Wang, 2009).

#### ***6.1.2 Revise current Maritime Code in China***

The Financing Lease Law, as the main basis of applicable law of the finance lease contract, can be considered as general law of ship finance lease. However, in view of the particularity of maritime transport, it is necessary to revise the current Maritime Code in order to make up for the application inadequacy of the general law.

1) Add a special chapter of "ship finance lease contract" in the Maritime Code, to define the third party's rights and obligations of the ship finance lease and regulate the unique maritime legal relationships in the ship finance lease. Drawing on the financing lease law (draft), the chapter should make special provision on the particular rights and obligations between the parties in relation with finance lease contract. For instance, in the transfer of the ship, the shipbuilder or the seller finishes the actual delivery directly to the lessee and undertakes the obligation of caution processing to trial of the ship for the lessee, at the same time the seller or the shipbuilder performs legal transition with the lessor for the transfer formalities of ownership of the ship. The legal effect of the maritime lien and possessory lien on

the lessor and the lessee of the ship should be clarified, as well as liability exemption for warranty of defects of ship and right protection for the lessor.

Clear rules and limits should be made that the charterer is banned to terminate the contract midway. Based on contractual nature of the finance lease, it is specified in the law that in the ship finance lease, even if the ship is lost or damaged due to the reason of force majeure, the lessee shall not terminate the contract midway and remove the obligation of paying rent and damage compensation unless it is based on that the lessor and lessee agree in writing to discharge the agreement, or shipbuilder or the seller does not fulfill its obligation to deliver the ship due to the fault of the shipowner, or the lessee's possession and use of the leased ship is disturbed by the claim right of a third party due to the fault of the lessor. If in view of the latter two reasons, the lessee and the lessor terminate the contract, and the lessee may claim compensation for damage against the lessor (Feng, 2012).

In addition, specific provisions should be made for maritime lien, possessory lien and affirmation of liability for oil pollution damage in the ship finance lease. In conclusion, ship finance lease should be taken as a separate legal relationship in the Maritime Code, and its particular maritime legal relationships shall be clear to makes the ship finance lease more complete and more systematical so that there are laws and rules to follow for the ship finance lease activities.

2) Modify provisions on arrest and auction of ship in SMPL and specify the arrest and auction of finance lease ship.

3) Revise the RRS and add registration announcement system of the finance lease ship. The principle of registration separation of ownership and ship finance lease should be established. The registration of transference, alteration of the ownership, the mortgage in finance lease should be limited as well as the nullifying registration

of ship finance lease.

### ***6.1.3 Perfect accounting law and tax law matched with ship finance lease***

No. 21 of Accounting Standards for Business Enterprises - Lease promulgated in 2006 distinguishes the finance lease with the business lease and stipulates the standard of finance lease. "At the expiration of the lease term, the ownership of the leased asset transfers to the lessee" or "even if the ownership of the assets is not transferred, but the lease accounts for most of the service life of the leased asset" can be both regarded as a finance lease. The standard also makes detailed provisions on accounting operation of the lessor and the lessee in the finance lease and changes the casual status of finance lease accounting confirmation before. However, the rule does not require unlisted companies to implement, so it needs a long time to promote in the finance leasing to verify the actual effect (Li, 2010).

In the tax policy, the current regulations on ship finance lease business income tax deduction in China is that the lease depreciates from the lease ship and the rent the lessee pays cannot be treated as expense deduction. In many countries worldwide, in order to encourage ship finance lease, depreciation is all done by using by financing lease the lessor and the rent is allowed to deduct pre-tax as production costs to reduce the lessee's costs.

The method of accelerated depreciation should be allowed in ship finance lease companies. Many countries in the world adopt accelerated depreciation as an important tax preferential policy to promote the development of ship finance lease. In the way of accelerated depreciation, depreciation is higher than the rent inevitably in the first few years of the ship finance lease and the lessor's paper losses can reduce income tax. If the lessor returns this part of the proceeds to the lessee, the lessee's cost of financing can be reduced to create a win-win situation for the lessor and the

lessee (Rui, 2007).

## **6.2 Other methods to promote the ship finance lease**

### ***6.2.1 Perfect the preferential policies of ship finance lease***

#### 1) Ship finance lease tax incentives.

The Capital Construction Funds system in USA regulates that the operator can retain an income in the form of fund to buy a new ship. If the income is used within a prescribed period of time, tax deferral will be acquired and it is equivalent to the government providing interest-free loans to the ship investment. China can draw lessons from the practices of the USA and other world shipping developed countries and impose or collect a lower tariff and value-added tax for the ships constructed abroad. As a result, capital cost of China's shipping enterprise can be reduced and the investment of the shipping industry will increase, making China's shipping industry more competitive.

#### 2) Ship finance lease finance subsidy policy

The Japanese government adopts financial preferential policies of "system lease" to support domestic ship finance lease business. The financial sector takes different approaches of capital investment, according to leverage of the discount and relief tax measures formulated by the industrial policies, credit guarantee and government procurement orders, to pull the ships lease financing and increase the social investment by cooperation with ship lease companies. The Chinese government can adopt the discount policy to leasing companies while the enterprises carry out technical innovation through financing of leasing company and leasing companies pull the bank loans, which can also exert the leverage of discount. This may lead to the development of both banking sector and ship finance lease industry in China.

#### 3) Ship finance lease insurance policy

Ship finance lease is a capital-intensive industry with great risk in every aspect. For certain risks financing lease company suffers such as political risk and default risk, the government should implement policy insurance to domestic enterprises, in order to ensure their economic interests. For instance, Japan protects the economic interests of the domestic leasing company when the lessee defaults by the way of government agencies signing contracts with the leasing company. Learning from Japan's experience, China should provide various forms of credit insurance business for domestic enterprises of doing ship financing business by the Chinese government agencies, to eliminate the worries of domestic investors (Zheng, 2004).

#### 4) Ship finance lease credit policy

For a long time, the British government supports the ship investment in the form of low-interest loans and the proportion of loans can reach 80 percent of the total price of the ship. From the current reality, obtaining loans from channels of both domestic and foreign is the principal sources of fund to buy ships for the shipping companies. So China government should provide shipping enterprises with more preferential policies to promote the development of shipbuilding and shipping industry, such as appropriately extending the shipbuilding loans repayment period, lower level of interest rates, increasing the amount proportion of loans in the total amount of investment funds and providing the adequate loan guarantees.

In a word, China should learn advanced financing policies and development experiences from the shipping developed countries in the world and take a variety of means of financing in ship export, domestic financing and shipbuilding subsidies into a whole to uplift the support efforts of the shipping industry.

#### ***6.2.3 Moderate supervision on ship finance lease***

The financial leasing supervision authorities in China include two departments of CBRC and MOFCOM. The dispersed situation of bicephalic management is not

conducive to the sustained and stable development of finance leasing industry, so a unified regulatory authority is needed. The author believes CBRC as the supervision authority of finance leasing more appropriate. The reasons are:

1) Shipping financing lease is to achieve the purpose of financing in the form of leasing-assets, which is the financial lease of taking ship as credit guarantee, so it has typical financial natures. Thus, the risk of the industry can be effectively avoided under the supervision and management of CBRC;

2) China has taken the ship finance lease as a financial business all the time, so it is more appropriate to be supervised by CBRC;

3) The finance leasing companies will continue to seek funds diversification, so it can adapt to changes better in the future if CBRC as the administration authority.

In the strength of supervision, the supervision of ship finance lease should be appropriate. The purpose of the supervision is to remedy the market defect with the involvement of the state power, so the intervention of the state power to the economic needs certain limits and exceed the boundaries to become leading role of the market. Moreover, the ship finance lease business has just begun to grow in recent years, so the purpose should take more consideration for how to protect and promote the development of ship finance lease industry (Zheng, 2012).

For the object of regulation, not all of the parties of ship finance lease are incorporated into the regulatory scope. Only the finance leasing company (the lessor) should be the supervision object.

For the determination of the regulatory content, the principle should be moderate supervision and financial risk control. Chief supervision and management should be focused on market access, business scope, risk control, internal control mechanism and market exit of finance leasing companies, to prevent the financial risks from

emergence and motivate its steady development.



## **CHAPTER 7 Conclusion**

With the development of global economic integration and the shipping market booming, ship finance market demand for money is becoming larger and larger while the funds provided by the traditional financing way are increasingly inadequate. So, ship finance lease becomes a widely adopted way of ship financing abroad. Financing lease in China began in the 1980 s. After a long-term slow development, finance lease business has already had a certain scale and increased significantly in recent years. The finance lease companies have to put the eye on aircraft, ships and other large equipments now, which also provides an unprecedented opportunity for the ship finance lease. Especially in response to the serious impact on the shipping industry by the global economic crisis, shipbuilding industry importantly related to shipping industries was listed as one of the top ten revitalization industries in China. These all provide a good external environment for the development of ship finance lease.

However, ship finance lease is still new in China still and in its beginning stage. It cannot simply rely on market forces to promote the development of the industry and more supports in all aspects from government are also needed. At the same time, the ship finance lease, as a kind of complex investment behavior, is different from the general equipment finance lease, making the ship finance lease more legal problems. This paper introduces ship finance lease as the starting point and discusses the

necessity of establishing ship finance lease registration system in the case of the ship registration system now with weak support for the ship finance lease business in China. Two legal problems in the ship finance lease are also studied. One is the arrest and auction of the ship finance lease, which cannot simply refer to bareboat charter ship but should be analyzed in accordance with the specific situation. The other one is collision risk analysis of the finance lease ship, including the liability of collision and the liability distribution of oil pollution caused by collision. It also needs to discriminate according to the specific circumstances. At the same time, in view of the existing ship finance lease law system in China, the author puts forward the corresponding legislative suggestions, in order to perfect the development of ship finance lease in China. Although the study is of great value itself, there are a lot of important aspects not discussed due to the limitation of the author's limited knowledge and restriction of conditions, for which the author feels quite sorry.

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