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## Study on the legal issues concerning the mortgage of ships under construction

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**WORLD MARITIME UNIVERSITY**

Dalian, China

**STUDY ON THE LEGAL ISSUES CONCERNING  
THE MORTGAGE OF SHIPS UNDER  
CONSTRUCTION**

By

**GE ZI YI**

**The People's Republic of China**

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

**MASTER OF SCIENCE**

**(MARITIME SAFETY AND ENVIRONMENTAL MANAGEMENT)**

2016

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## **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.

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## **ABSTRACT**

Title of the research paper: **Study on the Legal issues Concerning the  
Mortgage of Ships under Construction**

Degree: **MSC**

China has become the world's first-class shipbuilding country. While shipbuilding is not only a technology-intensive industry, but also a capital-intensive industry, the mortgage problems of ships under construction in shipyard is becoming increasingly complex.

This paper, firstly, defines the concept of ships and ships under construction, does a systematic analysis of the legal basis of the under construction ship, and then gives a brief description of the significance of the establishment of the ship mortgage for them.

Secondly, it mainly analyses the problem of the subject and object of ship mortgage. And then it discusses the ownership, the nature of the contract, and the mortgaged scope of ships under construction.

The third chapter of this paper is about the establishment, registration and realization of the mortgage of the ship under construction.

Finally, this paper analyses the lack of legislation in China, discusses the ship mortgage financing approach of ships under construction in the three provinces, and makes suggestions on China's legal application of the law applicable to the current status of the relevant laws.

**Key Words:** ships under construction, mortgage, registration of ships.

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## **LIST OF ABBREVIATIONS**

ABCYC	Agricultural Bank of China Yueqing City Branch
BCSLs	Bank of Credit Suisse Limited by Share Ltd
COGSA	Carriage of Goods by Sea Act
CL	Contract Law of P.R.C
CRRRVC	Convention related to Registration of Rights in Respect of Vessels under Construction
CWIETC	China Wuhan International Economic and Technical Cooperation Corporation
ESGC	Eastern Shipbuilding Group Co., Ltd.
G&S	Gold and Silver series ships
GL	Guaranty Law of P.R.C
GP	German Phoenix shipping company
GPCL	General Principles of Civil Law of P.R.C
MC	Maritime Code of P.R.C
MLPIL	Model Law of Private International Law of P.R.C
MTSL	Maritime Traffic Safety Law of P.R.C
MSA1894	Merchant Shipping Act 1894
MSA1995	Merchant Shipping Act 1995
MSA	Maritime Safety Administration
OGJP	Office of the people's Government of Jiangsu Province
OGLP	Office of the people's Government of Liaoning Province
OGSP	Office of the people's Government of Shandong Province
PL	Property Law of P.R.C
RRR	Convention related to Registration of Rights in Respect of Vessels under Construction
RGRS	Regulations of the People's Republic of China Governing Registration of Ships

SAJ 1974

Shipbuilder's Association of Japan 1974

WCB

Wuhan Commercial Bank

## **CHAPTER 1**

### **INTRODUCTION**

#### **1.1 Research background**

Shipbuilding is not only a technology-intensive industry, but also a capital intensive industry. Construction of a modern large-scale vessel often requires a large amount of money. In addition to paying the wages of workers, it is necessary for the shipyard to order a large number of raw materials and equipment. Therefore, funding is a vital factor in ship construction projects.

While the shipyard or the ship buyer rarely relies entirely on its own funds to pay for expensive price. On the one hand, it may not have the appropriate financial strength, on the other hand, even with strong financial strength, it fully relies on its own funds to complete the construction of the ship, which is not conducive to the transfer of funds. Therefore, the shipyard or ship buyer usually chooses the way of external financing to get most of the money it needs. External financing methods usually have the issue of stocks, corporate bonds, national policy bank loans, current capital loan of commercial banks, commercial bank ship project loans and ship financing lease.

Shipbuilding funds generally have two sources, one is that the buyer pays for shipbuilding which may cause the credit and loan of the buyer. During the shipbuilding market downturn, in order to win orders, shipyard probably will advance shipbuilding payment for buyers, after the delivery the buyer will amortize instalments which may generate shipyard credit and loan.

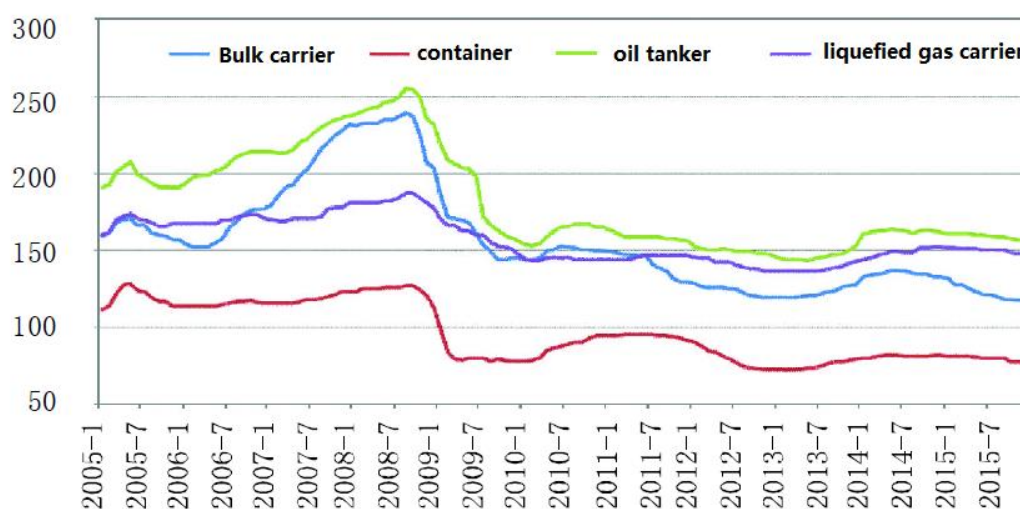
Whether it is the buyer credit or the credit of the shipyard, it is difficult to obtain a loan when there is no guarantee. Especially for our country, most of the shipbuilding enterprise scale is not large, fixed assets is limited or usually have been used for other debt guarantee. So a mortgage on ships under construction to obtain financing has become one of the most direct and effective way of guarantees.

The mortgage of ships under construction has gradually become a special form of shipbuilding financing guarantee. Therefore, it is very important to do some research on the mortgage of ships under construction.

## 1.2 The impact of global shipping market

The development trend of the international shipbuilding market has great impact on the ownership of ships under construction. Many factors will affect the trend of the international shipbuilding market. Besides the ship market inherent cyclical changes, the external changes of macroeconomic environment, the shipping market expected performance, and other uncertain factors will affect the market trends from different ways (Bao &Zhang, 2015).

Figure 1.1: The main changes in the global ship cost index trend



Source: Clarksons, 2015

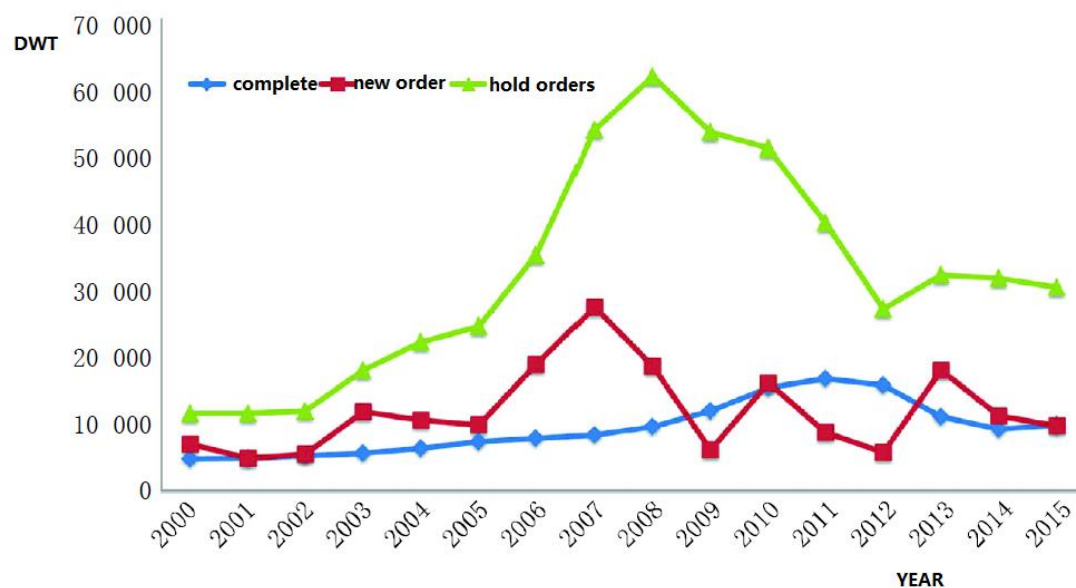
In recent years, due to the impact of the shipping market downturn, the main shipbuilding indicators indicate a continued decline trend.

At the end of December 2015, from the Clarksons new ship cost index, we can see that the index of bulk carriers is 117, drop 11.5%; container ship is 77, down 6.1%; oil tankers for 157 points, down 3.1%; liquefied gas ship for 148 points, down 2.8%. The trend of the global main ship cost index is shown in figure 1.1 (Yin &Xie, 2016).

From the Figure 1.2 we can see that three major indicators of the global shipbuilding industry have reached the peak during 2007-2009, and then dropped dramatically. Both new orders and holding orders keep a low level compared to several years ago.

It is worth noting that, although the number of new shipbuilding orders and handheld orders are maintained at a low level, the new orders are significantly lower than the hand held orders, only 1/3 of the hand hold orders. This means that the shipyard's liquidity will be more intense, and the pressure of their capital will be greater.

Figure 1.2: Three major indicators of the global shipbuilding industry trends



Source: CIMTEC, 2015

It is obvious that the mortgage of ships under construction is the inevitable demand of shipbuilding industry development. At the same time, due to the imperfect legal system, the financing institutions give a very cautious attitude to ships which use collateral financing methods (Tan, 2003). On the other hand, due to the lack of specific provisions of the operation, the maritime authority rarely registers the mortgage of ships under construction, which seriously affects the effect to carry out the mortgage financing. Thus, it is vital to do more research on legal issues concerning the mortgage of ships under construction.

### **1.3 The purpose and significance of the research**

Theoretically, this study summarizes the creation and the realization of mortgage on vessel under construction involved legal norms, theory, and so on. It analyses the mortgage setting of ships under construction, registration, legal application and realization way on the legal basis.

In judicial practice, it will be more conducive to the construction of the ship's mortgage dispute arising from the qualitative, while conducive to the effective implementation of the decision if related legal issues are clear and definite.

## CHAPTER 2

### An Overview of the Mortgage Right of Ships under Construction

#### 2.1 The concept of ships

##### 2.1.1 The concept of common ship

Laws or regulations all around the world are roughly the same about the concept of ships. According to the *Merchant Shipping Act 1894* of British, provisions of article 742 say that: ‘a ship refers to all that can be used for sea transport unit, but except the ship with the mechanical power of scull oar.’ (MSA, 1894). The 311<sup>th</sup> provisions of *Merchant Shipping Act 1995* stipulates that ‘a thing designed or adapted for use at sea and described in the order is or is not to be treated as a ship for the purposes of any specified provision of this Act’. And in the 313<sup>th</sup>, ‘Every description of vessel used in navigation’ (MSA, 1995). According to the *Carriage of Goods by Sea Act* of the USA, a ship refers to ‘Any vessel used for the carriage of goods by sea’ (COGSA, 1999).

But in China, the definition of a ship is a bit different. According to the third article of *The Maritime Code of the People's Republic of China*, ‘a ship as referred to in this Code means a sea-going ship and other mobile units, but does not include ships or craft to be used for military or public service purposes, nor small ships of less than 20 tons gross tonnage’ (MC, 1992). In *Maritime Traffic Safety Law of the People's Republic of China*, ‘Vessels means all types of displacement or non-displacement ships, rafts, seaplanes, submersibles and mobile platforms’ (MTSL, 1983).

According to the domestic and international law, it can be seen that a ship in maritime law refers to the floating device at sea. That means ships under construction cannot be considered as ships.

### **2.1.2 The concept of ships under construction**

On the ship under construction or unfinished ship, each country or organization does not give a unified definition.

Despite China's Maritime Code stipulates: 'ships under construction can set the mortgage', but what is a ship under construction is not made specific provisions in the relevant chapters. A vessel under construction is a thing that is being constructed or not yet completed. In other words, it is only after the completion of construction that it can be seen as a ship, but it takes time.

At different construction stages, the scope and quantity of property of ships under construction is also different, which is changing through the building process. At the same time, its value increases with the construction process. Therefore, the definition of the ship under construction should be able to reflect its special features.

Then, how to define the ship under construction? According to the eighth article of *Convention related to Registration of Rights in Respect of Vessels under Construction*, the domestic law may stipulate that the right to register the ship under construction shall be attached to the area in shipyard, and the materials, machinery and equipment to be installed on a certain vessel shall be clearly indicated by marking or other methods (CRRRVC, 1967).

In China, the definition of ships under construction by MSA in *Regulations of the People's Republic of China Governing Registration of Ships* is that it has been placed on the keel or in a similar construction stage (RGRS, 1995). While in German law,



they treat ships under construction are ships which are not yet built, or not left the ship berth are ships (Tang, 2003).

The views of various countries' laws and international conventions, basically are summarized from shipbuilding physical state or build time to determine the concept of ships under construction. From the view of time, some accept the existence of ships under construction from the ship contract was established, some are not accepted until the keel of ship is laid down. Ships under construction are in the process of changing; in the physical form they are a series of shipbuilding raw materials and equipment combination.

Ships under construction belong to a collection of objects, and it is difficult to think from a point in time to identify whether ships under construction exist. Using a point in time as a concept of ship starting built and the definition of construction standard cannot fully reflect characteristics of ships under construction. Nevertheless, using a certain period of time as foundation, from ships under construction in the scope of the subject matter to set the definition is more reasonable.

## **2.2 Meaning and characteristics of the mortgage of ships under construction**

### **2.2.1 Meaning of the mortgage of ships under construction**

According to article 11 of Maritime Code (MC), the right of mortgage with respect to a ship is the right of preferred compensation enjoyed by the mortgagee of that ship from the proceeds of the auction sale made in accordance with law where and when the mortgagor fails to pay his debt to the mortgagee secured by the mortgage of that ship (MC, 1992).

According to provisions of article 33 of *Guaranty Law of People's Republic China* (GL), the mortgage refers to the debtor or a third party without transferring the possession and provide security for the property, when the debtor fails to perform his obligation, shall be entitled to enjoy the guarantee of property appraise and priority rights (GL, 1995).

Since our country does not make a clearly definition on mortgage of ships under construction. Therefore, according to the ship mortgage of ML and the mortgage of GL, we can make the definition of ships under construction. It can be understood that ships under construction provided to mortgagee for the mortgage by the mortgager as debt guarantees, when the mortgager fails to perform the debt, the mortgagee has the right to distressed exchange the ship under construction by guaranty of mortgage debt, or from the auction, the proceeds from the sale of the construction price of ship priority in compensation rights.

### **2.2.2 Characteristics of the mortgage of ships under construction**

First of all, ships under construction and general ships have many common characteristics. The commonness of unfinished ships in the mortgage and common ship mortgage is unfinished ship mortgage and the mortgage of ship is set up in order to ensure the realization of creditor's rights, and secured creditor have subordinate relationship.

The right of mortgage is accessory rights, while the creditor's right secured by the mortgage is the principal right. When the principal right is invalid or does not exist, the mortgage of the ship cannot exist; the main creditor's rights transfer, the mortgage will also be transferred; the main creditor's rights will be eliminated, and the mortgage will be eliminated (Ke, 2007).

At the same time, mortgage of ships under construction and the general mortgage also have big differences. As the object of ship mortgage, the ship has certain characteristics. But during the construction phase, the object of the right of mortgage on ships under construction is uncertain. The shape of ship is changing, from the beginning shipbuilding dispersed materials, such as steel, mechanical and electrical equipment become into a complete ship, it is to go through a process of change.

What's more, the effectiveness of the mortgage on ships under construction is not unalterable, it changes with the construction progress dynamic extension of the construction of various stages. As Wang states in her paper, 'The dynamic nature of the validity of the mortgage, which is determined by the dynamic nature of the object, is one of the characteristics of the mortgage of the future object' (Wang, 2005).

### **2.3 Significance of the mortgage of ships under construction**

Mortgage on ships under construction is the mortgager to achieve continued construction funds of ship loans and to achieve its legitimate means of ship construction contract and credit certificate, along with ships under construction investment assets without transferring the possession of the mortgaged to the bank as a creditor guarantee. When the debtor fails to perform his debt, the creditor shall have the right to discount the property in accordance with the law or the price of the sale of the property by auction or sale shall be paid in priority (Liu, 2003).

It has important practical significance in the way of mortgage of ships under construction, and this practice has been recognized in many countries, and has established the corresponding construction ship mortgage system in the relevant legislation.

## **CHAPTER 3**

### **Subject and Object of Mortgage of Ships under Construction**

#### **3.1 Analysis on the ownership of ships under construction**

A mortgager is the person who must have right to dispose the collateral, and the titleholder of property or its authorized person, and whether it is both of which, the rights are derived from the ownership.

When a ship is built as collateral, it is different from the general mortgage. In addition to the constant changes in property conditions, the ship building materials may be derived from the buyer, or raw material suppliers in the shipyard. They will retain ownership of the raw materials and machinery until the payment is made, and may also include raw materials and machinery and equipment which have been paid in full, but have not yet been delivered.

In this way, we cannot confirm that ships under construction as collateral that property rights are owned by the shipyard or the builder of all. Whether the ownership of ships under construction exists determines whether the mortgage of the ship is established or not. In other words, the ownership of the ship is a key issue to decide whether or not the mortgage of the ship is established.

According to the principle of autonomy of private law, the parties should be allowed to agree on the ownership of ships under construction of the contract.

The 7th provisions of the standard format shipbuilding contract in Shipbuilder's Association of Japan (1974), Title to and risk of loss of the vessel shall pass to the buyer only upon delivery and acceptance thereof having been completed as stated above; it is expressly understood that until such delivery is effected, title to and risk of the vessel and her equipment shall be in the builder (SAJ, 1974).

According to the 31<sup>st</sup> article of new building contract of *The Baltic and International Maritime Council* (BIMCO), 'Title and risk of loss of or damage to the Vessel shall rest with the Builder until exchange of the Protocols of Delivery and Acceptance is effected, immediately upon which title and risk shall pass to the Buyer' (BIMCO, 2007).

In the UK, shipbuilding contract usually includes ownership transfer clause, after the buyer pays the first instalment payment, ships under construction (including building part, all materials and components) that belongs to the purchaser. The shipyard only has the right of lien in the premise during the ship continues occupation.

In the shipbuilding contract of Germany, the parties can make free agreements on the ownership of ships under construction. As agreed ships under construction is the property of the buyer, the shipyard will have the right of lien if the buyer does not perform the payment obligation; when the agreed property is owned by the shipyard, the shipyard can set mortgage on ships under construction as to the buyer to provide performance guarantees (Lennart, 1983).

In practice, China's ship export generally refers to SAJ 1974, combined with the current status of China's shipbuilding industry, title to and risk of the ship, shall pass to the buyer only upon delivery thereof (Lennart, 1983), which means the ship under construction (or has been built but not been delivered) owned by the shipyard, owned by the buyer until delivery.

In China, the 14th article of maritime code and 188th provisions of property law regulate that ships under construction can be set mortgage. But currently, no existing law clearly define the ownership of ships under construction. According to article 25 of the maritime code, we can only infer that if ships under construction owned by buyer, the ship builder will have the right of lien; on the contrary, if the ships under construction owned by the ship builder, or there are other co-owners, the right of lien does not exist.

In summary, under the guidance of the principle of autonomy of private law, ownership of ships under construction should respect the freedom of agreements between the parties, both ex ante and ex post. If before the dispute, the parties on this issue does not make an explicit agreement in contract, and after the dispute does not reach an ex post efficient protocol case, the ownership of the ships under construction should be determined by the legal nature of the contract.

### **3.2 Analysis on the nature of ship construction contract**

Concerning the contract nature of shipbuilding contract, legal and academic mainly have two kinds of views, one is that the shipbuilding contract is sale contract, the other is processing contract.

For the nature of the contract, different countries have their own identification and practices. In the UK, contract about construction and sale of ships are incorporate into sales contract. The law of Norway, Sweden also considers shipbuilding contracts as sales contract, ownership and risk of the ship will not transfer to the buyer until delivery (Yang, 2007).

The 559<sup>th</sup> provision of the Japan civil code says that the legal principle of the sales contract is also applicable to the processing contract. Japan believes that the nature of

the shipbuilding contract does not require legislation to define. It is well known that unless the construction has been completed before the signing of the contract, it is a processing contract. So in Japan, the shipbuilding contract is regarded as the processing contract (Chang, 2003).

This paper argues that it is not easy to give the definition of a shipping contract if it's a sales contract or a processing contract because of its complexity. As mentioned above, most of the ships built by the shipyard are designed and built in accordance with the requirements of buyers. During the process of construction, the shipyard should use the money paid by the buyer to purchase equipment and raw materials, and accept the supervision during the construction process of the ship. This process is like processing contract mostly. In fact most shipbuilding contracts stipulate that the builder should provide materials, therefore, most of the shipbuilding contract should have the dual nature of sales contract and processing contract.

It is considered that the person who provides construction materials can be used as a criterion to determine the nature of the ship construction contract.

Firstly, buyers pay the ship building cost, and the builder buys equipment and raw materials according to the requirements and standards of buyers. It is a typical processing contract, and the ship under construction is owned by the buyer without question.

Secondly, shipbuilding contract shall be deemed to be a processing contract if the buyer provides all or most of the shipbuilding materials. Ship builders possess materials and have obligations to achieve requirements of the contract. The ship under construction is owned by the buyer, after the completion of the construction, the ship should be delivered to the buyer. At this time, if the payment is not fulfilled, the ship builder has the right to retain the ship before delivery.

Thirdly, building contract of the ship should be regarded as a mixture of processing contracts and sales contract if all or most of the materials and equipment for the ship's construction is offer by shipyard. At this time, the terms of the rights and obligations of the shipbuilding contract shall be governed by the law of processing contract, and the terms of passing of title shall apply to the law of the sales contract.

### **3.3 Analysis of mortgaged scope**

#### **3.3.1 Regulations of different countries**

The German law regulates that the mortgage effectiveness of ships under construction are as follows;

- (1) Building part;
- (2) Equipment;
- (3) The components are clear and identify for the ship.

In addition to components within the scope of ownership of the newly built ship owner, if the owner has a special insurance during construction, the insurance claim also belongs to the subject matter of the mortgage.

Although the UK does not has mortgage system of ships under construction, they treat ships under construction as a general movable property to set mortgage. And they allow the mortgage of the ship effectiveness to govern the owner in the shipbuilding contract, and all the interests and rights included in shipbuilding contract (Lennart, 1983).

In Greece, the mortgage is based on newly registered ships under construction and materials, machinery and equipment. According to the Greek law, the materials and other equipment in the shipyard are not affected by mortgage, unless the equipment is described and confirmed in the mortgage contract.



According to article 8 of *Convention related to Registration of Rights in Respect of Vessels under Construction*, the national law may provide that the registered rights on a vessel under construction shall attach to materials, machinery and equipment which are within the precincts of the builder's yard and which by marking or other means are distinctly identified as intended to be incorporated in the vessel (RRR, 1967).

In China, article 6 of *Maritime Code* amendments stipulates that ships under construction referred to in the preceding paragraph, means ships in possession of shipbuilders and particular ship materials, machines and equipment in general have been identified will be used for the construction, but to completed construction in accordance with the provisions of article 3 of this code. (MC, 1992) In 1944 *Regulations of the People's Republic of China Governing Registration of Ships* published by MSA point out that ship under construction means a ship that has been placed in a keel or in a similar stage of construction. Accordingly, under the legislation of our country, mortgage of ships under construction should at least the ship which has been placed in the keel in similar construction stage (RGRS, 1994).

### **3.3.2 Analysis of mortgaged subject**

According to the principle of *Guaranty Law* of China, from mortgage validity view, the mortgage right effect extends to the collateral, fruits and subrogation respectively. Regardless of the ownership of ships under construction belong to buyer, ship builder or both, it will not affect ships under construction as a whole to be mortgaged. The mortgagee is usually a bank, finance leasing company and other financial institutions to provide financing for ships under construction.

Secondly, in the fruits aspect, since ships under construction does not have use value, it is not possible to produce general interests, such as rent, freight or other income, the validity of ship mortgage may not natural in this implementation.

At last, in subrogation claims, 58<sup>th</sup> article of *Guaranty Law* says that the rights of the mortgagee cease to be effective when the mortgaged property ceases to exist, compensation received for the loss consequently suffered shall be treated as mortgaged assets. While 20th article of Maritime Code stipulate that the effect of the mortgage is reduced to the insurance compensation after the loss of the ship. In general, the civil law of all countries advocate that the subrogation of mortgage is over claim for compensation. Therefore, this provision is obviously flawed, and it should be corrected.

Whether equipment and raw materials are mortgaged subject matter in some special cases is worth discussing.

#### **3.3.2.1 Materials delivered to shipyard and shipped**

In accordance with the Article 72 of the *General Principles of Civil Law of the People's Republic of China* and Article 133 of *Contract Law of the People's Republic of China*, if there is no stipulation by law or parties, ownership of these machines, equipment and materials has been transferred since the delivery. At the same time, if the on-board action makes them become a part of the ship under construction, it should also belong to the scope of the subject matter of mortgage.

#### **3.3.2.2 Materials delivered but not yet shipped**

The ship under construction is a collection of movable property, that is a collection of materials, machinery and equipment used in construction. It must be emphasized that these materials, machines and equipment must be clearly indicated in some way to be used in a particular ship. That is obviously distinguished from other kinds of ships.

Otherwise, it cannot be considered as the object of the mortgage of ships under construction, because it is necessary to exclude the possibilities that the ship builder may build several ships at the same time.

#### **3.3.2.3 A purchase agreement signed but not yet delivered**

Although a purchase agreement has been signed with the materials, equipment, machinery suppliers, and fully paid the price, but not yet delivered. The ownership of materials, machines and equipment transfer has not yet occurred, cannot be identified as ships under construction mortgage subject matter scope.

#### **3.3.2.4 Signed ownership reservation**

The supplier signs the ownership reservation clause with the ship builder or the owner, and the ownership shall not be transferred until the payment has been made. At this time, before the final payment, regardless of the ship builder or buyer is unable to obtain the ownership or entitled to set mortgage. So it does not belong to the mortgaged subject matter scope.

## **CHAPTER 4**

### **Establishment, Registration and Realization of the Mortgage of Ships under Construction**

#### **4.1 Establishment of the mortgage of the ships under construction**

##### **4.1.1 mortgage with ownership**

In accordance with the civil law, real right is divided into two categories, ownership and fixed limit real right. Ownership means that owners have the right to possess, use, profit and dispose from their own property. At the same time, fixed limit real right is based on ownership.

As mentioned in chapter 3, legal nature of the contract is the key point to determine the ownership of the ships under construction. When it comes to ships under construction, there are two kinds of contract. One of the shipbuilding contract is sale contract, the other one is processing contract.

##### **4.1.2 Setting time of the mortgage**

In addition to the ownership of ships under construction, setting time of mortgage is also required to specify. This is because the setting time of the mortgage of ships under construction directly affects when the shipyard will obtain the needed capital during construction project.

Because of schedule and benefits concerns, the shipyard often expects the mortgage to be established as early as possible. However, if ships under construction will be able to set up the mortgage when the ship's construction has not yet begun, or only a very small part has been built, the creditors will need to bear relatively large risk. According to article 188<sup>th</sup> of *Property law of the people's Republic of China*, 'a vessel or aircraft under construction are mortgaged, the mortgage right shall be established from when the mortgage contract comes into effect. If the mortgage has not been registered, the parties concerned may not challenge any bona fide third party' (PL, 2007).

In other words, the time of the mortgage of ships under construction is the time when mortgage contract takes effect. Such a provision also implies that in practice the registration of mortgage is not effective condition on mortgage of ships under construction. If the registration of the mortgage after its setting, that is, after the mortgage contract is valid, it will not affect the mortgage itself (Zhang, 2007).

## **4.2 The registration of the mortgage of ships under construction**

### **4.2.1 Legislative status of mortgage registration**

As mentioned in 4.1.2, *Property Law* of China has made regulations about mortgage registration, but it does not explain under what circumstance the mortgage contract of ships under construction will come into force. At the same time, the ships under construction shall be applicable to the 43<sup>th</sup> article of *Guaranty Law* 'Where other types of property are mortgaged, the parties involved may voluntarily register the mortgaged property. The mortgage contract takes effect on registration.' (GL, 1995).

That is to say, if people on both sides of mortgage on ships under construction only signed a mortgage contract but not yet registered, the mortgage set up between the

two sides is still effective but cannot take the right to fight the third people's request. Of course, the establishment of the mortgage is to achieve priority to other creditors of the effect on compensation. Although, there is no mandatory requirement to make a registration, the parties especially the mortgagees are willing to carry it out.

*Maritime code* also mentions about it. The 14<sup>th</sup> article of MC says that ‘Mortgage may be established on a ship under construction. In registering the mortgage of a ship under construction, the building contract of the ship shall as well be submitted to the ship registration authorities.’

Regulations of the *People's Republic of China Governing the Registration of Ships* promulgated by the State Council in 1994, also have some provisions about it. In the 20<sup>th</sup> section, the registration of the mortgage on ship shall requires to submit the written application form signed by both parties, the registration certificate of the ownership of the ship and the contract for the construction of the ship and the mortgage contract of the ship. Due to the *Maritime Code* is the superior law of RGRS. Therefore, in accordance with the requirements of Article 14 of the *Maritime Code*, the ship construction contract is a necessary document for the registration of the mortgage of ships under construction. Moreover, according to the provisions of RGRS, the ship ownership registration certificate and the ship construction contract is an alternative choice. As long as there is a ship construction contract, the parties will meet its requirements. Of course, the ship mortgage contract is also indispensable (Tan, 2008).

Therefore, we can consider that at present in our country, to obtain the ship construction contract and the ship mortgage contract is the premise of the mortgage registration of ships under construction.

#### **4.2.2 Required conditions of mortgage registration**

According to article 4 of *Convention related to Registration of Rights in Respect of Vessels under Construction*, registration of rights in respect of a vessel which is to be or is being constructed shall be permitted when a contract for the building of a properly specified vessel has been executed or the builder declares that he has decided to build such a vessel for his own account.

However, the domestic law considers that laid down keel or completed similar construction projects as the registration conditions. Accordingly, there are two options in respect of timing and conditions for the application for registration of ships under construction of contracting states. Firstly, in the domestic law, the provisions of the application for registration of ships under construction must have been placed keel or similar construction projects completed. Secondly, follows the provisions of convention, as long as a building contract has been signed or builder declares that he has decided to use its own funds to build the ship, the ship under construction shall be registered.

Different countries have different regulations on this issue. The law of France and Italy regulates that registration must before the start of the construction. Maritime and inland waterway law in Socialist Federal Republic of Yugoslavia regulate that registration maybe done at any time during construction, and construction begins when the kneel is laid or a similar operation carried out (Malcolm, 1982).

According to the ship registration conditions on several issues of the People's Republic of China released in 1994 by former Harbour Superintendency Administration, defined the ship under construction as a ship which has placed the keel or at a similar stage of construction of the ship. Article 4 of this regulation stipulates that as the mortgage of ships under construction, as for block construction, ought to have been completed at least more than a ship section and during the stage of construction; as for the whole building, the keel must be laid and still in the

construction phase. This provision complies with the spirit of the international convention.

#### **4.2.3 Validity period of mortgage registration**

The term of validity of the mortgage registration concerning ships under construction, refers to the effective period to realize the priority of compensation owned by mortgagee of ships under construction. Due to the specific subject matter, the mortgage of ships under construction is not only restricted by legal or contractual, but also affected by the collateral.

When the ship is finished and delivered to the owner, the mortgage of ships under construction is still valid. This is because, if it is determined that after the ship was built and delivered, the mortgage of the ship under construction will automatically fail, which will result in the bank's mortgage on the ship under construction lose power to against the other creditors of the mortgager. (Sun, 2007) This will increase the risk of the lender, and it is contrary to the legislative purpose of the ship under construction can be set mortgage.

On this issue, safety of transactions must be considered. It is possible that after the delivery of the ship, the buyer will resell the ship, and the corresponding vendee probably doesn't know that there still exists mortgage on ships under construction. In other words, after the delivery of the ship, the mortgager and the mortgagee shall jointly apply to alteration of ships under construction mortgage registration, otherwise mortgage of ships under construction cannot be against bona fide third parties.

### **4.3 The realization of the mortgage of ships under construction**

#### **4.3.1 Realization condition**



In China, the *Maritime Code* didn't address the conditions of the realization about the mortgage on ships under construction. Thus, we need to analysis the *Guaranty Law* and *Property Law* with the corresponding content.

According to the 53<sup>th</sup> article of the *Guaranty law*, there are two realization conditions about the mortgage of ships under construction: first is the debt discharge period expires: second one is the mortgage is not paid off. According to article 195<sup>th</sup> of the *Property Law*, the mortgage of ships under construction is mainly divided into two kinds. The first one is that the obligor fails to pay his due debts. The second kind of situation is that any circumstance as stipulated by the parties concerned for realizing the right to mortgage really happened.

It is clear that the provisions of *Guaranty Law* belong to the former case *Property Law*. According to the 178<sup>th</sup> article of *Property Law*, where any provision in the *Guaranty Law* conflicts with that of the present law, the latter shall prevail. So, at present, the realization condition of the mortgage on ships under construction in our country is the content of the 195<sup>th</sup> article of Property law.

#### **4.3.2 Realization way**

According to China's *Maritime Code* and *Guaranty Law*, realization way of ship's mortgage mainly includes auction, sale or discount respectively. However, it is not appropriate to realize the mortgage of ships under construction in ways of auction, sale or discount.

Firstly, the ship is designed and built according to the requirements of the buyer. For example, a shipping company will purchase vessels to open up a new route for bulk cargo transport, and other shipping companies may not have such a need. Therefore, when mortgager breaks the contract and the mortgagee want to sell collaterals,

whether or not the completion of the construction of collateral, other people may not be interested in it. Secondly, the exchange value of ships under construction is lower than the finished one. It is also very difficult to make up the mortgage loan through the auction or sell. At last, the main business of bank is not shipping business, they usually do not expect to get the ownership of ships under construction. At the same time, because banks do not understand the status of the shipping industry, it is difficult for them to decide to finished it or sell it. Therefore, the realization of the mortgage concerning ships under construction needs other feasible ways.

There is a great difference between the object of the mortgage on ships and the object of the mortgage on ships under construction. Based on the particularity of the mortgage of ships under construction, several aspects should be considered in the realization of the mortgage right by the mortgage contract parties. Firstly, is to use mortgage facilities including equipment and mortgaged workers to continue ship construction until completion. Secondly, it is to use the facilities of the mortgager but not use its workers, continues to ship construction until completion and requests the mortgager to give assistance. Thirdly, it is to transfer the part of completed parts to other locations, in order to complete the construction (Zheng, 2002).

The similarity of these three ways is that all of them try to keep the mortgage to the completion of the ship construction until the ship get the maximum value. In this way, the impact of low value in exchange can be avoid, and will preserve and improve the value of collateral extremely. At the same time, although the bank will pay additional management fee, but these costs can be enjoyed priority in compensation from the changing price of the ship. Therefore, if these methods can be used in the actual operation, the financing function of the collateral will operate more effectively. This is good for both the bank and the shipyard.

## CHAPTER 5

### Current Situation and Suggestions on the Application of the Law

#### 5.1 Limitation of the legislation

In China's *Maritime Code*, there are no related mortgage regulations on ships under construction. The regulations concerning the mortgage of ships under construction is only provided with first item of the article 14<sup>th</sup>: The ship's mortgage can be set up during the construction of the ship. At the same time, it does not explain the definition of ships under construction. Also it regulates that ships under construction for mortgage registration, should also submit ship construction contract to the ship registration authority, but does not specify the nature of the ship construction contract.

In *Model Law of Private International Law of the People's Republic of China*, the law only applicable to the mortgage of the ship, while the application of the law on mortgage of ships under construction is not mentioned. Although China's *Maritime Code* sees ships under construction as ships, but the law of ship mortgage used in the mortgage of ships under construction is not appropriate. The mortgage of the ship under construction should have its own legal selection rules to guide the disputes.

In order to solve disputes of ships under construction arising in financing construction process, China should fill the legislative defects in *Maritime Code*, by increasing the applicable legal provisions of the mortgage on ships under construction.

## 5.2 Corresponding measures

### 5.2.1 Mortgage financing measures in some provinces

Office of Jiangsu Province promulgated the *Jiangsu Province ships under construction mortgage financing pilot approach* on June 27, 2006; Shandong Province is on January 31, 2007 promulgated the *Shandong Province ships under construction mortgage financing pilot scheme*, while Liaoning Province established *Interim Measures for the mortgage financing of ships under construction* in December 14, 2007. All these measures put their own scope of application for the shipbuilding industry priority support of key enterprises in their own province, and focusing on the ships under construction mortgage financing related activities.

These measures include the import and export Bank of China and the general commercial bank into the scope of the mortgage. Compared to the provisions of Shandong Province, Jiangsu adds large foreign trade companies and guarantee corporation as a viable mortgage. As an appropriate attempt to expand financing channels, the provisions of Jiangsu Province are relatively appropriate on the actual operational level. (OGJP, 2006)

The 9<sup>th</sup> article of Liaoning Province measure requests the mortgager to submit the articles of association, board members and the resolution of the board of directors, as well as financial audit reports and financial statements of the last nearly 3 years. If the enterprise did not open for 3 years, the latest financial statements and the annual financial audit reports since the date of the establishment should be provided (OGLP, 2007). Such requirements are basically consistent with the securities law for the company to apply for the issuance of bonds, which draws on the practical experience of China's current financial market and financial operation, but also takes the usual shipbuilding financing cycle into consideration. It is necessary and effective to risk prevention on ships under construction mortgage financing.

Shandong Province requests the mortgager to provide shipbuilding contract text, ship building insurance documents, the economic benefit analysis of the project, project cash flow statement and the mortgage documents of ships under construction ownership in paragraph 6 to 10 of its 8<sup>th</sup> article. However, if the contract between buyer and builder is signed as usual the mortgage documents of ships under construction ownership should be included in shipbuilding contract, so requirement 10 will be repeated with requirement 6. Because our country has not established specific laws and regulations concerning the ascription of the ownership yet. If buyer and builder do not reach an agreement, difficulty of the mortgage loan financing procedures will increase as well as the mortgage setting time will be deferred relatively, the mortgage may even not be established or in force in the reality (OGSP, 2007).

The *Property Law* which entered into force on October 1, 2007, stipulates the provisions on the mortgage of ships under construction of its 188<sup>th</sup> article. This provision has brought some impact on the mortgage of ships under construction. According to its 188<sup>th</sup> article: 'here properties as provided for in items 4 or 6 of Paragraph 1 of Article 180 of this law or a vessel or aircraft under construction as provided for in item 5 are mortgaged, the mortgage right shall be established from when the mortgage contract comes into effect. If the mortgage has not been registered, the parties concerned may not challenge any bona fide third party.' (Property Law, 2007).

The *Property Law* chose registration antagonism on mortgage of ships under constructions, which is not mandatory for the parties to finish the mortgage registration. The registration time of the legal provisions should take the effects which may be brought into consideration. However, Jiangsu and Shandong province has made special provisions on the registration time on the mortgage of ships under construction. Particularly, Jiangsu requires that the overall construction of the ship has

been placed in the keel stage or the ship construction has been completed for all or part of the section, and the evaluation value reached more than 8% of the price of shipping contract. While Shandong requires that at least more than one ship section has been completed and is still under the construction stage. Of course, these two provinces are made before the property law to get the National People's Congress enacted, it is impossible to take the provisions of the property law into consideration. At the same time, there is no limit on the time limit for the construction of the ship mortgage in Liaoning Province.

### **5.2.2 Interim Measures for the mortgage registration**

In order to improving the national shipbuilding industrial revitalization, expanding shipbuilding financing channels for enterprises, regularize the ships under construction mortgage registration, MSA of China promulgated the *Interim Measures for the registration of the mortgage of ships under construction* on June 9, 2009. It should be said that the interim measures fill the gaps in the relevant legislation to a certain extent. It is clarified that when setting construction ship mortgage, the mortgager and the mortgagee shall go to authorized ship registration authority in the place of domicile of the enterprise to finish registration of the mortgage.

Previously, it is difficult to find specific practices on the ship under construction mortgage registration provisions in China. Although several provinces such as Jiangsu, Shandong, Liaoning, promulgated the applicable measures of the construction ship mortgage financing in their own province. It's a beneficial attempt for issues related to the mortgage of the ship under construction of legislation, but because of the low level of these local effects, and basically ship mortgage financing only limited to key enterprises and key type, thus it works limited (Jiang, 2009).

The first paragraph of article 4 of the interim measures stipulates that the mortgager applies for the mortgage of ships under construction should be the ship builders. The

provisions of this article actually support that the ship construction contract is a kind of sale and purchase contract. According to 3 provisions of the 4<sup>th</sup> article in interim measures, the owner of the mortgage has the ownership of the mortgaged ship. That is to say, first of all, the mortgager must be a shipbuilding enterprise, and ownership of the ship under construction must also be agreed on.

The contract of ships under construction is defined as the sales or purchase contract rather than the contract of hired work, and the ownership of the ship in the hybrid contract is clearly defined. Such a provision is beneficial to the shipyard, although the parties are free to make an agreement, but the interim measures stipulates that the mortgager is a shipbuilding enterprise and has the ownership of the mortgaged ship by using the form of law, which indirectly support the shipbuilding contract for the sale and purchase contract (Zhang, 2012).

### **5.3 Relating cases analysis**

Due to the particularity of ships under construction, the mortgage of ships under construction has some special legal issues, which makes the mortgagee of the ship or other mortgage relationship may face more and more complex legal risk. Due to the international of maritime and shipbuilding industry, related legal relations often involve foreign parties, and even constitute a complex structure. In the adjustment of the specific legal relations, the laws of various countries have different provisions. Therefore, in order to resolve related disputes quickly and effectively, ship construction and mortgage related on the disputes need to have clear feasible conflict rules. Several cases can give us some enlightenments as follows.

#### **5.3.1 The ships under construction mortgage contract disputes in Wuhan**

On May 22, 2004, China's Wuhan maritime court accepted the Wuhan commercial Bank of China sued Wuhan international economic and technical corporation on the mortgage contract dispute of ships under construction. This case was worth 165 million yuan, which was also the largest amount in maritime cases since the founding of the maritime court of Wuhan.

Disputes started from September 18, 2002, the defendant China Wuhan International Economic and Technical Cooperation Corporation(CWIETC) for the project of the exporting to Germany's four 12000 tons of bulk cargo ship turn to the Chinese Import and Export Bank(CIEB) loans 2.2 billion yuan. The two sides signed a copy of export seller credit loan contracts, loan period of 20 months. Wuhan Commercial Bank(WCB) is the agency of the lender, responsible for the loan contract, the use of supervision and the implementation of the ship construction contract. At the same time, it is the borrower CWIETC's guarantor, WCB pledge all of its book-entry T-bonds to CIEB and issue a letter of guarantee.

Therefore, borrowers CWIETC build ships in Jiangxi Jiangzhou shipyard, Registered name of ships were Ocean 1, Ocean 2, Ocean 3, Ocean 4, respectively (hull numbers are A458, A459, A460 and A461 respectively). This four ships under construction as collateral to the WCB to provide counter guarantee. Subsequently, the plaintiff and defendant signed the contract for the mortgage of ships under construction, and go to Wuhan MSA to make mortgage registration. In the mortgage contract, it is appointed that the mortgage shall not sell or transfer the collateral without the written consent of the WCB; if the mortgager defaulted, the mortgagee WCB shall have the right to take over the ship under construction.

On February 26, 2004, with the absence of the WCB consent, CWIETC and the shipyard attorned ship A458 to the German Phoenix shipping company(GP). The shipyard lacked total funding up to 71.9 million yuan, the construction project was completely stalled, Jiangzhou shipyard was faced with bankruptcy. On May 18, 2004,



WCB applied to the Wuhan maritime court for the preservation of property prior to litigation, demanding the detain of three ships A459, A460 and A461, which belonged to respondent CWIETC. WCB initiating legal proceedings by ship mortgage contract, requesting WCB to take over three ships under construction, whose hull numbers are A459, A460 and A461 respectively. Therefore, Wuhan maritime court mediated quickly, CWIETC and shipyard agreed that WCB invested 2269 million as ship construction funds. On 21 June, Jiangzhou shipyard restored to finish the ship ‘Ocean 2’ and delivered to the German shipowner, which recovered 9.6 million yuan. After the court interpreted the meaning of takeover, both WCB and CWIETC reached an agreement that WCB will take over two ships A460 and A461 on 1 September (Tan, 2009).

In effect, this case was settled by mediation, and losses of both parties were reduced to the minimum. However, the dispute in the case between the two sides focused on whether the mortgagee was entitled to take over the ship under construction to achieve his right. This also involves that the national law should be obeyed, to determine how to realize the mortgage of ships under construction. According to article 14 of the maritime code of the people's Republic of China, the ships under construction can be set the mortgage; and article 271 stipulates that the mortgage of the ship applies to the flag state law. If these two articles are combined, it seems to be applicable law to the mortgage ships under construction.

But in fact, according to the definition of a ship in article 3 and 11 of *Maritime Code*, the ship which can be used as the mortgage object, should not include the ship under construction. However, the first paragraph of 14<sup>th</sup> article in the maritime code stipulates that ships under construction can set the mortgage. Besides, in this case, the mortgage of subject matter is still in construction phase, the flag state has not been selected. In fact, there is no specific link between the relevant provisions of the law, resulting in the fact that no applicable law can be chosen.

Finally, the court just mediates both parties by the principle of party autonomy. However, it is not appropriate to make a judgment on the basis of the general principle of law without explaining the basis of applicable law, especially on the foreign contract dispute. Of course, in accordance with the legislative law, the courts of our country have no legislative power. Faced with the problem of no specific provisions of the law, the Wuhan Maritime Court can be said to be reluctant action.

### **5.3.2 Gold and silver series of ship- Evasion of law in cross border financing**

In recent years, some shipyard or ship owners in order to obtain bank mortgage loans many times by evading the law, repeat registering for ship mortgage in different countries or regions. There occur a number of phenomena that a ship has been mortgaged several times under the different law jurisdiction. Such as the Ningbo maritime court trial of a series of Gold and Silver series ships (G&S) mortgage contract dispute case. Eastern Shipbuilding Group Co., Ltd. (ESGC) Loan to the Agricultural Bank of China Yueqing City Branch (ABCYC), using G&S series of ships under construction as the maximum mortgage. From 2008 to 2009, the registration of the ownership and mortgage of ships under construction is applied in domestic China. The series of ships after being built, were transferred to shipping companies in Singapore and Hong Kong associated with ESGC, and then registered in Hong Kong by the name of the new ship respectively. But the registration of the ownership and mortgage of the ship under construction has not been cancelled in domestic China. In 2010, these shipping companies used a total of seven ships as collaterals for the mortgage loan to the Bank of Credit Suisse Limited by Share Ltd (BCSLS), and registered the mortgage in Hong Kong.

China is one of the few countries that recognize the mortgage of ships under construction. But supporting registration and regulatory system did not keep up with, lead to the newly built ships which has been set mortgage and are easily sold overseas. If the transfer country or region does not recognize the registration of ships under

construction, there is no cancellation of the original registration and will not review the existence of the construction registration whether been cancelled, which means that the registration is initial registration. Even in countries that acknowledge the registration of ships under construction, if the parties want to conceal the truth, it is difficult for the registration authority to review it. There is avoiding space between domestic and abroad (Wu & Xiao, 2015).

In G&S series of cases, BCSLS and ABCYC successively apply for seizure and auction 3 and 4 mortgaged ships respectively in Ningbo Maritime Court and the Court of Singapore. In the two courts, both banks filed a series of lawsuits, requiring the exercise of the right of ships mortgage, and each applies for the third people to participate in other side case litigation. Considering that the Singapore Court may not recognize the mortgage of ships under construction, ABCYC withdrew the prosecution in Singapore subsequently, not getting auction in the other 4 ships. But law of our country hold positive attitude to mortgage on ships under construction. In the case of Ningbo Maritime Court, ABCYC believes that the transfer act is invalid without the mortgagee agreement the transfer of the ship, BCSLS mortgages of ships is also invalid. About ship mortgage disputes should be governed by the laws of the People's Republic of China. While BCSLS believes that ABCYC does not have the mortgage right of involved ships, the ship mortgage disputes should be in accordance with the mortgage contract agreed to apply the laws of the Hong Kong Special Administrative Region.

## **CHAPTER 6**

### **CONCLUSION**

#### **6.1 Suggestions on the application of law**

In our country, the regulation of the mortgage on ships under construction should be flexible as well as taking the certainty as its value orientation, so as to solve the legal conflict of the mortgage of ships under construction. At the same time, in order to balance benefits between mortgagee of ships under construction and third party after delivery of the ship, all aspects of the mortgage on ships under construction should be distinguished to determine the applicable law. From the institutional level, the legislation should be improved, but also practical problems should be solved in the maritime trial. Today, in the absence of a unified international convention applicable, on the one hand, our country should improve the ship registration and supervision system, to reduce different jurisdictions phenomenon from the source. On the other hand, by modifying the relevant provisions of the maritime code, and to further improve the provisions of the mortgage on ships under construction in our country.

Firstly, with regard to the establishment and effect of the mortgage of the ship under construction, the parties may stipulate the applicable law of which country in the contract.

Secondly, as mentioned earlier, the connection point of flag state cannot solve the conflict of legal problems involved in the mortgage of ships under construction. On the setting of the mortgage of ships under construction, if the parties have not agreed in the contract or invalid, shall apply to the local law of the shipbuilding place.

Because the certainty and predictability of the local law in the shipbuilding place, and ship building materials, machinery and equipment are concentrated in shipbuilding place, applicable local law of shipbuilding place is conducive to the realization of mortgage right and benefit for a judgement of the execution.

Thirdly, in the aspect of the validity of the mortgage on ships under construction, if the parties have not agreed in the contract or invalid, shall apply to the ship mortgage right registration method of shipbuilding place. This can increase the certainty of applicable law, but it should be explained that: on the compensation order of the mortgage on ships under construction, whether it is between mortgage itself or mortgage and other security interests, all of them belong to the validity of ship mortgage, also belong to scope of application of the local law of registration.

Fourth, improve the regulatory system avoiding a ship has been mortgaged serval times to reduce the legal conflict. The phenomenon of a ship has been mortgaged serval times occurs mainly in the situation that selling ships to abroad, especially the new ships. It is proposed that relevant departments to improve the registration cancellation system and approval procedures for the ship's exports and transfer. Requiring the parties submitted to the ship ownership registration cancellation certificate, documents not secured by mortgage or documents of mortgagee agreed to transfer ownership of the mortgaged ship to others. In order to reduce a ship has been mortgaged serval times in the different jurisdictions from source.

Last but not least the maritime code should be modified through perfecting the applicable law to mortgage on ships under construction. China's current legislation on mortgage of ships under construction are too simple, only maritime code article 14 involved in this, while legal and institutional relief is not perfect. We should make some changes to the relevant provisions of maritime code. Firstly, it is necessary to make sure the ship under construction just like the mortgage property. It is also suggested that article 14 of the maritime code should cover mortgage of ships under

construction. Secondly it is indispensable for the Code to set up the mortgage conflict rules of ships under construction. That means article 271 should add the provision of applying for *lex loci actus*, which is the law of mortgage registration place. Once the ship unregistered one should be applicable to the law of construction place. Thirdly it is essential to set up the order of compensation for solving the problem of a series of mortgages. Finally, it is proposed that article 275<sup>th</sup> should be covered the included *Lex fori*, which is the applicable law of the court if the auction procedure is to be accepted.

## **6.2 Conclusion**

This paper introduces legal issues about mortgage on ships under construction, including: the concept definition of ships and ships under construction, analyse the problem of the subject and object of ship mortgage, discussed establishment, registration and realization of the mortgage of ships under construction, find lack of legislation in China and make suggestions. On this legal issue, the author consults the relevant information and reads a lot of others papers and then makes a lot of researches on his study, but due to the author's limited professional knowledge, the mortgage of ships under construction study is not specific and comprehensive, therefore, it needs further discussion and study in the future.

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