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Introduction

Statistics show that in 2007, China contracted for about 46% and constructed about 23% of the global newbuilding tonnage. For the first time, China could claim to be the world’s first shipbuilding state. The achievement is largely attributed to the radical development of small and medium-sized shipyards which are mainly privately-owned (the “SMS Yards”). It is expected that China would be an unrivalled newbuilding factory by 2015. The 8 kilometres quay of the recently relocated Shanghai Jiangnan Shipyard is a reflection of that ambition.

Following the cost-efficient rule, the purchasers surge to China for the value-for-money newbuildings. The large state-owned shipyards, e.g. the CSSC, CSIC, CSC subsidiaries, are fully booked for the next few years. As a result, many purchasers have to turn their eyes to the SMS Yards, which are gathered in Zhejiang, Jiangsu and Shandong Provinces. However, when dealing with the SMS Yards, the purchasers will confront with a common problem – the SMS Yards are unable to provide the refund guarantee (the “Shipbuilding Refund Guarantee”) for the pre-delivery advance payments made.

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2 The People’s Republic of China is composed of four separate jurisdictions: the Mainland, Hong Kong, Macao and Taiwan. In this article, “China” refers to the jurisdiction of Mainland.

3 The word “newbuilding” is used as a general term through the article to cover the ship contemplated in the shipbuilding contract, vessel under construction, ship completed but yet to be unregistered, registered ship.

4 Data acquired from the China Association of National Shipbuilding Industry (the “CANSI”) show that in 2007, Chinese shipyards contracted to construct the newbuildings of about 98,450,000 dead weight tons (“DWT”) and constructed the newbuildings of about 18,930,000DWT, which had the respective annual increase rates of about 132% and 30%.

5 Data acquired from the CANSI show that in 2007, China surpassed Korea and Japan (ex No. 1 and No. 2) in terms of the yearly-contracted newbuilding tonnage and surpassed Japan (ex No. 2) in terms of the cumulatively-contracted newbuilding tonnage. As to the yearly-constructed newbuilding tonnage, China moved much more closer to Korea and Japan (No. 1 and No. 2). In combination of the three aspects, China could be said to be the No. 1 shipbuilding state for the year of 2007.

6 In this article, the “shipyard” refers to the builder and/or seller of the newbuilding, the “purchaser” refers to the shipping company who acquires the newbuilding for its own business operation, and the “purchaser’s financier” refers to the bank or any other financial institution which lends money to the purchaser for the acquisition of the newbuilding. The “bank” includes the government-sponsored, government-owned commercial and privately-owned commercial bank.

7 Data acquired from the CANSI show that in 2007, the SMS Yards contributed 44% of China’s yearly-contracted newbuilding tonnage, 60% of China’s cumulatively-contracted newbuilding tonnage and 52% of China’s yearly-constructed newbuilding tonnage. The SMS Yards are said to occupy about 55% of the Chinese shipbuilding industry.

8 Shanghai Jiang’nan Shipyard is relocated in the Changxing Island of Shanghai, which is one of the three government-nominated shipbuilding base in China.

9 Information acquired from various media.

10 The Shipbuilding Refund Guarantee must be distinguished from the performance guarantee. The former is merely to return what has been advanced, whereas the latter is to pay the damages (incl. what has been advanced and the losses suffered) for the failure of performance. There are two types of Shipbuilding Refund Guarantee: on-demand
by the purchasers under the shipbuilding contract.

The Shipbuilding Refund Guarantee is essential for the purchasers and their financiers, especially when they are foreign parties,\(^\text{11}\) as it is virtually the only effective means to protect their advancements.\(^\text{12}\) Normally, the Chinese shipyards will require 30% of the purchase price to be advanced prior to the delivery. In the present shipyard’s market,\(^\text{13}\) the percentage of advancement is astonishingly increased to 80%. This market situation further intensifies the essence of the Shipbuilding Refund Guarantee. Unfortunately, the SMS Yards are incapable to ‘persuade’ their banks\(^\text{14}\) to issue the Shipbuilding Refund Guarantee, especially whey the purchasers and their financiers are foreign parities.\(^\text{15}\) The reason is that the present banking and financial system in China attaches an unreasonably low credit and security rating to the small and medium-sized enterprises (incl. the SMS Yards.)\(^\text{16}\) As a result, the banks are reluctant or ‘administratively prohibited’ to issue the Shipbuilding Refund Guarantee for the SMS Yards.\(^\text{17}\) Many deals fall apart simply because of the unavailability of Shipbuilding Refund Guarantee, as the author experienced.

In practice, there appear to be two alternatives to the Shipbuilding Refund Guarantee. One is the construction mortgage\(^\text{18}\) and the other is the “Taizhou Model.”\(^\text{19}\) Despite the fact that those practical means were ‘used’ from time to time to circumvent the Shipbuilding Refund Guarantee, neither of them was legally feasible prior to the

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11 The “foreign party” means a natural or legal person who/which is not domiciled or incorporated in the Mainland of People’s Republic of China, includes according to R. 178 of the Opinions on Several Issues concerning the Implementation of the “General Principles of the Civil Law of China” (Pilot) as enacted by the Supreme People’s Court of China (the “SPCC”) on 26 January 1988 with official code “Fa (Ban) Fa [1988] No. 6” (the “GPCLC Implementation Rules 1988”). These opinions are judicial interpretations and went into effect on the date of enactment.

12 In comparison, the domestic purchasers and their financiers will be in a relatively advantageous position, because they could theoretically insert the Continuous Title Transfer Clause into the shipbuilding contract to secure their title to the newbuilding during the period of construction (see below). However, they will still face the practical difficulty of the title enforcement, as the newbuilding will be in the possession of the shipyard at all times.

13 When this article is being written, the international and Chinese freight and shipbuilding markets are declining. However, the vast majority of Chinese shipyards still require for the “80% advancement.”

14 The foreign purchasers and their financiers usually insist that the Shipbuilding Refund Guarantee be issued by the government-sponsored, state-owned commercial or large privately-owned bank.

15 The provision of Shipbuilding Refund Guarantee in favour of a foreign party is treated equally as the borrowing from overseas, which shall be stringently regulated and administered, according to the Administration Rules for the Provision of Security by the Domestic Institutions to Overseas as enacted by the People’s Bank of China (the “PBC”) on 25 September 1996 with the official code of “Zhong Guo Ren Min Yin Hang Ling [1996] No. 3.” These rules are ministerial rules and went into effect on 1 October 1996.

16 The Chinese government is aware of this deficiency of the present financial system, and the State Council of China enacted the Opinions on the Enhancement of Construction of the Credit and Security System for Medium-sized and Small Enterprises on 23 November 2006 with immediate effect. These opinions are administrative regulations and with the official code of “Guo Ban Fa [2006] No. 90.” However, these opinions do not resolve the financial problems of the SMS Yards, according to the author’s observation.

17 The state-owned or large privately-owned shipyards will not have this problem.

18 In this article, the “construction mortgage” refers the mortgage charged over the vessel under construction, with the shipyard acting as the mortgagor and the purchaser as the mortgagee. The assignment of construction mortgage between the purchaser and its financier is beyond the scope of this article.

19 Taizhou is a region of Zhejiang Province, which is presently the No. 1 location of SMS Yards in China. The “Taizhou Model” was initially created to resolve the contradiction between the reluctance of official finance and the enthusiasm of private finance in respect of the Chinese shipbuilding industry (see below).
effectiveness of Real Rights Law 2007 (the “RRLC 2007”).20 The RRLC 2007 offers some unexpected approaches to achieve the construction mortgage and “Taizhou Model,”21 though this law does not expressly perfect or improve the legal status of those practical means. Such far-reaching effect may not be in the contemplation of draftsmen.

Among the practitioners in the field of shipbuilding, there are discussions of other possible alternatives to the Shipbuilding Refund Guarantee as follows:22

(1) engaging a credible trading house in the shipbuilding contract as the co-seller, which is capable to arrange the Shipbuilding Refund Guarantee;

(2) vesting the title of the vessel under construction in the purchaser *ab initio* by insertion of the Continuous Title Transfer Clause into the shipbuilding contract and registering its ownership under the purchaser’s name in China or the foreign jurisdiction which legally allows the same, which will make the Shipbuilding Refund Guarantee unnecessary; and

(3) charging and registering the construction mortgage in the foreign jurisdiction which legally allows the same.

However, none of those possible alternatives could produce a satisfactory resolution for the SMS Yards, because of the following rigid rules:

(1) The co-seller will normally be held jointly and severally liable for the shipyard’s obligations under the shipbuilding contract.23 None of the trading houses is willing to undertake such huge liability unless it is entitled to share a material part of the profit. But, none of the shipyards is willing to share the profit with the trading house which, in its eyes, merely arranges the Shipbuilding Guarantee;24

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20 This law is also called the “Rights in *Rem* Law.” It was promulgated by the People’s Congress of China on 19 March 2007 and went into effect on 1 October 2007.

21 This article exclusively studies the legal feasibility of construction mortgage and ‘Taizhou Model’ under the RRLC 2007; without reference to the operation, execution and realisation of construction mortgage and ‘Taizhou Model’ in practice. In order to realise those practical means, the relevant parties need to meet various conditions and go through various formalities, according to various legal provisions. Those conditions, formalities and legal provisions appear to be onerous, especially from the point of view of foreign purchasers and their financiers.

22 The author has carried out numerous researches on the legal and practical feasibilities of those possible alternatives.

23 Usually, the shipbuilding contract will provide that the co-sellers shall undertake the joint and several liabilities. Without such contractual provision, the joint and several liabilities will be presumed according to Art. 67 of the Contract Law of China 1999 (the “CLC 1999”). This law was promulgated by the People’s Congress of China on 15 March 1999 and went into effect on 1 October 1999.

24 In this sense, the engagement of the trading house as the co-seller will not only offer the purchaser and its financier the Shipbuilding Refund Guarantee, but also a much deeper pocket for damages in case of the shipyard’s failure to perform the shipbuilding contract.
(2) The ownership of a vessel under construction cannot be registered under the Chinese law. Moreover, neither a foreign party nor a wholly or majority foreign-owned Chinese enterprise (legal person) may register a ship and become the registered shipowner under the Chinese law;

(3) The Chinese court may not recognise and enforce the ship-related rights and obligations which are constituted in a foreign jurisdiction or according to the foreign law. Moreover, the Chinese court may not recognise and enforce a foreign judgment. Under Chinese law, ship is deemed as the extraordinary movable asset, which is treated almost in the same manner as the fixed asset. So, the Chinese court is enthusiastic to exercise the exclusive jurisdiction over this “floating territory.”

Construction Mortgage - Pre the RRLC 2007

Construction mortgage is not a new concept in China. The right to charge a vessel under construction by way of mortgage has long been recognised as a substantive right under the Maritime Law of China 1992 (the “MLC 1992”). Art. 14 of this law provides:

“A mortgage may be charged over a vessel under construction.

When making the application for the registration of construction mortgage, [the relevant parties] shall also submit the relevant shipbuilding contract to the ship registration authority [in addition to the documents they need to submit for the registration of ship mortgage according to Art. 13 of this Law].”

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25 The difference between R. 8 of the Implementation of the “Ship Registration Regulations of China” 1994 (Repealed) (the “Ship Registration Explanations 1994 (Repealed)”) and its repealing successor - the Explanations of Several Issues in relation to the Implementation of the “Ship Registration Regulations of China” 2004 (the “Ship Registration Explanations 2004”) clearly shows that the ownership of a vessel under construction cannot be registered in China. These explanations are ministerial rules, which were enacted by the Maritime Safety Administration of China (the “MSA”) on 28 October 2004 with the official code of “Hai Chuan Bo [2004] No. 522” and went into effect on the date of enactment. For the MSA, see supra fn. 32.

26 The “ship” refers to a device which is recognised as a ship under the Chinese law (see below).

27 Art. 2 of the Ship Registration Regulations of China 1994 (the “SRRC 1994”). These regulations are administrative regulations, which were enacted by the State Council of China on 2 June 1994 and went into effect on 1 January 1995.

28 The dispositive attitude of the Chinese court towards the application of foreign law and recognition and enforcement of foreign judgment is reflected in various civil procedure legislation and previous judgments.


30 The MLC 1992 is law, which was promulgated by the Standing Committee of People’s Congress of China on 7 November 1992 and went into effect on 1 July 1993. The latest legislation which recognises the construction mortgage is the Rules for Civil Litigation Causes of Action as enacted by the SPCC on 4 February 2008 with the official code of “Fa Fa [2008] No. 11”, which provides that the claim arising from the rights associated with the construction mortgage amounts to a separate and independent cause of action (R. 58(6)). These rules are judicial interpretations, which went into effect on 1 April 2008.

31 The author only reproduces the Chinese legal provision or par thereof, which is relevant to the charge and
The above Art. 14 indicates that in terms of registration, the draftsmen of the MLC 1992 treated the construction mortgage in the same manner as the ship mortgage. The construction mortgage shall be registered with the “ship registration authority” - the Maritime Safety Administration of China (the “MSA”): otherwise, the construction mortgagee will not gain a secured position against the other creditors of the mortgagor in terms of the vessel under construction. In another word, an unregistered construction mortgage is worthless to the purchaser.

However, to one’s surprise, the substantive right of construction mortgage cannot be realised in practice, as there is no corresponding procedural right. The Ship Registration Regulations of China 1994 (the “SRRC 1994”), which was enacted to implement the registration of ship and ship-related rights recognised by the MLC 1992, does not contain any procedure for the registration of construction mortgage. Nor does any other legislation. In the absence of registration procedure, the MSA rejects virtually all applications for the registration of construction mortgage, as the author experienced. Therefore, while the shipyard could theoretically charge the construction mortgage in favour of the purchaser (i.e. execute the construction mortgage contract), the purchaser will not acquire any material benefit in reality.

It should be noted that neither the MLC 1992 nor the SRRC 1994 defines “a vessel under construction.” The definition was made in the Explanations of Several Issues in relation to the Implementation of the “Ship Registration Regulations of China” 1994 (the “Ship Registration Explanations 1994 (Repealed)”) as appealed and replaced by the Explanations of Several Issues in relation to the Implementation of the “Ship Registration Regulations of China” 2004 (the “Ship Registration Explanations 2004”). R. 8 of the Ship Registration Explanations 1994 (Repealed) provides the following, which was succeeded in full by R. 7 of the Ship Registration Explanations 2004:

“A vessel under construction’ means a vessel [which is being built and] whose keel has been laid or whose construction has reached a similar stage.”

registration of construction mortgage. The English translation of the relevant Chinese legal provision is made by the author. To fill in the gap between the Chinese draftsmen’s expression and English readers’ comprehension, the author inserts some necessary explanations in the square brackets.

32 The MSA is a department of the Ministry of Communications of China (the “MOC”). In this article, the “MSA” refers to its headquarters in Beijing and about 20 directly-controlled branches which are authorised by the headquarters to register the ship and ship-related rights. Those branches are located in the major ports of China, such as Shanghai, Guangzhou, Dalian and Nanjing.

33 These regulations are administrative regulations, which were promulgated by the State Council of China on 2 June 1994 and went into effect on 1 January 1995.

34 The procedure for registration of ship and ship-related rights normally includes the completion of application form, provision of supporting documents, submission of the application to the MSA and MSA’s examination of and decision on the application.

35 The author was engaged in various dialogues with the MSA Shanghai, Guangzhou, Jiangsu and Liaoning Branches in respect of the registration of construction mortgage. None of those branches agreed to register the construction mortgage. In a meeting with the MSA Shanghai Branch in 2005, an MSA official implied that the MSA Shanghai Branch had registered only 1 construction mortgage by the time of meeting.

36 See supra fn. 25.
The above R. 7 mirrors Art. 4(2) of the Convention relating to Registration of Rights in respect of Vessels under Construction, Brussels, 1967 (the “Brussels Convention 1967”), though China does not ratify that convention. The provision of R. 7 is far to be perfect. Above of all, the provision fails to define the “similar stage.” Nowadays, many ships are built in segments without laying the keel. For those ships, it will be difficult to ascertain when their construction reaches the “similar stage,” i.e. the time of birth of construction mortgage. Secondly, the provision fails to define the scope of the vessel under construction: whether it includes the materials, machinery and equipment which have specifically been allocated for the vessel under construction but which have not yet been installed on it. Thirdly, the provision of R. 7 fails to define when a vessel under construction ceases to be so, i.e. the time of demise of construction mortgage. Normally, that time coincides with the time when the vessel under construction becomes a ship recognised under the Chinese law. Art. 3(Para. 1) of the MLC 1992 provides:

“A ship which is subject to this Law refers to a sea-going ship or other mobilising devices on the sea…”

One school of thoughts is that the vessel under construction becomes a ship when the construction is completed and the vessel meets the legal definition of ship, no matter whether it is registered with the MSA as a ship. In practice, when a vessel under construction commences the sea trials or if later, when it finishes the sea trials, it becomes a “mobilising device on the sea” and thus, a ship. In contrast, the second school of thoughts is that a vessel under construction becomes a ship when it is registered with the MSA as a ship. The reason is that under the Chinese law, ship is the extraordinary movable asset and the ship-related rights and obligations must be legally affirmed by registration with the MSA; thus, “whether it is a ship or not” is not a sheer matter of substantive law, but a mixed matter of substantive and procedural law (i.e. registration with the MSA). Although the ‘time of demise’ issue has not yet been formally debated or tested, some previous judgment seems to support the first school of thoughts. In Shanghai Container Terminal Ltd., Co. v Shanghai Shipyard, the

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37 The Chinese law does not absorb Art. 8 of the Brussels Convention 1967, which provides that the scope of the vessel under construction may include the 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” under construction.

38 The construction mortgage shall lapse when the vessel under construction extinguishes.

39 Under the major thoughts, the vessel under construction will become a ship even before the classification society issues the classification certificates. Those certificates will be issued within a few days to weeks of the sea trials.

40 Under the SRRC 1994, the ship registration includes the registration of nationality and ownership.

41 The sea trials are arranged, within a few days to weeks of the completion of construction, to test the general operation of the ship and performance of her engines and machinery on the open sea. Almost all shipbuilding contracts provide that when the ship passes the sea trials, it will be ready for delivery and the purchaser ought to accept it. The delivery will normally take place within a few weeks to months of the sea trials.

42 See supra fn. 29.

43 There is no precedent system in China. However, a previous judgment may be used as persuasive evidence, especially when it is made by a higher court or the SPCC. The SPCC publishes the Typical Judgments, from time to time, to guide the low courts on the application of law and conduction of trial.

judges of Shanghai Maritime Court appeared to agree that a vessel under construction which was on the way back from the sea trials was a ship under the MLC 1992.45

The above failures of R. 7 of the Ship Registration Explanations 2004, especially the failure to define the “time of demise,” will have unexpected effects on the charge and registration of construction mortgage in practice (see below).

In addition to the MLC 1992, the Security Law of China 1995 (the “SLC 1995”)46 sets out further provisions in relation to the charge and registration of construction mortgage. Art. 34(Para. 1) of this law reaffirms the substantive right to charge the construction mortgage:

“The following assets may be charged by way of mortgage:…

(6) other assets [i.e. assets which are not listed in the Arts. 34(Para. 1)(1)-(5) of this Law] may be charged by way of mortgage, provided such charge is expressly permitted by other laws…”

Obviously, the vessel under construction is one of the “other assets” and the MLC 1992 is one of the “other laws.”

The SLC 1995 goes on to provide:

“Art. 41 When the relevant parties charge a mortgage over an asset listed in Art. 42 [which can be mortgaged as per Art. 34 of the SLC 1995], the mortgage must be registered [with the relevant authority]. The mortgage contract shall not go into effect until the time when the registration is completed.

Art. 42 The authorities which shall deal with the registration of mortgage are as follows:…

(4) when the mortgaged asset is...ship..., the authority which shall deal with the registration of mortgage is the same authority which deals with the registration of [nationality and ownership of] that asset;

45 In this case, a vessel under construction, on its way back from the sea trials, hit the jib of a shore crane and caused damage to a container terminal. The case was mainly focused on the quantification of damage. As the market value exceeded the highest possible damages the claimant could claim, “whether it is a ship or not” was not put forward by the parties as an issue. However, when making the judgment, the judges applied the provisions of MLC 1992 to apportion the liability and quantify the damage, which provisions shall only be applied to a physical contact between a ship and a shore object. This clearly shows that the judges held the vessel under construction to be a ship (otherwise, different provisions would have been applied).

46 See supra fn. 29.
Art. 43  When the relevant parties charge a mortgage over a piece of other assets [which are not listed in Art. 42 but which can be mortgaged as per Art. 34 of this Law], they may register the mortgage at their will. The mortgage contract shall go into effect upon execution.

If the relevant parties opt not to register the mortgage, the mortgagee shall not gain a secured position against the third party. If the relevant parties opt to register the mortgage, the authority which shall deal with the registration is the [county] notary public office within whose territory [i.e. the county] the mortgagor is domiciled."

The above provisions seem to suggest a material difference between the ship mortgage and construction mortgage in terms of registration. Whereas the ship mortgage has both its validity and security-effectiveness conditional on the registration (Art. 41 and Art. 42(Para. 1)(4), the construction mortgage only has the security-effectiveness conditional on the registration (Art. 42(Para. 1) and Art. 43). The validity of ship mortgage contract and construction mortgage contract is not referred to in the MLC 1992. It should be noted that as neither the law of equity nor trust exists in the Chinese legal system, an executed (valid) but not registered (security-effective) construction mortgage seems worthless to the purchaser and their financier.

Furthermore, Arts. 41, 42 and 43 of the SLC 1995 appear to suggest that a vessel under construction may be deemed as “a piece of…other movable assets owned by” the shipyard (Art. 42(Para. 1)(5)) or “a piece of other assets” owned by the shipyard (Art. 43(Para. 1)). As a general principle of the Chinese law, when a party is granted two substantive rights in parallel or duplication, that party is free to exercise each or both of the rights simultaneously or sequentially. Therefore, if the afore-mentioned suggestion were legally acceptable, the construction mortgage could be treated as the mortgage of ordinary moveable asset and the registration of construction mortgage could be achieved with some authority other than the MSA and under some regulations other

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47 The notary public office was an organ of the Chinese government. However, since the Notarisation Law of China, as promulgated by the Standing Committee of People’s Congress of China, went into effect on 1 March 2006, the notary public office has been legally detached from the government.

48 China is mainly of continental law, though she adopts more and more common law elements.

49 Under the law of equity or trust, an executed but not registered construction mortgage may constitute an equitable mortgage, which may provide the mortgagee with some imperfect secured position against the third party.

50 Nowadays, the Chinese shipyards are incorporated, existing and operating in the form of liability limited company under the Chinese law. Liability limited company is both enterprise and legal person (the so-called “legal person enterprise”).
than the SRRC 1994.

However, in whichever category of asset the vessel under construction falls, the registration of construction mortgage will remain submerged in the quagmire of the MSA and SRRC 1994. Firstly, in order to implement Art. 42(Para. 1)(5) of the SLC 1995 in practice, the Administration Rules for the Registration of Mortgage of Moveable Assets owned by the Enterprise was enacted in 1995 and amended in 1998 and 2000 (the “Mortgage Registration Rules 2000 (Repealed)”). These rules were repealed and replaced by the Moveable Assets Mortgage Registration Rules 2007 (the “Mortgage Registration Rules 2007”) enacted to implement the RRLCC 2007. R. 3 of the Mortgage Registration Rules 2000 (Repealed) provides:

“When an enterprise charges a mortgage over an asset which is not an aircraft, ship or motorcar and which is listed as follows, that enterprise shall register the mortgage with the industrial and commercial administration authority after the mortgage contract is signed or chopped[,] The mortgage contract shall go into effect on the date when the registration is completed.

(1) the equipment of the enterprise;

(2) the raw and supplementary materials of the enterprise;

(3) a product or commodity of the enterprise; and

(4) other movable assets on which the enterprise may charge a mortgage according to the [Chinese] law…”

Apparently, a vessel under construction did not fall in the above categories (1), (2) or (3). The wording of category (4) must be interpreted by application of ejusdem generis and within the context of Art. 42(Para. 1)(5) of the SLC 1995. Thus, the scope of “other movable assets” should be limited to the movable assets which were of the same type, class and nature as those listed in categories (1), (2) and (3). Doubtlessly, a vessel under construction, which is by nature a semi-finished (or unfinished) product of the shipyard, was not caught by category (4) and was not caught by the Mortgage Registration Rules 2000 (Repealed) at all.

Even if a vessel under construction had been covered by the Mortgage Registration Rules 2000 (Repealed), these rules would not have had any effect on the registration of construction mortgage. The reason is that in terms of the application of law to a legal

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51 These rules were ministerial rules, which were enacted by the SAIC on 1 December 2000 with immediate effect.
52 These rules are ministerial rules, which were enacted by the SAIC on 12 October 2007 with immediate effect.
53 Ejusdem generis is not formally recognized as a principle of legislation interpretation in Chinese law. However, the Chinese court shall, and in practice will, refer to the principle as a universally accepted international custom when interpreting the ambiguous legislation.
issue, the special law (legal provisions) shall take priority over the general law (legal provisions). On the issue of the registration of construction mortgage, Art. 14(Para. 2) of the MLC 1992 (which provides the MSA as the registration authority) is the special law (legal provisions) and Art. 42(Para. 1)(5) of the SLC 1995 (which provides the SAIC as the registration authority) is the general law (legal provisions). The former shall take priority over the latter. Therefore, the charge and registration of construction mortgage should remain subject to the MSA and SRRC 1994, and the parties could not benefit from the “Art. 42(Para. 1)(5) Route” offered in the SLC 1995.

Secondly, in order to implement Art. 43(Para. 1) of the SLC 1995, the Rules for the Registration of Mortgage by Notary Public Office 2002 (the “Mortgage Registration Rules 2002”) was enacted. R. 3 of these rules provides:

“The ‘other assets’ referred to in Art. 43 of the Security Law of China include:

(1) the materials of production owned by an individual, public institution, social organisation or non-enterprise organisation, such as machinery, equipment… and

(4) other assets which are not covered by Arts. 37 and 42 of the Security Law of China [but which can be charged by way of mortgage according to Arts. 34 of the Security Law of China]…”

By application of the same analysis as applied to Art. 3(Para. 1) of the Mortgage Registration Rules 2000 (Repealed) and Art. 42(Para. 1)(5) of the SLC 1995, a vessel under construction did not fall into the above categories (1) or (4) and therefore was not caught by the Mortgage Registration Rules 2002. Even if it had been covered by the Mortgage Registration Rules 2002, these rules should have given way to Art. 14(Para. 2) of the MLC 1992 and the registration of construction mortgage should have remained subject to the MSA and the SRRC 1994. As a result, the parties could not benefit from the “Art. 43(Para. 1) Route” offered in the SLC 1995.

In recent years, several provincial governments have attempted to fill in the procedural gap for the registration of construction mortgage by enactment of the local rules. Jiangsu is the first to “eat the crab.” It enacted the Pilot Rules for the Registration

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54 Point 6 of Para. 3 of the Minutes of National Economic Trial Work Conference enacted by the SPCC on 6 May with the official code of “Fa Fa [1993] No. 8”. Those minutes are judicial interpretations and went into effect on the date of enactment.

55 When registering the ship and ship-related rights, the MSA will strictly comply with the SRRC 1994 and its delegated legislation, and will never refer to any other legislation.

56 According to the author’s research, the SAIC has never dealt with the registration of construction mortgage.

57 Those rules are ministerial rules, which were enacted by the Ministry of Justice on 20 February 2002 with immediate effect.

58 Art. 57 of the SLC 1995 lists the assets which are prohibited from being charged by way of mortgage.

59 According to the author’s research, the SAIC has never dealt with the registration of construction mortgage.

60 E.g. Jiangsu, Shandong and Liaoning Provinces.
of Mortgage Charged over the Vessel under Construction for the Financial Purpose 2006 (the “Jiangsu Pilot Rules 2006”). Dozens of construction mortgages have been registered with the MSA Jiangsu Branch under the Jiangsu Pilot Scheme 2006. However, the local rules are incapable to resolve the deficiency of the upper-level legislation.

Firstly, a provincial government never has the power to make local rules in relation to the charge or registration of movable asset mortgage. Prior to the effectiveness of the RRLC 2007, a provincial government was not authorised to make local rules in relation to the charge and registration of any asset mortgage. Art. 246 of the RRLC 2007 opened half of the window:

“Before the laws and regulations are enacted to clarify the scope, registration authority and detailed methods of the registration of fixed asset mortgage, the local rules may be made in accordance with the relevant provisions of this Law.”

Therefore, so far, a provincial government has only been allowed to make the local rules in relation to the registration of fixed asset mortgage, and has only been allowed to do so when the upper-level legislation is absent. In any event, the enactment of Mortgage Registration Rules 2000 (Repealed), Mortgage Regulations Rules 2002 and Mortgage Regulations Rules 2007 left and leave no space to a provincial government to make the Jiangsu Pilot Scheme 2006 alike. Although the legitimacy of the Pilot Jiangsu Scheme 2006 has not yet been formally debated and tested, some judges and practitioners expressed doubts on the validity and enforceability of the ‘locally registered’ construction mortgage.

Secondly, the scope of application of the Pilot Scheme 2006 is extremely narrow. For instance, the mortgagor must be one of the short-listed Chinese shipyards which are state-owned or government-approved, and the mortgagee must be one of the short-listed

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61 The Jiangsu Pilot Scheme 2006 was enacted by the Provincial Government of Jiangsu on 27 June 2006 with the official code of “Su Zheng Ban Fa [2006] No. 52.” These pilot rules are local rules and went into effect on the date of enactment.

62 For instance, Jiangsu Taizhou Kou An Shipyard borrowed funds from Taizhou Sub-branch of Jiangsu Branch of Construction Bank of China charged for construction of two newbuildings, and charged two construction mortgages in favour of the bank. The shipyard and bank had the construction mortgagees registered with the MSA Jiangsu Branch in 2005. Other shipyards and banks which successfully registered the construction mortgage with the MSA Jiangsu Branch include New Century Shipyard, Da Yang Shipyard, Yang Zi Jiang Shipyard, Import and Export Bank of China, Bank of China and Bank of Communications of China.

63 According to the Legislation Law of China 2000 (the “LLC 2000”), the Chinese law is generally divided into 6 levels which, from the highest to the lowest, are the Constitutions, ratified international conventions, laws (statutes), administrative regulations (statutory instruments), rules (delegated legislation) and international customs. The “rules” include the ministerial rules, local rules and judicial interpretations. Art. 79 of the LLC 2000 provides that the laws (e.g. the MLC 1992) and administrative regulations (e.g. the SRRC 1994) shall take priority over (i.e. be the upper-level laws of) the rules (e.g. the Jiangsu Pilot Rules 2006). The LLC 2000 is law, which was promulgated by the People’s Congress of China on 15 March 2000 and went into effect on 1 July 2000.

64 Arts. 63 and 64 of the LLC 2000.

65 In an informal conversation with the author, a senior maritime court judge of Wuhan Maritime Court expressed the doubts on the ‘locally registered’ construction mortgage. Wuhan Maritime Court has the jurisdiction over the disputes arising from the construction mortgage charged and registered by most of the Jiangsu shipyards.
Chinese financial institutions which are government-sponsored or government-approved. Moreover, the transaction underlying the construction mortgage must be a simple loan facility or security arrangement, which is made directly between the mortgagor and mortgagee without involving any third party. So, the ‘locally-registered’ construction mortgage will not benefit the purchaser or its financier, especially in the present shipyard’s market. In practice, the operation of ‘locally registered’ construction mortgage is also subject to some ‘internal rules’ held by the provincial government, which makes uncertain the application of the Jiangsu Pilot Scheme 2006.

Thirdly, the Jiangsu Pilot Scheme 2006 does not resolve the “time of demise” issue associated with the construction mortgage (see above). R. 14 provides:

“Prior to the delivery of the vessel under construction which has been charged with a construction mortgage, the mortgagor and mortgagee shall apply to the Maritime Administration Authority for cancellation of the registration of construction mortgage…”

In practice, the cancellation of the registration of construction mortgage will be arranged to take place simultaneously with the shipyard’s delivery of ship and the purchaser’s payment of outstanding price. Immediately after the cancellation, delivery and payment, the purchaser will register the ship with the ship registry it prefers. Therefore, it seems that R. 14 of the Jiangsu Pilot Scheme 2006 converges with the second school of thoughts - a vessel under construction becomes a ship when it is registered with the MSA as a ship (see above). This provision has a loophole, with reference to Diagram 1 below.

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66 Rs. 3 and 7 of the Jiangsu Pilot Scheme 2006. The short-listed financial institutions include government-sponsored banks, commercial banks and trading houses. Some short-listed shipyards and financial institutions have minority foreign shareholders.

67 Rs. 3 and 7 of the Pilot Scheme 2006.

68 The author heard that those ‘internal rules’ include the mortgagor’s performance of the construction mortgage and the underlying transaction must be affirmed by the provincial government and the funds the mortgagor receives from the underlying transaction must be subject to the management and supervision of the mortgagee.

69 The Jiangsu Pilot Scheme 2006 does resolve the ‘time of birth’ issue associated with the construction mortgage. R. 10 provides: “…when a vessel under construction is built in segments, the construction mortgage may be charged and registered when 8% of the total construction work has been completed.”

70 This arrangement is subject to the cooperation between the shipyard, mortgagee and MSA. The shipyard and the mortgagor must submit to the MSA the application for cancellation a few days prior to the delivery in order that the MSA could approve and effect the cancellation at the exact moment of the delivery.

71 A ship can be provisionally registered with the MSA or any other major ship registry immediately. Subsequent to the provisional registration, the purchaser will apply to the ship registry for the permanent registration of the ship. The permanent registration will take a few days to weeks.
Diagram 1

<table>
<thead>
<tr>
<th>Nb.</th>
<th>Pre Point 1</th>
<th>Negotiations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Point 1</td>
<td>The time of execution of the shipbuilding contract</td>
<td></td>
</tr>
<tr>
<td>Point 2</td>
<td>The time of commencement of vessel construction (e.g. cutting the first steel plate)</td>
<td></td>
</tr>
<tr>
<td>Point 3</td>
<td>The “time of birth” of the vessel under construction (i.e. the earliest possible time when the construction mortgage can be charged and registered)</td>
<td></td>
</tr>
<tr>
<td>Point 4</td>
<td>The “time of demise” of the vessel under construction (normally, when it becomes a ship)</td>
<td></td>
</tr>
<tr>
<td>Point 5</td>
<td>The time of delivery (when the registration of construction mortgage is cancelled)</td>
<td></td>
</tr>
<tr>
<td>Point 6</td>
<td>The time of registration of ship (which takes place immediately after the time of delivery)</td>
<td></td>
</tr>
<tr>
<td>Post Point 6</td>
<td>Ship operation</td>
<td></td>
</tr>
</tbody>
</table>

Normally, the sea trials take place a few weeks to months prior to the delivery. Assuming the first school of thoughts is correct - the vessel under construction becomes a ship when it meets the legal definition of ship (i.e. when it commences or finishes the sea trials), there would be a gap of time (between Point 4 and Point 5) in which the purchaser or its financier would NOT:

(1) be protected by the construction mortgage, because the construction mortgage lapsed due to the extinction of the vessel under construction, despite that the construction mortgage remains registered with the MSA;

(2) be protected by the title of the ship, because the title cannot be acquired or registered with the MSA or any other ship registry until the time of delivery; and

(3) be protected by the ship mortgage, because the ship mortgage cannot be charged or registered with the MSA or any other ship registry until the time when the ownership and nationality of the ship have been registered with the ship registry.

Fourthly, the Jiangsu Pilot Scheme 2006 does not answer the question: whether the vessel under construction includes the materials, machinery and equipment which have

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72 With reference to a normal shipbuilding contract, the title of ship will remain vested in the shipyard until the time of delivery. The transfer of title is evidenced by the parties’ execution of the Protocol of Delivery of Acceptance and other delivery documents.

73 Reg. 13 of the SRRC 1994 provides that for the registration of the ownership of newbuilding, the owner must submit, *inter alia*, the Protocol of Delivery and Acceptance. All ship registries have the similar provision.

74 Reg. 20 of the SRRC 1994.
specifically been allocated for but which have not yet been installed on it. This will largely reduce the protection the construction mortgage is supposed to give the purchaser and its financier, especially when the market declines or the shipyard goes bankrupt.

Fifthly, the registration procedure the Jiangsu Pilot Scheme 2006 sets out is complicated, lengthy and costly. For instance, the parties need to submit at least 25 supporting documents, together with the application, to the MSA for the registration of construction mortgage, and there is no time limit within which the MSA must examine and decide on the application. In comparison, for the registration of ship mortgage, the parties only need to submit 5 supporting documents and the time limit for the MSA to grant the registration is 7 working days.

Sixthly, the Jiangsu Pilot Scheme 2006 does not resolve the “value problem” entailed by the SLC 1995 and its delegated legislation. Art. 35(Para. 1) of the SLC 1995 provides:

“The debts the mortgagor undertakes to secure shall not exceed the value of the mortgaged asset.”

R. 51 of the Explanations of Several Issues in relation to the Implementation of “Security Law of China” 2000 (the “SLC Implementation Explanations”) supplements:

“When the debts the mortgagor undertakes to secure exceeds the value of the mortgaged asset, the excess shall not be treated as secured debts [i.e. the mortgagee shall not gain a secured position thereto].”

During the course of construction, the value of the newbuilding will increase day by day. Thus, in order to protect its own interests, the mortgagee has no alternative but to requesting the mortgagor to apply to the MSA for changing the registered construction mortgage in the same pace as the value increase of the vessel under construction. In practice, the mortgagee will request for the registration change three times which respectively correspond to the three (2\textsuperscript{nd}, 3\textsuperscript{rd} and 4\textsuperscript{th}) pre-delivery advancements made by the purchaser. Each time, all that needs to be changed is the item “Value of the

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75 Rs. 7, 8, 10 and 11 of the Jiangsu Pilot Scheme 2006.  
76 R. 12 of the Jiang Pilot Scheme 2006. The absence of time limit gives unlimited space to the MSA to implement the “internal rules” of the provincial government.  
77 With general reference to the SRRC 1994.  
78 These explanations are judicial interpretations, which were enacted by the SPCC on 13 December 2000 with the official code of “Fa Shi [2000] No. 44” and went into effect on the date of enactment.  
79 With reference to two real construction mortgages charged and registered with the MSA Jiangsu Branch in 2005 by Jiangsu Taizhou Kou An Shipyard as the mortgagor and Taizhou Sub-branch of Jiangsu Branch of Construction Bank of China as the mortgagee.  
80 In the present shipyard’s market, the Chinese ships will normally require the purchasers to advance 80% of the purchaser price prior to the delivery: 1\textsuperscript{st} advancement - 20% of the purchaser price at the time of execution of the shipbuilding contract, 2\textsuperscript{nd} advancement - 20% of the purchase price at the time of keel laying, 3\textsuperscript{rd} advancement - 20%
Vessel under Construction” in the Construction Mortgage Registration Certificate. However, each time, the parties have to go through the same complicated, lengthy and costly procedure. The costs amount to a serious concern. For each registration change, the MSA will charge 0.05% of the spot market value of the vessel under construction. The parties also need to pay the evaluation, lawyering and administration fees.

Ironically, the time-consuming and costly multiple-registration may not suffice to protect the mortgagee’ interests. The reason is that the value increase of the vessel under construction is uneven, and is vulnerable to the fluctuation of the international and domestic freight and shipbuilding markets. Thus, the spot market value of the vessel under construction, as assessed by the evaluator and inserted in the Construction Mortgage Registration Certificate, may be less or far less than its true value, especially in a rising market. Furthermore, sometimes, the MSA may request that the figure which could be inserted as the “value of the vessel under construction” not exceed 70% of the spot market value or 70% of the secured debts, whichever is lower. This is a good example of the “internal rules” held by the provincial government. It is supposed to protect the interests of the mortgagee in a declining market; however, in practice, such “internal rule” will damage the interests of the mortgagee in a stable or rising market and have no effect on the interests of the mortgagee in a declining market.

The above analysis shows that prior to the effectiveness of the RRLC 2007, the procedural absence virtually negated the substantive rights associated with the construction mortgage. This phenomenon reflects the contradiction between the fast economic growth and the slow legislative evolution in China. The local rules, which attempted to fill in the gap left by the upper-level legislation, were, in nature, provisional administration-oriented guidelines rather than long-term legislation-oriented policies. The imprudently-drafted wording of those local rules shows a staggered position between the market demands in practice and the draftsmen’s contemplation of ‘legal ideology.’

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81 According to R. 7(5) of the Jiangsu Pilot Scheme 2006, the spot market value must be ascertained by a qualified and MSA-approved surveyor.
82 In the current market, a 35,000DWT bulk carrier has a market value of about RMB315,000,000 (appr. USD45,000,000). The three times of registration change will cost about RMB400,000 (appr. USD57,000), among which the MSA charge is about RMB283,500 (appr. USD40,500).
83 At the beginning of construction, huge investment is required for design, plans and drawings and purchase of materials and machinery, but the value of the vessel under construction increases very slowly. In contrast, towards the end of construction, little investment is required for the final strike, but the value of the vessel under construction increases sharply.
84 The construction of a 35,000DWT bulk carrier may take 1-2 years. Any unexpected variation of the market will well take place during such a long period.
85 The reason is that the effectiveness of this “internal rule” is based on an assumption that the mortgagor (shipyard) is able to provide to the mortgagee (financial institution) other security in additional to the construction mortgage. That is why the MSA deliberately lower down the “value of the vessel under construction,” in order to ‘push’ the mortgagor or the mortgagee to request the mortgagor to provide other security. However, in practice, such assumption is simply groundless. The construction mortgage is the security which the mortgagee least likes. If the mortgagor had been able to provide other (better) security (such as the refund guarantee or mortgage of land-use right), the mortgagee would have requested for the construction mortgage.
Construction Mortgage - Under the RRLC 2007

Now, the RRLC 2007 offers a novel approach to realise the substantive rights associated with the construction mortgage. This novel approval, which may not be in the contemplation of the draftsmen, enables the practitioners to gingerly step between the law and practice. But, its efficiency is yet to be tested in reality.\(^{86}\)

The novel approach starts from Art. 180 of the RRLC 2007, which provides:

“A debtor\(^{87}\) or third party may charge a mortgage over the following assets which it has the right to dispose of:…

(4) the equipment of production, raw materials, semi-finished products or finished products;

(5) the building, vessel, aircraft which is under construction;…

(7) other assets which are not prohibited by the laws or regulations for being charged by way of mortgage…”

The above Art. 180(Para. 1)(5) reaffirms the substantive right to charge the vessel under construction by way of mortgage (construction mortgage). In parallel to Art. 180(Para. 1)(5), Art. 180(Para. 1)(4), for the first time, makes it feasible to deem a vessel under construction as a “semi-finished product”\(^{88}\) of the shipyard and charge it by way of mortgage (ordinary moving asset mortgage). Furthermore, Art. 180(Para. 1)(4), for the first time, makes it feasible to deem a finished vessel under construction (ship\(^{89}\)) as a “finished product” of the shipyard and charge it by way of mortgage (ordinary moving asset mortgage). Those feasibilities\(^{90}\) rely on the fact that the RRLC 2007 takes priority over the MLC 1992 in terms of the application of law (see below). Art. 180(Para. 1)(7) provides a safe-net for Art. 180(Para. 1)(4). In case that the vessel under construction cannot be deemed as a “semi-finished product” or a finished vessel under construction (ship) as a “finished product” of the shipyard, the subject matters can still be deemed as “other assets” and be charged with the ordinary movable asset mortgage.\(^{91}\)

The novel approach summits on Art. 181 of the RRLC 2007, which provides:

\(^{86}\) According to the author’s research, no party has tried this new approach in practice.

\(^{87}\) “A debtor” includes individual, legal person and civil organisation. Normally, enterprise is legal person.

\(^{88}\) According to the accounting and taxation law and General Accounting Practice of China, the ship is the product of and the vessel under construction is the semi-finished product of the shipyard.

\(^{89}\) Here, “ship” means that the finished vessel under construction meets the legal definition of ship under Art. 3 (Para. 1) of the MLC 1992.

\(^{90}\) Those feasibilities are the most far-reaching effects of the RRLC 2007.

\(^{91}\) No Chinese laws or regulations prohibit the charge of movable asset mortgage over the vessel under construction.
"When agreed [in advance] in writing by the relevant parties, an enterprise…may charge a mortgage over the equipment of production, raw materials, semi-finished products or finished products it presently owns or will own in the future [to secure its own debts or the debts of a third party]. When the debtor fails to fulfil its obligation of repayment or an event of default as agreed by the parties [in advance in writing] occurs, the mortgagee may exercise its right against the mortgaged assets which are caught by the mortgage [i.e. crystallised] at the occurrence of the failure of fulfilment or event of default."

The assets which are covered in the above Art. 181 look similar to Art. 180(Para. 1)(4). However, those two provisions embody two entirely different concepts. Art. 180(4) reaffirms the substantive right of a party to mortgage the ordinary movable asset it presently owns,92 and on that basis, widens the scope of the ordinary movable asset which may be mortgaged.93 In the contemplation of Art. 180(Para. 1)(4), the ordinary movable asset must be in the solid and invariable form. While Art. 180(4) merely upgrades the old mode, Art. 181 introduces a brand-new mode to charge the movable asset by way of mortgage - "floating charge."94 This concept, which originated and grows in the common law system, specifically allows a party to charge a mortgage over the ordinary movable asset which will physically and materially vary from time to time (the “floating asset”). Of course, the “floating asset” is a type of ordinary movable asset, and the “floating charge” is a type of moveable asset mortgage. In practice, a vessel under construction can be deemed as the “floating asset” - a semi-finished product of the shipyard which will physically and materially grows day by day.

It seems that the shipyard has three separate and independent substantive rights to charge the following mortgages over the vessel under construction: construction mortgage, ordinary moveable asset mortgage and floating asset mortgage. Under the Chinese law, the shipyard will be free to exercise each and every of those rights simultaneously or sequentially (see above).95

The novel approach perfects via Arts. 188 and 189 (esp. the latter) of the RRLC 2007, which provides:

"Art. 188 When a mortgage is charged over an asset listed in the Arts. 180(Para. 1)(4) and (6) or a vessel…under construction listed in Art. 180(Para. 1)(7) and (8)…"

92 This right has long been recognised in Art. 34 of the SLC 1995.
93 This scope is further widened by Art. 180(Para. 1)(7) of the RRLC 2007 to the maximum extent.
94 The Chinese legislation in which the term “floating charge” first appeared is the Reply to Permit Some Trust Investment Companies to Use the Depository Reserves, enacted by the PBC on 8 June 1998 with the official code of “Yin Fu [1998] No. 176.” That reply is ministerial rule and went into effect on the date of enactment. As the Chinese law does not recognise the substantive right to charge a mortgage over the (contingent) right, only the raw materials, semi-finished products (work in progress), finished products (stocks) are referred to in Art. 181.
95 There is loophole here, as the owner of the vessel under construction may charge multi-mortgages over the same asset and register the mortgages with different authorities. To close this loophole (avoid the multi-mortgages), there must be a cooperation mechanism set up between the authorities.
1)(5), the [substantive] rights associated with the mortgage will be constituted when the mortgage contract goes into effect[]. If the mortgage is not registered [with the relevant authority], the mortgagee shall not obtain a secured position against a bona fide third party [i.e. a third party who is acting in good faith].

Art. 189 When an enterprise...charges a mortgage over the movable assets according to Art. 181 of this Law, the enterprise shall register the mortgage with the industrial and commercial administration authority within whose territory [i.e. the county] the mortgagor is domiciled. The [substantive] rights associated with the mortgage shall be constituted when the mortgage contract go into effect. If the mortgage is not registered, the mortgagee shall not gain a secured position against a bona fide third party [i.e. a third party who is acting in good faith].

The mortgage which is constituted under Art. 181 of this Law should not prejudice the rights and interests of the purchaser who acquires the title of the movable assets, which may be caught by the mortgage, by payment of a reasonable price and in the course of ordinary business.”

Therefore, as the author believes, the substantive rights associated with the construction mortgage can be achieved through the “Art. 180(4) Route” and “Art. 181 Route”, as the following chart shows. The “Pre-RRLC Impasse” is included for the purpose of comparison. The charge of the finished vessel under construction (ship) by way of the ordinary moveable asset is also included to offer a complete picture.

<table>
<thead>
<tr>
<th>Pre-RRLC</th>
<th>Post-RRLC</th>
</tr>
</thead>
<tbody>
<tr>
<td>No matter whether the construction pause, terminates or goes on</td>
<td>The construction pauses or terminates</td>
</tr>
<tr>
<td></td>
<td>The construction proceeds</td>
</tr>
<tr>
<td></td>
<td>The Construction finishes</td>
</tr>
<tr>
<td>Construction mortgage under Art. 14(Para. 1) of MLC 1992</td>
<td>“Art. 180(4) Route”</td>
</tr>
<tr>
<td></td>
<td>“Art. 181 Route”</td>
</tr>
<tr>
<td></td>
<td>“Art. 180(4) Route”</td>
</tr>
<tr>
<td>Impasse of the SRRC 1994</td>
<td>The vessel under construction is treated as the “semi-finished product” of the shipyard</td>
</tr>
<tr>
<td>----------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Defective local rules, e.g. the Jiangsu Pilot Scheme 2006</td>
<td>The charge must be reduced to a written mortgage contract</td>
</tr>
<tr>
<td>The parties must register the mortgage with the competent branch of the MSA</td>
<td>The parties may register the mortgage with the competent county branch of SAIC</td>
</tr>
<tr>
<td>If registered</td>
<td>If not registered</td>
</tr>
<tr>
<td>What the mortgagee will really gain is uncertain</td>
<td>The mortgagee will gain a secured position against any third party</td>
</tr>
</tbody>
</table>

Chart 1

While one main reason that the mortgage over the vessel under construction is achievable under the RRLC 2007 is that it introduces the novel approach, the other main reason is that this law takes priority over the MLC 1992 in terms of the application of law to the movable asset mortgage. The RRLC 2007 is promulgated by the People’s Congress as a basic law to “sustain fundamental economic institutions of the state” according to the Constitutions of China. In comparison, the MLC 1992 is resolved by the Standing Committee of the People’s Congress as a law to “promote the

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96 In contrast, the SLC 1995, Mortgage Registration Rules 2000 (repealed by the RRLC 2007), Mortgage Registration Rules 2002 and Pilot Scheme 2006 cannot make the same achievement is that they are subordinate to the MLC 1992 and SRRC 1994 in terms of the law of application to the moveable asset mortgage.
97 Art. 1 of the RRLC 2007.
developments of maritime transportation, economy and trade.”

Thus, although the RRLC 2007 and MLC 1992 are both law, the former has a general priority against the latter. Moreover, the RRLC 2007 is more recent than the MLC 1992 and the moveable asset mortgage (e.g. the semi-finished product mortgage and “floating charge”) provided in the former are not referred to at all in the latter. Therefore, on the specific issue of the charge and registration of mortgage over the vessel under construction, the RRLC 2007 shall take priority over the MLC 1992 in terms of the application of law.

In addition to the introduction of the novel approach, the RRLC (esp. Arts. 188 and 189) offer more protection to the mortgagee of the vessel under construction than the MLC 1992 (esp. Art. 13) and the SLC 1995 (esp. Arts. 42 and 43):

(1) as described in Chart 1, the vessel under construction may and must take three forms. In whichever form it is, the charge and registration of mortgage could be achieved under the RRCL 2007. This law provides a non-gap protection;

(2) one the mortgage contract is executed, not only that contract but also the “[substantive] rights associated with” the mortgage will immediately go into effect. One example of the “[substantive] rights” is the mortgagee’s right to assign the mortgage to a third party (e.g. its financier). The RRLC provides an overall protection; and

(3) even if the mortgage is not registered, the mortgagee will still gain a secured position against the third party who is not a “bona fide third party.” The third party purchaser who acquires the mortgaged assets “by payment of a reasonable price and in the ordinary course of business” (Art. 189(Para. 2) of the RRLC 2007) is one type of the “bona fide third party.” This provision will have a particular use for the mortgagee in a rising market, where the mortgagor (shipyard) may wilfully sell the newbuilding, finished or unfinished, to a third party purchaser for the higher price. The mortgagee can argue that the third party purchaser is not a “bona fide third party,” on the ground that it does not act in “ordinary course of business” (when it purchases the unfinished newbuilding) or that it does not act in good faith (when it purchases the finished newbuilding with the actual or imputed knowledge of the mortgage, mortgagee or the underlying transaction between the mortgagee and the

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99 Art. 7 of LLC 2000.
100 Art. 83 of the LLC 2000.
101 Prior to the effectiveness of the RRLC 2007, the term “bona fide third party” or “third party acting in good faith” was universally used but not defined in any Chinese legislation.
102 The sale and purchase of an unfinished newbuilding is not an ordinary business of the shipyard or the purchaser (shipping company).
mortgagor. The RRLC 2007 provides an unexpected protection.

Furthermore, the RRLC resolves the uncertainties and defects of the previous legislation in respect of the mortgage of the vessel under construction. Firstly, this law (esp. Art. 180(Para. 1)(7)) extremely widens the scope of the movable assets which may be charged by way of mortgage (see Appendix 1). This provision will have the following effects on the mortgage of the vessel under construction.

(1) with reference to Diagram 1, the vessel under construction may be charged by way of the moveable asset mortgage or “floating charge” from Point 1 (the time of execution of the shipbuilding contract) to Point 4 (the “time of demise” of the vessel under construction). From Point 4 to Point 6 (the time of registration of ship), the finished vessel under construction may be charged by way of the moveable asset mortgage. There is no long any need to ascertain the “time of birth” or “time of demise” of the vessel under construction (see the “time of birth” and “time of demise” issues above).

As a general principle, a (contingent) right cannot be charged by way of mortgage under the Chinese law. Thus, some practitioner may argue that the vessel under construction cannot be charged between Point 1 and Point 2 (the time of commencement of vessel construction), as there exists nothing material on which the mortgage could stand. However, under 180(Para. 1)(7), as long as there is something material (though tiny) in relation to the construction of the vessel, the mortgage may be charged on the vessel under construction. The required “something material” may come into being between Point 1 and Point 2 (even immediately after Point 1), such as the drawings and plans, materials, machinery or equipment which are purchased or otherwise acquired by the shipyard for the construction of the vessel;

(2) the vessel under construction may include all materials, machinery and equipment which are owned and allocated by the shipyard for the construction of the vessel, no matter whether they are located in the shipyard or not or whether they are actually installed onboard the vessel or not. Thus, there is no long any need to define the scope of the vessel under construction (see the “narrow scope” issue above); and

(3) the mortgagee could be any domestic or foreign individual, legal person or civil

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103 In a rising market, even the shipyard provides the refund guarantee, the purchaser is recommended to request for the RRLC 2007 mortgage(s).
104 This situation coincides with Art. 4 of the Brussels Convention 1967, see Supra Fn. 26.
105 For example, the shipbuilding contract provides that the shipyard will install on the ship (to be constructed) some main engine which has was purchased an arrived at the shipyard prior to the execution of shipbuilding contract. Thus, a moveable asset mortgage or ‘floating charge’ could be made over that main engine (deemed as the vessel under construction) immediately after the execution.
106 This situation coincides with Art. 8 of the Brussels Convention 1967.
organisation. This is a gospel to the foreign purchasers and their financiers (see the “narrow scope” issue above).

It is worth noting that Art. 180(Para. 1)(7) of the RRLC 2007 shows, for the first time, a shift of legal ideology from “one can do nothing unless expressly permitted by the law to do so” to “one can do everything unless expressly prohibited by the law to do so.” Such enormous shift resolves the long-standing conflict between Art. 34 (which provides an exclusive list of assets which can be mortgaged) and Art. 37 (which provides an exclusive list of assets which cannot be mortgaged) of the SLC 1995. Now, those two provisions are replaced by and absorbed into Art. 180(Para. 1)(7).

Secondly, the procedure for registration of moveable asset mortgage and “floating charge,” as set out in the RRCL 2007, is relatively simply, quick and inexpensive. To implement Arts. 180 (4), (5) and (7) (except the building under construction), 181 and 189 of this law, the Mortgage Registration Rules 2007 was enacted (which repealed and replaced the Mortgage Registration Rules 2000). According to R. 3(Para. 1) of those rules, the supporting documents which the parties need to submit together with the application for the registration of mortgage are only two:

“…(1) the “Movable Assets Mortgage Registration Letter” as signed or stamped by the relevant parties; and

(2) the documents which can prove the legal status of the relevant entity party(ies) or identification of the individual party(ies)…”

The time limit and costs for the registration of mortgage are subject to the working rules of each SAIC branch. Taking the working rules of SAIC Shanghai Songjiang District Branch as an example, the time limit for this SAIC branch to examine and decide on the application for mortgage registration is 5 business days from the date of its receipt of the application and supporting documents. The mortgage registration is free of charge at present.

Thirdly, the RRLC 2007 resolves the “value problem” (see above). In respect of the

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107 The Reply to the Qualification of the Mortgagee in the Registration of Enterprise Moveable Assets Mortgage, enacted by the SAIC on 8 February 2001 with the official code of “Gong Shang Zi [2001] No. 36). That reply is ministerial rule and went into effect on the date of enactment.

108 Cf. 25 documents need to be submitted for the registration of the construction mortgage under the Jiangsu Pilot Scheme 2006.

109 If a party entrusts a (legal) representative to deal with the registration, that party must also submit to the authority the Power of Attorney it grants to the preventative and the representative’s identification document (R. 3(Para. 2) of the Mortgage Registration Rules 2007).

110 http://qyfwzx.songjiang.gov.cn:88/qyfwzx/bszn.do?attributeId=80901&categoryId=185601, last visited on 5 October 2008. The author also reviewed the working rules of other SAIC branches available on the internet, such as Shenzhen and Hejian, and found those working rules are very similar to those of SAIC Shanghai Songjiang District Branch.
“floating charge,” the secured position the mortgagee will gain is based on the value of the “floating asset” at the time of crystallisation rather than its value at the time of mortgage registration. The “crystallisation value”\(^\text{111}\) of the vessel under construction (mortgaged “floating asset”) will grow in the same pace of the course of construction and will reflect the true value of the vessel under construction at any time. Thus, there is no need to change the mortgage registration (more precisely, the item of “Value of the Vessel under Construction” in the Construction Mortgage Registration Certificate) in the course of the vessel construction.\(^\text{112}\)

It seems that the RRLC 2007 makes the construction mortgage feasible by introduction of an unexpected route - “floating charge.” The “floating charge” was initially created to deal with the stocks and book debts in the common law system. It is now transplanted in to the Chinese legal system, which is continental law based, and opens the window for the construction mortgage beyond the draftsmen’s imagination. The aftermath of the transplanted law is yet to be seen, and the effect of this unimaginable vehicle is yet to be tested in the economic reality of China.

“Taizhou Model” - Pre the RRCL 2007

The second alternative to the Shipbuilding Refund Guarantee is the “Taizhou Model.”\(^\text{113}\) This author-created\(^\text{114}\) term refers to a unique business model that the SMS Yards in Taizhou\(^\text{115}\) operate to raise the pre-delivery finance from the “folk investor” to construct the newbuildings. The “folk investor” may be a very wealthy or trustworthy individual or family, but most of them are a small group of individuals. The “folk investor” borrows money from the “geo-financial clan”, and then sub-lends the borrowed funds, usually together with their own money, to the shipyard for a particular newbuilding project or invests the combined funds in the project as a stakeholder. The difference between the sub-lending and investment is the return of “folk investor:” in the former, it is the interest received from the shipyard; and in the latter, it is the profit shared with the shipyard. A “geo-financial clan” includes all or part of the residents in the same rural village or urban town, who are tied-up by blood, family, working or personal relationships and who trust and are willing to lend, for interest, their savings together to the same “folk investor” in respect of a particular newbuilding project.

The legal relationship between the “geo-financial clan” and “folk investor” is “folk

\(^{111}\) The “crystallisation value” represents the true market value of the asset(s) which is(are) caught by the mortgage and at the time of occurrence of a failure of performance or event of default.

\(^{112}\) There is no equivalent of the item of “Value of the Vessel under Construction” in the Moveable Asset Mortgage Registration Certificate. Instead, there is an item of “the Name, Quantity, Quality, Status, Location and Ownership/Right of Use of the Mortgaged Moveable Asset” in that certificate. The relevant legal provision is R. 4(6) of the Mortgage Registration Rules 2007.

\(^{113}\) The “Taizhou Model” may be used in other industrial areas.

\(^{114}\) The author has been engaged in numerous shipbuilding and ship finance matters which were carried out under this model, and has had intensive experience with the “folk investors”, “geo-financial clans” and “folk lending” (defined below).

\(^{115}\) The “Taizhou Model” is now widely used in other locations of shipbuilding in China, such as Lianyungang of Jiangsu Province, Zhoushan of Zhejiang Province and Ma’anshan of Anhui Province.
lending,” which is permitted by Art. 90 of the General Principles of Civil Law of China 1986 (the “GPCLC 1986”). The legal relationship between the “folk investor” and shipyard is “folk lending” when the return is interest, or commercial cooperation when the return is profit. The folk lending between the individual and enterprise is permitted by the Reply to the Question: How to Ascertain the Validity of the Lending Activity between the Citizens and Enterprises 1999, while the commercial cooperation between the individual and enterprise is generally permitted by the GPCLC 1986.

The involvement of the “folk investor” and “geo-financial clan” and the legal relationships between those two parties and between each of them and the shipyard are usually kept unknown to the purchaser. Mover, the purchaser has no effective means to probe whether there stands the “folk investor” and “geo-financial clan” behind the shipyard.

The “folk lending” must be distinguished from the “illegal lending,” which is prohibited under the Chinese law. “Illegal lending” is defined as “lending money to the general public to make the high and unlawful income without the permission of the financial administration authority.” In the “illegal lending,” the lender may be a small group of individuals who are structured to carry out the illegal business, the so-called “private money shop.” The fundamental difference between the “folk lending” and “illegal lending” is in the former, the individuals lend their money to the particular person(s) for particular purpose(s), whereas in the latter, the individuals offer their money to the general public (whoever wants to borrow the money for whichever purpose).

The operation of the “Taizhou Model” looks similar to, but differs fundamentally from, that of the capital venture in the Western countries. In the case of capital venture, the individual investors are not tied-up by any domestic or personal relationships. They entrust their savings with, rather than lend their savings to, the venture capital (normally in the form of liability limited company) for the highest possible return. The venture capital and its managers act as trustee or agent to manage and invest the entrusted funds for and on behalf of the individual investors. The legal relationship between the individual investors and the venture capital is trust or agency. There is no direct relationship between the individual investors and the venture capital managers. Neither the venture capital nor its managers will undertake any risk of the investment of the

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116 For the details of “folk lending,” please refer to the People’s Bank of China (2008) Monetary Policy Implementation Report – Second Quarter of 2008, pp. 21-23. The “folk lending” is said to be a serious problem which the Chinese financial system is confronting with, as it is often associated with illegality and usury.

117 This is law, which was promulgated on 12 April 1986 and went into effect on 1 January 1987.

118 This reply is judicial interpretation, which was enacted by the SPCC on 26 January 1999 with the official code of “Fa Shi [1999] No. 3” and with immediate effect.

119 With general reference to the Regulations for Cancellation of the Illegal Financial Institutions and Illegal Financial Business Activities 1998. Those regulations are administrative regulations, which were promulgated by the State Council of China on 13 July 1998 with immediately effect.

120 R. 2 of the Reply to Question: How to Ascertain the Legal Nature of the Activity of Money Leading to the Indefinite Borrowers in the Society in the Form of Usury, enacted by the General Office of PBC on 26 April 2001 with the official code of “Yin Ban Han [2001] No. 283.” That reply is ministerial rule, which went into effect on the date of enactment.

121 With general reference to the Notice for Cancellation of the Private Money Shop, enacted by the PBC on 7 July 1996 with the official code of “Yin Fa [1996] No. 230.” This notice is ministerial rule, which went into effect on the date of enactment.

122 The venture capital, especially the industrial venture capital, is not generally permitted under the Chinese law.
entrusted funds or put their own money in the same investment pot.

The “Taizhou Model” is borne and grows in practice to make the two ends meet: the SMS Yards’ keenness for the surviving and developing finance and the individuals’ enthusiasm for the quicker and higher investment return. There exists no effective ‘official channel’ to reach the same task. To substitute the Shipbuilding Refund Guarantee is only one function of the “Taizhou Model.” As the following diagrams show below, this model appears to benefit all concerned. On the first side, the purchaser only needs to advance about 20% of the purchaser price upon the execution of the shipbuilding contract, with the remaining 80% to be paid at the time of delivery. This payment arrangement will not only save the purchaser a huge amount of interest, but also minimise the pre-delivery financial risk it may be exposed to. Moreover, in many cases, when the purchaser signs the shipbuilding contract, the vessel construction has already been completed to a great extent. The purchasers can see by its naked eyes what they will more or less get. As a result, the purchaser will no longer persist in requesting for the Shipbuilding Refund Guarantee.

On the second side, the shipyard no longer needs to provide the Shipbuilding Refund Guarantee, which is beyond its capacity, and can then secure and proceed the shipbuilding contract without any difficulty. In the purchaser’s market, the “Taizhou Model” has another essence for the shipyard, which needs to use it to tap the private financial sources and raise the necessary pre-delivery finance for the vessel construction. Of course, the shipyard needs to pay interest to or share the profit with the “folk investor,” which may be much higher than the commercial loan interest. But, the huge profit the shipyard will obtain from the shipbuilding contract is much higher than what it needs to pay. On the third side, the “folk lender” and the underlying “geo-financial clan” will obtain the return (interest or profit) which may be much higher than other means of investment. On the fourth side, the government-sponsored and government-owned banks and other financial institutions will be under less pressure

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123 The Chinese government has attempted to legitimise and institutionalise the “folk lending.” The China Banking Regulatory Commission and the PBC have jointly enacted the Rules for Pilot Operation of Small-sum Loan Companies on 04 May 2008 with the official code of “Yin Jian Fa [2008] No. 23.” These rules are ministerial rules, which went into effect on the date of enactment. The “pilot operation” is now being implemented in Jiangsu and Zhejiang Provinces.

124 The shipyard may first enter into the shipbuilding contract with the purchaser and then seek the pre-delivery finance from the “folk investors” on a case-by-case basis. Or, the shipyard may sign a general provision of pre-delivery finance agreement with the “folk investor” in advance and then seek the purchaser of suitable newbuildings in the market. But, more often, the shipyard borrows money from the “folk investor” and commences the construction of vessel (which is popular in the market) without first securing the shipbuilding contract, and then seeks the purchaser in the market.

125 In the purchaser’s market, the shipyard will only receive about 30% of the purchaser price prior to the delivery, and needs to use the “Taizhou Model” to raise about 50% of the purchaser price on its own to complete the construction of vessel. In this sense, the “Taizhou Model” is essential both for survival and development of the SMS Yards.

126 The interest of “folk lending” shall not exceed 400% of, the corresponding depository interest as published by the PBC from time to time, according to R. 6 of the Several Opinions on the Trial of Borrowing and Lending Cases by People’s Courts 1991. These opinions are judicial interpretations, which were enacted by the SPCC on 13 August 1991 with the official code of “Fa (Min) [1991] No. 21” and with immediate effect.
from the SMS Yards and can then focus on the large shipyards and newbuilding projects.

**The “Taizhou Model” and its Variations**

<table>
<thead>
<tr>
<th>Purchaser</th>
<th>Shipyard (builder &amp; seller)</th>
<th>Folk Investor (co-seller)</th>
<th>Geo-financial Clan</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%+80%</td>
<td>Interest Loan</td>
<td>Interest Loan</td>
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</table>

**Diagram 2-1**

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<th>Folk Investor (co-seller)</th>
<th>“Geo-financial Clan”</th>
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</thead>
<tbody>
<tr>
<td>20%+80%</td>
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</tr>
</tbody>
</table>

**Diagram 2-2**

<table>
<thead>
<tr>
<th>Purchaser</th>
<th>Folk Investor (builder &amp; seller)</th>
<th>Geo-financial Clan</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%+80%</td>
<td>Interest Loan</td>
<td></td>
</tr>
</tbody>
</table>

**Diagram 2-3**

The variation of “Taizhou Model” in Diagram 2-1 (the “Variation 1”) offers the most effective alternative to the Shipbuilding Refund Guarantee from the purchaser’s point of view. Here, there is no legal relationship whatsoever between the purchaser and the “folk investor” or “geo-financial clan.” The legal relationship between the shipyard and the “folk investor” is only the “folk lending.” Thus, the purchaser will obtain a full and clean title of the newbuilding at the time of delivery. Of course, the purchaser is free, though unnecessary, to use the “floating charge” (see above) or the “co-owning method” (see below) proffered in the RRLC 2007 to secure the 20% advancement.

The variation of “Taizhou Model” in Diagram 2-2 (the “Variation 2”) is the most used model in practice. Here, the “folk investors” and the shipyard co-invest in and co-build the newbuilding. Normally, the two parties will sign a very brief cooperation agreement, which sets out the investment, contribution and profit of each part in relation to the

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127 The percentages and other figures narrated in this article may vary from case to case in the real world.
newbuilding project. The cooperation agreement may look like a partnership agreement, but the legal relationship between the two parties is clearly commercial cooperation. The cooperation agreement is usually kept unknown to the purchaser. In order to protect its own interests, the “folk investor” may, in addition to the cooperation agreement, request the shipyard to:

1. add the investor’s name\(^{128}\) to the shipbuilding contract as the co-seller (this will constitute a contractual relationship between the purchaser and “folk investor”);

2. open a joint account\(^{129}\) with the “folk investor” for receipt of all the payments from the purchaser (this will not constitute any legal relationship between the purchaser and “folk investor”); or

3. allow the purchaser to participate\(^{130}\) in the planning, operation, management and supervision of the newbuilding project to ensure that everything is done within the budget and in an appropriate manner (this will not constitute any legal relationship between the purchaser and “folk investors”).\(^{131}\)

In practice, no matter which role the “folk investor” plays, the purchaser will request the shipyard and only the shipyard to sign the delivery documents to effect the transfer of title, e.g. the Protocol of Delivery and Acceptance, Bill of Sale and Commercial Invoice. The reason is that in the ordinary exception of ship registry, a newbuilding is constructed, sold and title-transferred by the shipyard to the purchaser. The co-execution of the delivery documents by the “fold investor” may confuse the ship registry.\(^{132}\) (The purchaser will acquire a full and clean title of the newbuilding if both the “folk investor” and the shipyard sign the delivery documents.)

Therefore, no matter whether the “fold investor” appears as the co-seller in the shipbuilding contract or not, the purchaser will confront with the “title question”: whether the sole execution of the delivery documents by the shipyard suffices to transfer a full and clean title of the newbuilding to it? The “folk investor” may have grounds to argue that it has part of the title of the newbuilding or at least has the title of the materials, equipment and machinery it purchased and paid for.\(^{133}\) especially when

\(^{128}\) Normally, only one individual of the “fold investor” will be added to the shipbuilding contract.

\(^{129}\) Under the banking practice of China, a joint account may be opened and held by two Chinese persons, but may not by one Chinese and one foreign persons or two foreign persons.

\(^{130}\) The participation may include the purchase of materials, machinery and equipment, engagement of subcontractors and suppliers, arrangement of launching, sea trials and delivery, preparation of documents and communication with the relevant authorities.

\(^{131}\) The “folk investors” may merely act as a financier (in the position as a trading house) without any participation in the planning, operation, management and supervision of the construction of vessel.

\(^{132}\) The difference between the “co-sellers” in the shipbuilding contract and one-party execution of the delivery documents will by explained by the purchaser to the Ship Registry that the “folk investor” is the trade agent or some shareholder, director or manager of the shipyard.

\(^{133}\) Art. 72 of the GPCLC 1986 and Art. 133 of the CLC 1999.
the “folk investor” actively participated in the newbuilding project. Prior to the effectiveness of RRLC 2007, the Chinese law gave a negative answer to the question.

Art. 78 of the GPCLC 1986 provides:

“An asset may be co-owned by two or more citizens or legal persons. The co-ownership may be in the form of tenancy in common or joint tenancy...

The joint tenants shall exercise the rights and undertake the obligations in relation to the asset in proportion to their respective shares...

Each joint tenant is entitled to [transfer its share to another joint tenant or a third party]. When the joint tenant transfers its share to a third party in the form of sale, the other joint tenants shall have the prioritised right to purchase the share (to be sold out) in the same conditions.”

The above Art. 78 is supplemented by the Opinions on Several Issues concerning the Implementation of the “General Principles of the Civil Law of China” 1988 (Pilot) (the GPCLC Implementation Rules 1988):134

“R. 88 When some co-owners claim the co-ownership to be joint tendency and some others claim the co-ownership to be tenancy in common, the co-ownership will be deemed as tenancy in common unless it can be proved otherwise.

R. 89 The tenants in common shall exercise the rights and undertake the obligations in relation to the co-owned asset. During the period of co-ownership of tenancy in common, when part of the tenants in common dispose of the asset without the consents of other tenants in common, the disposal shall in principle be deemed invalid. However, if a third party acquires the asset with consideration and in good faith, the rights of the third party shall be protected...”

Therefore, in Variation 2, the shipyard and the “folk investor” will be deemed as the co-owners of the vessel under construction, no matter whether the latter appears as the co-seller in the shipbuilding contract (Art. 78(Para. 1) of the GPCLC 1986). The cooperation agreement between the two parties, which sets out the investment, contribution and profit of each party, suffices to rebut the presumption of tenancy in common and prove the co-ownership between the two parities to be joint tenancy (R. 88 of the GPCLC Implementation Rules 1988). According to Arts. 78(Para. 2) and (Para. 3) of the GPCLC 1986, the shipyard can transfer and only transfer its share of the title of

134 These opinions are judicial interpretations, which were enacted by the SPCC on 2 April 1998 with the official code of “Fa (Ban) Fa [1988] No. 6” and with the immediate effect.
newbuilding to the purchaser.

Even if the co-ownership could be deemed as tenancy in common, the wording of R. 89 of the GPCLC Implementation Rules 1988 would be insufficient to protect the purchaser, as the terms “with consideration” and “in good faith” are not defined at all in these rules or any other legislation. Such uncertainty places the purchaser’s fate on the exclusive discretion of the Chinese court.

There is a related issue thereto. The Protocol of Delivery and Acceptance, Bill of Sale and any other delivery document, which are signed by the shipyard alone and which presents and warrants the shipyard to have the full power to transfer a clean title of the newbuilding to the purchaser, may be deemed as false, deceptive or even fraudulent under the Chinese law and the laws of the state with whose ship registry the purchase intends to register the newbuilding. Thus, when the purchaser submits those documents, together with the application, to the ship registry for the registration of newbuilding and the related rights (e.g. mortgage), the ship registry may turn down such application or if the registration has been granted, withdraw the registration, by reason of false, deceptive or even fraudulent documentation. The afore-said may have unexpected effects on the purchaser and its financier.

Some practitioners will argue that the co-operation agreement may constitute a legal relationship of partnership between the shipyard and the “folk investor” in respect of the newbuilding project. Under the partnership, the shipyard (a partner) may have the express, implied or ostensible authority to dispose of the newbuilding (asset of the partnership) for and on behalf of the partnership. However, according to Arts. 30-35 of GPCLC 1986 and Arts. 9-11 of the Enterprise Partnership Law of China 1997 as amended in 2006, an individual and an enterprise cannot constitute a partnership, unless they apply to and obtain from the SAIC the Registration Certificate. In no event, the ship and the “folk investor” will make such application.

Some other practitioners will argue that in view of the cooperation agreement, the shipyard could act as the express, implied or ostensible agent, either disclosed or undisclosed, for the “folk investor,” in terms of execution of the delivery documents and transfer of the title of newbuilding. However, in order to establish the express or implied agency relationship, strong evidence must be discovered to prove that there

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135 In many common law systems, the title of a ship is divided into 64 shares, and the owner must have all the 64 shares in order to have a full and clean title.
136 The purchaser will not obtain a full and clean title, unless the “folk investor” co-signs the delivery documents.
137 E.g., Art. 51(1) of the SRRC 1994.
138 This law was amended by the Standing Committee of People’s Congress of China on 27 August 2006, and went into effect on 1 June 2007.
139 The Registration Certificate is also called “Business Licence.” The partnership will be deemed as constituted on the date of Business Licence.
140 The provisions of undisclosed agency are contained in Art. 403 of the CLC 1999.
141 If the “folk investor” is composed of two or more individuals, each individual is required to grants the express or implied power of attorney to the shipyard.
exists an agency agreement between the shipyard and “folk investor” and the agency agreement expressly or impliedly authorises the shipyard to act as the agent for the “folk investor.”

Such agency agreement could not be inferred from the cooperation agreement. And, there is no other written agreement between the parties. In lack of documentary evidence, the establishment of express or implied agency relationship will rely on the mercy of the “folk investor.” Anyway, in reality, the “folk investor” usually grants no express or impliedly power of attorney to the shipyard in relation to the construction of vessel or the shipbuilding contract.

As to the ostensible agency, Art. 49 of the Contract Law of China 1999 (the “CLC 1999”) provides:

“When the agent does not have the authority to act for the principal, acts beyond its authority or [act to] signs the contract for the principal after the authority expires, such action will be deemed valid on the condition that the third party has reason to believe that the agent has the authority [to act for the principal].”

When the “folk investor” does not appear as the co-seller in the shipbuilding contract, the cooperation agreement and co-ownership between the “folk investor” and the shipyard will be unknown (or kept unknown) to the purchaser. In this situation, the purchaser will have no reason to believe that the shipyard is an ostensible agent for the “folk investor” (unknown person(s)). When the “folk investor” appears as the co-seller in the shipbuilding contract, it will be deemed by the purchaser as a separate and independent party to the contract. As the “folk investor” and the shipyard will normally undertake joint and several liabilities for the shipbuilding contract, the purchaser will have every reason to believe that they are separate and independent parties (though both co-sellers) to the shipbuilding contract, rather than one party being he agent for the other.

A side issue is that the “geo-financial clan” may take legal actions to attach the part of the title of the newbuilding which belongs to the “folk investor,” when there is a dispute between the two parties in relation to the “folk lending.” The legal actions may freeze the construction of or block the delivery of the newbuilding, which may have a negative effect on its title transfer. In this sense, the purchaser may feel necessary to use the “floating charge” (see above) or the “co-owning method” (see below) proffered in the RRLC 2007 to secure its advance payment and protect its other interests in relation to the newbuilding.

142 Arts. 63-65 of the GPCLC 1986
143 The cooperation agreement will not contain any agency-related terms.
144 In very few cases, the “folk investor” authorises the shipyard to sign the delivery documents on its behalf, but it does that in oral and it is virtually impossible to prove the same.
145 Art. 66 of the GPCLC 1986 and Arts. 48 and 51 of the CLC 1999.
146 Arts. 92 and 93 of the Civil Procedural Law of China 1991 as amended in 2007 (the “CPLC 2007”). The CPLC 2007 is law, which was promulgated by the People’s Congress of China on 28 October 2007 and went into effect on 1 April 2008.
The variation of “Taizhou Model” in Diagram 2-3 (the “Variation 3”) is more and more used in practice. Here, the “folk investor” is in the driving seat for the construction of vessel. The “folk investor” solely invests in and builds the newbuilding, and thus solely owns the building.\textsuperscript{147} The shipyard retreats to a position where it merely leases the slipway, drydock, crane and other construction facilities to the “folk investor.” Moreover, the shipyard normally supplies the managerial, technical, engineering, labouring and marketing services to the “folk investor” in respect of the construction of newbuilding. Once again, the shipyard and “folk investor” will enter into a very brief cooperation agreement.\textsuperscript{148} This time, it looks like a leasing, supply and service contract. But, once again, the legal relationship between the two parties is clearly commercial cooperation. The cooperation agreement is usually kept unknown to the purchaser.

As usual, the purchaser will insist to execute the shipbuilding contract with the shipyard rather than some individual(s) (the “folk investor”).\textsuperscript{149} One reason is that the purchaser wants a smooth registration of the newbuilding with the ship registry (see above). The other reason is that the purchaser (indeed anyone else) trusts a properly incorporated, existing and operating shipyard far more than some individual(s) (the “folk investor”) in respect of the construction of newbuilding and performance of shipbuilding contract. So, one service the “folk investor” will normally require from the shipyard is to lend its name to be inserted into the shipbuilding contract as the sole seller or co-seller with the “folk investor.”\textsuperscript{150} (The purchaser will acquire a full and clean title of the newbuilding if the “folk investor” signs the delivery document.)

In view of the above, there will be three situations under the Variation 3:

**Situation 1** The shipyard appears as the sole seller in the shipbuilding contract, and it signs the delivery documents alone to transfer the title of the newbuilding to the purchaser.

In this situation, the purchaser will acquire a full and clean title of the newbuilding only when the shipyard could be deemed as the agent for the “folk investor” in terms of the construction and delivery of the newbuilding. In consideration that the “folk investor” specifically requires the shipyard to ‘act as the seller’ in the shipbuilding, it seems possible to...
infer an implied agency relationship between the two parties from their respective conducts. However, it is only a possibility. Whether the inference could be made or not is influenced by many factors.

One factor is that the engagement of the shipyard by the “folk investor” into the shipbuilding contract is to mislead the purchaser and lure it to enter into the shipbuilding contract. Moreover, the shipyard knows or ought to know the wilful intention of the “folk investor,” but it agrees to collude for its own interests (business and income). Such misconducts of the “folk investor” and the shipyard may be regarded as one of the followings, and therefore negates the implied agency relationship between the two parties: 151

(1) misrepresentation under Art. 42 (Para. 1)(2) of the CLC 1999; 152

(2) infringement of the principle of honest and credibility or deliberately acting in bad faith under Art. 42 (Para. 1)(3) of the CLC 1999; 153

(3) fraudulence under Art. 52(Para. 1)(1) of the CLC 1999, which may render the shipbuilding contract void ab initio;

(4) malicious collusion under Art. 52(Para. 1)(2) of the CLC 1999, which may render the shipbuilding contract void ab initio;

(5) material misunderstanding under Art. 54(Para. 1)(1) of the CLC 1999, which may make the shipbuilding contract voidable by the purchaser’s petition to the court.

Another factor is that the ship registry with which the purchaser registers the newbuilding will be misled by the shipyard-executed and purchaser-submitted delivery documents to believe the shipyard to be the builder and grant the newbuilding registration on that basis. Theoretically, the ship registry may withdraw the granted registration by reason of false, deceptive or even fraudulent documentation (see above).

As to the express and ostensible agency relationship, the cooperation agreement will not contain any express agency-related term. Moreover, as the “folk investor” and the cooperation agreement are kept unknown to the purchaser, it may be impossible to infer any ostensible agency relationship

151 Art. 58(Para. 1)(3), (4), (5) or (7) and Art. 58(Para. 2) of the GPCLC 1986.
152 This will make the two parties jointly and severally liable for the loss the purchaser may suffer as a consequence; of their misconducts. But, in practice, the purchaser may not suffer any material loss.
153 Ibid.
between the “folk investor” and the shipyard.

Situation 2 The shipyard and “folk investor” appear as the co-sellers in the shipbuilding contract, and the shipyard signs the delivery documents alone to transfer the title of the newbuilding to the purchaser.

In this situation, the purchaser will acquire a full and clean title of the newbuilding only when only when the shipyard could be deemed as the agent for the “folk investor” in terms of the construction and delivery of the newbuilding (same as Situation 2 above).

Situation 3 The “folk investor” appears as the sole seller in the shipbuilding contract, and it signs the delivery documents alone.

In this situation, the purchaser will acquire a full and clean title (same as Variation 1 above).

One side issue is that the shipyard may exercise the possessory lien over the newbuilding when there is any dispute between it and the “folk investor” in relation to the cooperation agreement.154 Moreover, the “geo-financial clan” may take legal actions to attach the newbuilding which belongs to the “folk investor,” when there is a dispute between the two parties in relation to the “folk lending.”155 These may freeze the construction of or block the delivery of the newbuilding, which may also have negative effects on its title transfer. In this sense, the purchaser may feel necessary to use the “floating charge” (see above) or the “co-owning method” (see below) proffered in the RRLC 2007 to secure its advance payment and protect its other interests in relation to the newbuilding.

Another side issue is that in some cases, to protect its own interests, the “folk investor” will register the newbuilding, when finished, under its name prior to its delivery (title transfer) to the purchaser.156 The “folk investor” may have such intention from the very beginning, but may only disclose it to the purchaser at the very end (usually, when the registration has been done).157 This will cause enormous difficulties to the purchaser, who wants a legally newbuilding rather than a legally second-hand ship (even unused). One difficulty is that the purchaser may be unable to persuade its financier to grant the funds for a changed transaction (from newbuilding to second-hand ship). The other difficulty is that the procedure and documentation for registration of second-hand ship are entirely different from those of newbuilding. That said, if the newbuilding is

154 Art. 25(Para. 2) of the MLC 1992.
156 If the “folk investor” is composed of two or more individuals, the newbuilding will be registered under one of them.
157 If the “folk investor” discloses its intention to the purchaser at the beginning, the purchaser may be reluctant to enter into the newbuilding contract, even if the shipyard is the sole seller or co-seller in the shipbuilding contract.
registered under the name of “folk investor” prior to the delivery, the purchaser will acquire a full and clean title of the legally second-hand newbuilding. In a rising market, the “folk investor” may use this mechanism to ‘enforce’ the purchaser to increase the purchase price.158

The above analysis shows that prior to the effectiveness of the RRLC 2007, the purchaser was exposed to the unexpected “tile question” when acquiring a newbuilding under the “Taizhou Model.” The shipyard and the “folk investor” might use some bogus argument to defeat the title acquired by the purchaser in relation to the newbuilding, whenever they thought ‘profitable.’ Moreover, the hidden “folk investor” may negate the newbuilding registration the purchaser intends to make with the ship registry. These phenomena reflect the ignorance of the draftsmen of what is happening in practice.

“Taizhou Model” – Under the RRLC 2007

Now, the RRLC 2007 perfects the title of the newbuilding the purchaser will acquire under the “Taizhou Model.” This perfection, which may not be in the contemplation of the draftsmen, enables the practitioners to gingerly step between the law and practice. But, its efficiency is yet to be tested in reality.159

Above of all, Arts. 6 and 23 of this law reaffirm that the title of the moveable asset (e.g. newbuilding) is transferred by the transferor to the transferee upon the delivery in accordance with the law.160 Arts. 93 and 94 of this law reaffirm the two forms of co-ownership (joint tenancy and tenancy in common) and the co-owners’ rights and obligations under each form as provided in the GPCLC 1986 and the GPCLC Implementation Rules 1988.

Then, the RRLC goes on to provide:

“Art. 26 When the title of the floating asset is lawfully possessed by a third party prior to…the delivery [from the transferor to the transferee], the transferor who is obliged to deliver the floating asset may effect the delivery by assigning to the transferee its right to claim the return of the floating asset from the third party…

Art. 97 [When the co-owners intend to] dispose of…the floating asset, [such intended disposal] shall be agreed by the co-owner[(s)] who holds 2/3 or more shares of the [ownership of the floating asset] in the case of joint tenancy…save the co-owners agree otherwise…

158 The “folk investor” may argue that it is not a party to and therefore not bound by the shipbuilding contract, and then ‘propose’ the purchaser to increase the price with the threat to sell the newbuilding to a third party for a higher price.
159 According to the author’s research, no party has tried this perfection in practice.
Art. 103 When the co-owners of...the floating asset do not make an agreement to clarify whether the co-ownership is in the form of joint tenancy or tenancy in common...such co-ownership shall be deemed as joint tenancy.

Art. 104 When the joint tenants do not make an agreement to clarify or if the agreement is made, it fails to clarify the respective shares of [the ownership of] the co-owners [in respect of the floating asset], the respective shares shall be decided according to the respective capital investments of the co-owners; [however,] if the respective capital investments cannot be ascertained, the co-owners shall be deemed as having equal shares of [the ownership of] the floating asset...

Art. 106 When a party who is not entitled to dispose of [a]...floating asset 'transfers' that...floating asset to a third party... the owner of that floating asset is entitled to recover it. However, the transferee [i.e. that third party] will acquire the [full and clean] title of that...floating asset, provided:

(1) the transferee acted in good faith to effect the transfer...of that floating asset;

(2) the transfer is made on the basis of a reasonable price [in relation to that floating asset];

(3) if that...floating asset must be registered according to the legal provisions, the transferee has completed the registration; if the registration is not required, the transferee has taken delivery of that floating asset..."

The above provisions provide a three-tier protection for the purchaser to acquire the full and clean title of the newbuilding.

Tier 1 Pre-emptive Protection

According to Art. 97 of the RRLC 2007, in case of joint tenancy, the co-owner(s) who own(s) more than 1/3 of the ownership of a moveable asset may block the transfer of title of that moveable asset to a third party, i.e. prevent the other co-owner(s) from disposing of the asset without its(their) consent(s). Thus, as to Variations 2 and 3, the purchaser could try to insert a term into the shipbuilding contract, which provides that once its advance payment hits the account of the shipyard and/or the “folk investor,” it will own more than 1/3 of the ownership of the newbuilding till the time of

161 Alternatively, the purchaser could try to enter into a collateral contract with the relevant party(ies) to the same effect.
But, this “co-ownership method” is subject to two caveats. Firstly, normally under the “Taizhou Model,” the purchaser will advance about 20% of the purchase price prior to the delivery. The shipyard and/or the “folk investor” may not be willing to alienate more than 1/3 of the ownership of the newbuilding when only receiving 20% of the purchase price. Secondly, this protection may be subject to the principle of “bona fide third party” as provided in Art. 106(Para. 1) (see below). In practice, one possible way to circumvent that principle is that the purchase makes the “co-owning term” known to the public as much as possible so as to eliminate the potential “bona fide third party.”

Tier 2 Defensive Protection

When the purchaser has no chance to take the pre-emptive action, it could consider taking the defensive action. In terms of Variation 2, Art. 103 of the RRLC 2007 makes it clear that the co-ownership between the shipyard and the “folk investor” will be deemed as tenancy in common. Thus, if the cooperation agreement could show that the shipyard contributes 2/3 or more of “the capital investment” to the construction of the newbuilding, it will own 2/3 or more share of the ownership of the newbuilding, and the purchaser will acquire a full and clean title of the newbuilding when the shipyard signs the delivery documents alone. This is notwithstanding whether the “folk investor” appears as the co-seller in the shipbuilding contract or not.

In terms of Variation 3, Art. 26 of the RRLC 2007 makes it clear that the “folk investor” may effect the delivery of the newbuilding by assignment no matter whether the shipyard cooperates or not. Under the Chinese law, such assignment will be composed of two parts. One is a written letter of assignment executed by the “folk investor” and delivered to the purchaser, which provides that the purchaser is vested with the right to take delivery of the newbuilding directly from the shipyard. The other part is a written notice of assignment signed by the “folk investor” and served on the shipyard, which informs the shipyard of the delivery. Thus, the shipyard cannot block the delivery nor do anything else to prevent the purchaser from acquiring a full and clean title of the newbuilding (except the charge of possessory lien).

Tier 3 Safe-net Protection

In many cases, when the shipbuilding contract is executed, the newbuilding has been constructed to a great extent. So, the co-ownership has something material and solid to stand on. The contribution from the shipyard will include usage of construction facilities and technical, engineering, labouring and other services, as well as capital investment. In practice, the non-capital contribution will be converted into capital according to its monetary value.

If the shipyard firmly holds the newbuilding, the purchaser may apply to the competent maritime court for the maritime injunction ordering the shipyard to delivery the newbuilding, or the arrest of the newbuilding pending the affirmation of the ownership of the newbuilding.
Art. 106 of the RRLC 2007 provides a safe-net to Tier 2 Protection. In respect of all other situations of Variations 2 and 3 (other than the situations narrated in Tier 2 Protection above), the purchaser will acquire a full and clean title of the newbuilding by reason of “bona fide third party” (Art. 106(Para. 1)). It is not unsafe to assume that in a normal transaction, the purchaser will:

1. negotiate, execute and perform the shipbuilding (incl. taking delivery of the newbuilding in “good faith” (Art. 106(Para. 1)(1));

2. have an arm-length transaction with the shipyard and/or the “folk investor” and pay a market-tolerable price for the newbuilding (Art. 106(Para. 1)(2)); and

3. register the newbuilding immediately after the delivery.\(^{168}\)

When there is any doubt regarding the above, the judicial authority could easily check the uncertain issue with the relevant parties (e.g. the newbuilding brokers or shipping exchange).

Tier 3 Protection can also defeat any attempts of the shipyard, “geo-financial clan” or any other party to block the transfer of title of the newbuilding or entail any negative effect on the transfer.

It seems that the RRLC 2007 makes the “Taizhou Model” feasible by perfection of the co-ownership provisions and definition of “bona fide third party.” The “bona fide” maxim could help the purchaser acquire a full and clean title of the newbuilding in a multi-party, multi-transaction and multi-relationship context. The effect of this unimaginable vehicle is yet to be tested in the economic reality of China.

**Conclusion**

The RRLC 207 may have many far-reaching effects beyond the contemplation of the draftsmen. This article studies only two vehicles arising from those effects: the charge of semi-finished product and “floating asset” by way of mortgage and the perfection of the transfer of title under the “Taizhou Model.” The vehicles could help the SMS Yards and their clients (esp. foreign clients) circumvent the obstacle of Shipbuilding Refund Guarantee, which is essential for the survival and development of the SMS Yards and the Chinese shipbuilding industry. Moreover, the vehicles could supplement the Shipbuilding Refund Guarantee to protect the interests of the purchaser, especially in a rising market.\(^{169}\) It seems that the vehicles provide all concerned with the commercial

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\(^{168}\) See *supra* fn. 71.

\(^{169}\) As illustrated above, the “floating charge” and “co-ownership method” could prevent the shipyard and/or the “folk investor” from unlawfully disposing of the newbuilding. In comparison, a Shipbuilding Refund Guarantee
reasonableness and business efficacy.

However, the effects of the RRLC 2007 are yet to be seen and tested in reality. From the author’s point of view, whether the above two vehicles could have real effects in the practice largely depends on the Chinese authorities’ recognition, comprehension and execution of this law. It may take time for the authorities to assume their new duties under the RRLC 2007, especially when those new duties may unexpectedly shift the administrative power from one authority to the other. For instance, the SAIC may be cautious to register the “floating charge” made over the vessel under construction, as the construction mortgage traditionally falls in the jurisdiction of MSA. In the meanwhile, the MSA will not register the “floating charge,” as this is not provided in its Bible - the SRRC 1994. Thus, a consultation and cooperation mechanism must be established between the two authorities to realise the “floating charge.” Furthermore, it may take time for the Chinese court system (esp. the SPCC) to work out the judicial guidelines for the correct interpretation and enforcement of the substantive rights granted under the RRLC 2007, in case the authorities fail to assume their duties. Every effort must be taken to avoid the reoccurrence of the procedural negation of substantive right.

Appendix 1

The RRLC 2007 (esp. Art. 180(Para. 1)(7)) extremely widens the scope of the movable assets which may be charged by way of mortgage

<table>
<thead>
<tr>
<th>The SLC 1995</th>
<th>The RRLC 2007</th>
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<tbody>
<tr>
<td>Art. 34(Para. 1)(2): machinery, transportation devices and other assets</td>
<td>Covered by Art. 180(Para. 1)(4) and (6)</td>
</tr>
<tr>
<td>Art. 34(Para. 1)(4): state-owned machinery, transportation devices and other assets</td>
<td>Covered by Art. 180(Para. 1)(4) and (6)</td>
</tr>
<tr>
<td>Art. 34(Para. 1)(6): the other moveable assets which can be charged by way of mortgage, e.g. the vessel, aircraft and building under construction</td>
<td>Covered by Art. 180(Para. 1)(5)</td>
</tr>
<tr>
<td>Art. 42(4): aircraft, ship and vehicle</td>
<td>Covered by Art. 180(Para. 1)(6)</td>
</tr>
<tr>
<td>Art. 42(5) (supplemented by Art. 3(Para. 1) of the Mortgage Registration Rules 2000 (Repealed)): enterprise’s equipment, raw and supplementary materials, product or commodity and other moveable assets</td>
<td>Covered by Art. 180(Para. 1)(4) and (7)</td>
</tr>
</tbody>
</table>

could only secure the return of the paid instalment(s) plus interest.
which can be charged by way of mortgage

<table>
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<tr>
<th>Art. 43(Para. 1) (supplemented by Art. 3(Para. 1) of the Mortgage Registration Rules 2002): the materials of production and other moveable assets owned by the individual, public institution, social organisation or other non-enterprise organisation, such as machinery, equipment and livestock, which can be charged by way of mortgage</th>
<th>Covered by Art. 180(Para. 1)(4) and (7)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Art. (Para. 1)(4): the semi-finished product and “floating assets”</td>
<td></td>
</tr>
<tr>
<td>Art. (Para. 1)(7): all the other movable assets which are not expressly prohibited by the laws or regulations for being charged by way of mortgage</td>
<td></td>
</tr>
</tbody>
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Finished together with Yingbo and our 100-day Yiyang at Juye Home, Shanghai, on 19 October 2008