

*By Yvonne Chu-Feetham*

## **Introduction**

Gibraltar, a British overseas territory in the southernmost tip of Spain, situated between two continents at the entrance to the Mediterranean Sea, benefits from a constantly growing marine sector. Gibraltar was captured by the British in 1704 and, has to date, remained British, enjoying British Overseas Territory Status. The head of state is Queen Elizabeth II who is represented by the Governor of Gibraltar. A self-governed territory and part of the EU under Article 227 (4) of the Treaty of Rome via Britain's membership, Gibraltar offers an outstanding portfolio of maritime services including its own ship registry ranking 23<sup>rd</sup> on the White List of the Paris Memorandum of Understanding on port state control. By virtue of its excellent geographical location and its successful legal system, based on the common law and statutes of England, the legal practice in Gibraltar specialises in various maritime matters including registration, seizures and arrests.

## **Registration**

The Gibraltar Ship Registry prides itself in offering high standards of efficiency and safety, and obtained ISO 9001/2000 quality certification in 2005. Classed as a Red Ensign Group Category 1 Register, the Registry now boasts a record of more than 280 ocean-going vessels on its register to-date.

The registry offers four categories of ship registry; (1) Full; (2) Bareboat; (3) Provisional; and (4) Ship under construction. Ships registered in Gibraltar are classified as EU Ships and will therefore enjoy the same access to cabotage trade as other EU-registered vessels.

## **Ship Finance**

Gibraltar is currently seen as an important jurisdiction in the shipping world, and ship finance undoubtedly plays an important role in this development.

## **Background**

Ship finance is a high risk capital intensive industry. Historically, acquisitions of vessels pre-World War II, were largely funded privately by ship owners. However, due to the expansion of European and Japanese economies post War, which resulted in the increase of international trades and the need for transportation by sea, ship owners began to look at credit institutions to support the demand for capital injection for the shipping industry in the 1950s and 1960s.

Various studies showed that during the period of 1950s and 1960s, credit institutions were happy to offer high advances to ship owners which were secured merely by a legal mortgage over their vessels. By the end of 1960s, 80% of independent tanker fleets on time charter were highly leveraged. Legal mortgages against loan advances were also considered sufficient collateral for the credit institutions despite the high risk involved in ship financings. This lack of prudence by the credit institutions led to disastrous

consequences whereby a recorded amount of shipping loans in default reached \$10 billion and credit institutions found themselves having to write off substantial amounts of default loans from ship owners that ran into financial difficulties in the 1980s.

Having learnt the lessons of their predecessors, credit institutions began exercising prudence which resulted in stringent regulations and credit risk awareness throughout the 1990s. Credit policies and risk assessments were put in place and were scrutinized closely. Information gathering and due diligence in respect of each borrower became vital. Due to the nature of the industry and the historical background of most shipping companies, which are by and large family owned, information gathering and risk assessment can sometimes prove to be a mammoth task for credit institutions. As commercial relations are often preserved by confidentiality by family-owned ship companies, there is a limit on information available. Further, shipping is a multinational activity and as such, every ship company has the option of choosing from a number of different Flag States, each with different regulations governing its vessels which result in further complications in the risk assessment process.

Given the risks involved, a loan agreement became an integral part of any loan advances as it governs the contractual relationship between the credit institution as lender and the ship owner as borrower. Great care is therefore required when drafting the loan agreement due to differing and conflicting interests by both parties. Furthermore, it has also become a common practice for warranties and covenants to be drawn into the loan agreement. Such clauses may stipulate the prohibition against disposal of the charged vessel or properties and may also include covenants on provision of annual financial statements of the borrower, sufficient insurance cover and proper maintenance of the vessel charged.

It is no longer sufficient to provide solely a legal mortgage over the vessel. Credit institutions are now requiring more security to be given against loan advances and in addition to the requirement for a first legal mortgage over the vessel, an assignment of income, an assignment of insurance policies and also personal and corporate guarantees are also normally required. For larger loans, credit institutions are also in favour of syndicating these loans, which allows the share in profits and also the spread of risk amongst the participating banks.

Choice of Flag State by the borrower has become an important factor in ship finance. During a sea voyage, a vessel will impart its Flag State nationality and the protection given by the Flag State adding to the confidence of those relying upon it, in particular credit institutions.

A credit institution will not want to advance loans to a borrower whose choice of Flag State and registration process shall cause undue delays to the enforcement of the lender's security. In addition, lenders and insurance underwriters would need to be aware of the Flag State's policies on enforcement of international safety and environment standards. For example, a reduced standard in observing international rules on environmental pollution may result in the vessel being exposed to liability for environmental pollution. The vessel may also be targeted and detained during its sea voyage by port state controls for failing to comply with international rules on environmental pollutions. This may lead to significant increase in operational costs which may then result in the borrower's ability to repay its loan to the lender.

The importance of the choice of Flag State in ship finance is therefore undisputable and no single factor can influence the selection of the Flag State. Political stability, efficient judicial system, unambiguous legislation on maritime law and mortgage registration system, proven safety record, registration and tonnage fees have all the potential to impact the vessel's income generating capability and ability to repay its indebtedness. Therefore, a great deal of consideration has to be given when choosing a Flag State.

Gibraltar, classed as a Red Ensign Group Category 1 Register complies with various international conventions of the sea. Its recent upgrade to number 23 on the White List of the Paris Memorandum of Understanding on port state controls makes Gibraltar a preferred choice of Flag State.

Further, Gibraltar is a common law jurisdiction and most of its Acts of Parliament are derived from English statutes and EU Directives. The Gibraltar Merchant Shipping (Registration) Act 1997 is the main governing piece of legislation in respect of registration of merchant ships, pleasure yachts and mortgages. The register of mortgages is open to public inspection and this is useful as credit institutions can conduct checks on the vessel to ascertain whether there are any existing encumbrances over the vessel. Its judicial system is also one based on English judicial system.

Having satisfied most, if not all of the criteria for a preferred Flag State, it shall undoubtedly continue to grow in its status as a Flag State of choice for both ship owners and credit institutions.

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