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DEVELOPMENTS IN SHIP FINANCING IN AUSTRALASIA

by

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Leveraged Leasing

1. It is interesting to look back on the informative and helpful paper which Ian James prepared for the 1981 Annual Meeting of this Association in Adelaide on "Aspects of Ship Financing in Australia", and to see how much of it he devoted to the mechanism of financing by a leveraged lease. Since 1981, for a New Zealander at least, leveraged leasing has receded in importance as a method of financing the acquisition of newbuildings, or of used vessels. In 1981, Ian could say that:

"3.02 The traditional forms of finance used in Australia have largely followed the London pattern which tends towards direct financing of shipowners by both single lenders and syndicates. In addition, there is a well-developed system of tax leasing in the U.K. which, in many cases, confers very substantial benefits on the operator of a ship.

"3.03 The last 2-3 years have seen the rapid development in Australia of our own system of tax leasing, known as leveraged leasing.

"3.04 Leveraged leasing is a technique of financing which was developed in the United States in the late 1960's to facilitate the financing of large items of equipment, such as railroad equipment, aircraft and ships. A leveraged lease involves cash timing benefits and the taxation benefits of ownership under the Income Tax Assessment Act, 1936 (C'wealth) (the "Tax Act") and the leveraging of those benefits by way of limited recourse loan debt. In this way it is often possible to finance the acquisition of a ship at an effective cost which is lower than alternate means of financing, some of which have already been referred to in paragraph 3.02 above."

2. Much has changed since 1981, in Australia as well as in New Zealand. The tax advantages which were once available to lessors, and thus, through lower financing costs, to lessees, in Australia under leveraged leasing arrangements were rendered harder to obtain by legislation announced by the Australian Treasurer in 1982, and incorporated in section 51AD of the Income Tax Assessment Act 1936. That legislation, which came into force in respect of the year of income in which 24 June 1982 occurred and all subsequent years of income, had the effect that certain property in respect of which the taxpayer lessor hoped to found deductions for interest and depreciation would be deemed not to have been occupied or used or held for use by the taxpayer at the relevant time for the purpose of producing assessable income or in carrying on a business.

3. This disallowance of the foundation stone for these crucial deductions did not apply, under section 51AD(8), to property of a taxpayer:

"Unless the whole or a predominant part of the cost of the acquisition or construction, as the case may be, of the property of the taxpayer [was] financed directly or indirectly by a debt"

which was effectively "non-recourse" or "limited recourse" debt. Such debt was fundamental to the classic structure of leveraged lease seen in Australian and indeed in New Zealand and other countries. As Ian James said in his paper:

"3.13 It is fundamental to our leveraged lease transaction that the funds required to repay the Debt Parties and to give the Equity Participants the balance of their return (after taking into account the tax benefits available to them) should come from the charter-hire and other moneys to be paid by the Australian Producer to ABC Leasing Limited under the Bareboat Charter. If, for any reason, the Australian Producer fails to pay the charter-hire, then the Equity Participants as borrowers are not obliged to repay the loans obtained from the Debt Parties. The recourse of the Debt Parties as lenders is limited to the moneys paid to ABC Leasing Limited by the Australian Producer under the Bareboat Charter and the security in the form of the Contract Assignment, the Refund Guarantee Assignment, the ship mortgage and the other assignments referred to in Stage 10. If any part or all of the charter-hire is paid, the Debt Parties receive their share of it first and the Equity Participants then receive the balance. In other words, the Debt Parties are preferential creditors and the Equity Participants are subordinated to them, so far as the charter-hire the securities are concerned."

4. One would have thought, then, that section 51AD, following the Treasurer's 1982 announcement, had struck at the heart of leveraged lease financing. Not so. There grew a practice of using finance which did not, at least on its face, rely upon non-recourse or limited recourse arrangements to support leveraged leasing, and which gave similar financial benefits to lessors and lessees, although with greater complexity. The more "aggressive" structures were able to be most attractive to lessees in Australia and elsewhere, for example in New Zealand.

5. Some reaction from the Australian Government was predictable. On 15 May 1984, the Treasurer, Mr Keating, announced measures to prevent the loss of revenue to the Australian Commonwealth Government through the use of non-leveraged finance leases and similar arrangements by governments and tax-exempt government authorities. That was itself soon considered by the Treasurer to be insufficient to stem the flow of quasi-leveraged leasing arrangements being put together by the feverish activities of lease packagers. On 16 December last year, therefore, Mr Keating

was moved to make yet another announcement on the topic, this time directed to the "cross-border" phenomenon of leasing which made use of the benefits available to Australian lessors, and which extended the consequent benefits of lowered financing costs to non-residents of Australia. In his December 1984 announcement, Mr Keating said that:

"It has become clear that a considerable amount of non-leveraged offshore leasing is being written involving property used overseas either by non-resident lessees or by resident lessees who are exempt from tax in Australia on income derived overseas from the use of the leased property. As with leasing to exempt authorities, under such offshore leasing arrangements both the Australian lessor and the lessee are able to gain financially at the Commonwealth's expense, compared to the alternative where the end user acquires the property through loan financing and cannot claim deductions (e.g. depreciation) for Australian tax purposes in respect of plant not used by the end-user to earn income assessable in Australia.

"Offshore lessees in some countries may in fact benefit from double dipping, whereby they not only benefit indirectly from the Australian tax treatment of the deductions under the leasing arrangements, but are also able themselves to obtain depreciation deductions in respect of the leased property from the country in which the leased property is used.

"The Government has decided, therefore, to extend the measures announced on 15 May 1984 to include non-leveraged finance leases (and similar arrangements) of property by:

- (a) non-residents, other than those who are subject to tax in Australia on income derived from the use of property; and
- (b) residents who derive income from sources outside Australia from the use of the property and are exempt from Australian tax on that income.

"This extension should involve considerable savings to the revenue in 1985-86 and subsequent years. The legislation will also contain anti-avoidance provisions to ensure that the spirit, as well as the letter, of the law is observed.

"The measures will apply to leases the formal contractual obligations in respect of which are entered into after 5.00pm Eastern Summer Time today."

6. At the time of writing this paper (August 1985), the promised legislation has yet to be seen. Nevertheless, it is clear that it has not spelt an end at least to Australian domestic ship financing by way of quasi-leveraged lease. I am conscious that arrangements of this kind for ship financing have been put in place recently for equipment costing over A\$93 million, and there has no doubt been a

considerable volume of which I have not become aware. The structures that are being proposed and accepted, though, often fall into the category of what the leasing market calls "very aggressive structures", involving credit sales agreements, deferred purchase arrangements, and careful scrutiny of the right level at which to pitch the residual value for the purpose of the underlying lease. It seems, therefore, fair to assume that the domestic Australian leveraged leasing market, albeit trading under another name, is by no means dead, and will be alive (and scrutinised by Commonwealth Treasurers) for some time to come.

7. The Australian experience, of course, only parallels or follows (I do not think it yet anticipates) the experiences of the leasing industry in many other countries. In the United States, for example, where the techniques of leveraged leasing were largely developed, there has been a proliferation of activity in the financial services industry, not only by traditional financial institutions, but by retailers, steel manufacturers, large industrial concerns, and others. The financial service industry has attracted these new entrants because each sees it as having some particular benefit, for example the smoothing out of cyclical trends, the boosting of margins, an opportunity to capitalise on access to money markets, and so on. This has resulted, too, in a growing trend towards product diversification by established lessors, through perceived new opportunities created by tax law changes and customer needs. Packages now being offered include "leveraged track leases" for cars and trucks (involving "terminal rental adjustment clauses"), leveraged joint ventures, residual value insurance, and of course the use of interest rate and currency swaps. There has been much recent speculation about the effect which the proposed elimination of the United States investment tax credit, and the requirement for longer periods for depreciation, will have on lease financing in the United States. It is thought that the effect, though significant, will not be terminal - on one observer's estimate, 40% of the dollar volume of leasing transactions in the United States are not tax-orientated.¹. No doubt the inventiveness of leasing specialists in the American financial services industry will continue to spawn new variations upon leasing techniques, which will eventually find their way to the ship financing arrangements for vessels to be used in Australia and New Zealand.

8. Australasian ships have also been financed through the leasing industry in the United Kingdom. Prior to the 1984

1. B. McKenna, President of American Association of Equipment Lessors, in London speaking at the Third International Leasing Convention in June 1985.

Budget and Finance Act in the United Kingdom, there was a general availability of a 100% first year allowance on most types of capital equipment, coupled with a corporation tax rate of 52%. An active leasing market existed, with lease rates reflecting the benefits to the lessor of the high rates of allowances. To the lessee, this source of finance, pre-tax, would cost typically up to 6% below the cost of alternative forms of bank support. The 1984 Budget, however, coupled with restrictions imposed in 1980 and 1982 on the ability of foreign lessees to obtain the benefits of United Kingdom tax-based leasing, have already changed the face of the leasing industry in United Kingdom, and thus its potential ability to help shipowners in Australia and New Zealand. There is to be a phased reduction in capital allowances, corresponding with a phased reduction in corporation tax rates, so that there will be only a 25% writing down allowance, even for domestic leases, from 1986 onwards. The 1980 and 1982 Finance Acts, which make it extremely difficult for lessors to offshore lessees of ships to obtain anything better than a 10% writing down allowance, with comprehensive wording designed to inhibit attempts to evade the restrictions, have effectively inhibited the use of United Kingdom based leases as a method of financing ships for Australian and New Zealand shipowners.

9. There has been a growing interest in providing lease-financing services through Japan. Japanese leasing companies have become active participants in cross-border leasing transactions, particularly for larger items and for blue chip (sovereign or quasi-sovereign) lessees. The so-called "shogun" leases, or yen-denominated cross-border leases for big ticket items, also fulfil the important function of channelling "surplus" yen out of Japan, and have to date been looked upon benignly by the Japanese regulatory agencies.

10. Cross-border leasing grew rapidly in popularity in 1980 because of the opportunities perceived, particularly in transactions between the United States and the United Kingdom, to obtain the so-called "double dip" benefit. This benefit arose because of inconsistencies in the treatment of the ownership and use of capital items between two countries, enabling tax benefits obtained by a lessor in one country to be paralleled by similar benefits obtainable by a lessee, under the same transaction, in the other country. This horrifying possibility was even referred to by Mr Keating in the statement of 16 December 1984.

11. Just as in Australia, revenue authorities around the world have acted to try to inhibit or prevent this "exporting of tax allowances". The 1980 and 1982 Finance Acts in the United Kingdom, the 1982 Australian changes, similar changes in New Zealand in that year, and legislation of a like kind in South Africa, Hong Kong and other places

have attempted to strike at the benefits to be obtained by, for example, shipowners and operators in Australia and New Zealand from the use of tax allowances available to lessors in, say, the United States or the United Kingdom. In 1984 in the United States, the amendments introduced by Congressmen Pickle and Dole as part of the deficit reduction package severely restricted the availability of tax allowances for certain tax-exempt bodies, including any foreign government or corporation which was not a United States incorporated and tax-paying body.

12. New Zealand's attempt to stifle the transfer of depreciation and other ownership and financing allowances from user to lessor commenced in 1982, with the introduction of sections 222A to 222D to the Income Tax Act 1976, to apply with respect to every lease entered into on or after 6 August 1982. The measures were anticipated, indeed feared, by the lease packaging industry in New Zealand, as elsewhere, and there was, as might be expected, frenetic activity up to the very last minute to put in place qualifying leases. Indeed, I can remember one lease, put together at breakneck speed at the last minute, which was signed at 7.25pm on Budget night, when the then Minister of Finance rose to speak at 7.30pm. New Zealand until recently has not been a capital exporting country, at least in the sense of providing finance for the enterprises of other countries, and the particular method chosen in New Zealand for this "anti-lease" legislation for a while seemed to play into the hands of the cross-border leasing industry. That industry found that qualifying leases (termed "specified leases") were to be regarded as deemed loans, and the legal lessor was to be treated for taxation purposes as having lent money, and interest, to the lessee. The lessee would be able to claim depreciation on the leased assets, and would claim the deduction for tax purposes of the financing or interest element in the lease payment. A domestic lessor, for its part, would not be taxed upon the lease payments in gross, but only upon the interest element deemed to have been received by it. Even leases which did not qualify were affected, in that the lease payments were not able to be "sculptured" into particular tax years, but had to be treated for tax purposes as though they were made proportionately over the period of the lease term. The most significant definition, of course, was that of a "specified lease", which was (and is) defined to mean:

- "(a) A lease which has a guaranteed residual value; or
- (b) A lease pursuant to which -
 - (i) The lease term is a period of more than 36 consecutive months, or, where the Commissioner is of the opinion that the economic life of the lease asset is less than 36 months, a period equal to the economic life of that lease asset; and

(ii) Any one or more of the following provisions applies:

- (A) Ownership of the lease asset is to be transferred to the lessee at the end of the lease term:
- (B) The lessee has the option to purchase on the expiry of the lease term the lease asset at a price which, in the opinion of the Commissioner, will be significantly lower than the value which will at the time of that expiry be the market value of the lease asset:
- (C) The sum of the aggregate of the amounts of the lease payments and the amount of the guaranteed residual value, if any, exceeds an amount that is equal to, or to a small extent less than, the cost price of the lease asset:
- (D) It is agreed between the lessor and the lessee that the lessee shall be liable for the payment of all, or nearly all, expenditure incurred in respect of the costs of repair and maintenance and any other incidental costs arising during the lease term in respect of the use of the lease asset,-

and includes any lease in respect of a lease asset where the ownership of that lease asset is acquired (whether directly or indirectly) by any means whatsoever, subsequently by the lessee, or by any other person where the lessee and that other person are associated persons, from the lessor, or from any other person."

13. As you can see, the 1982 changes in New Zealand, by giving a deduction to a lessee equivalent to that formerly arising out of ownership, and thus depriving the lessor of that deduction, opened up some scope for highly beneficial financing arrangements for ships and other items of capital equipment, at least where lessees were in a taxpaying position (leveraged leasing arrangements had formerly appealed particularly to lessees who had accumulated tax losses or were otherwise not in a position to take advantage of the taxation deductions available to the person who had ownership of capital equipment). For a while, therefore, there was considerable activity in devising lease structures between financiers in those countries which were still able to offer taxation advantages to lessors (the list of which included, surprisingly, Australia until 16 December last), and New Zealand taxpaying lessees. A kind of "double dip" arrangement was possible, of the type spoken of in relation to the United States and the United Kingdom earlier, whereby taxation advantages were able to be obtained both by the lessor and by a New Zealand lessee under a "specified lease".

14. With the action that has been announced or taken in Australia and other countries to limit the availability of such deductions with respect to cross-border leasing by lessors resident in those countries, the magnified benefits in terms of the reduction of cost that were otherwise available have been much more difficult to obtain. That is not to say, however, that the lease financing of vessels will not still continue (indeed, has continued in New Zealand), although almost certainly the structures which are accepted for financing will be more complicated.

Ship Registration

15. Ian James' paper in 1982 also went to considerable lengths to discuss the then recently introduced Shipping Registration Act, 1981 of the Commonwealth of Australia. This was said to be particularly significant for ship financing at that time, because of the previous preference of buyers of Australian exported minerals to purchase on FOB terms, which enabled buyers to arrange for the shipment of these exported minerals through low cost "foreign flag" or "flag of convenience" vessels. Australian exporters had perceived considerable benefits to them in trying to influence a movement toward selling on CIF terms, because the major merit of doing so would be to give some scope to the supplier to control the shipping arrangements to suit his own production and storage arrangements. There had also been considerable industrial unrest in Australia because of the perceived lack of opportunities for involvement in Australia's export trade by Australian seafarers. These influences towards a greater involvement of Australia flag vessels, together with the abandonment of the 1931 Commonwealth Merchant Shipping Agreement, had focussed attention on the need for updating the registry and flag requirements for vessels in Australia, leading to the 1981 legislation.

16. Obviously, owners are concerned to ensure that they have clear title to vessels which can provide security for financing arrangements, or in respect of which chartering arrangements are not subject to any doubt when scrutinised by lenders and others providing finance, whether by leasing or otherwise. Ian's summation of the effects of major aspects of the 1981 Act was:

"2.46 The effect of the ownership provisions of the Act is that it will not be possible for non-Australian citizens and corporations to have an interest in a ship registered in Australia unless they can bring themselves within the provisions of Section 8(1)(b) or (c) (which permit foreigners to hold a minority interest) or Section 14(d)) (which applies to a foreign owned ship which is demise chartered to an Australian-based operator). Where foreign interests wish to have more than a 50 per cent interest in an

Australian ship (other than as permitted by Section 14(d), they will have to incorporate an Australian company and register the ship in the name of that company.

"2.47 However, the Act is sufficiently flexible to enable foreign buyers under CIF export sales contracts to participate in the Australian carriage of cargoes which they have arranged to buy. As a result, a wider group of potential operators will be able to utilize Australian tax benefits, and this will undoubtedly present opportunities for those operators to obtain tax benefits in more than one jurisdiction."

There is no doubt that a clear and precise system of registration of interests in ships, whether of ownership or of a security nature, or in respect of maritime liens and similar claims against vessels, is essential to the sound and efficient financing of ships.

17. Interestingly, the history of ship registration had its birth in taxation, as do so many other aspects of ship financing. "Tonnage" measurement can be traced back to the year 1302, in the reign of Edward I of England when a tax of two shillings was levied on each "tun" or cask of wine imported into England by "the merchant vintners of Aquitaine". In return for this, the vintners were granted certain freedoms and privileges in England and the Sovereign renounced his right to the "prise" of two tuns of wine from every ship, one from before the mast and one from behind it. The tun was a standard legal measurement of wine, and was to measure not less than 250 gallons.² The earliest record of statutory tonnage measurement in Britain appears to be in 1421, in the reign of Henry V, when it was enacted that "Keelf that carry Sea-Coalf to Newcastle fhall be meafured".³ The identification of ships, too, was obviously important, and the practice of giving ships names seems to have been a very ancient one. The earliest known ship name appears to have been "Praise of the Two Lands" given to a large cedarwood Egyptian vessel, about 167 feet long, in the reign of Pharoah Sneferu, about 2680 B.C.⁴ The now well-known division in Australian and New Zealand registers of the property in a ship into 64 shares (section 11(1)(a) of the Shipping Registration Act 1981 (Australia), and section 384(1)(a) of the Shipping and Seamen Act 1952 (New Zealand)), was introduced in the major consolidation of the United Kingdom registration laws in 1823 under "an Act for the Registering of Vessels".⁵ Under that Act, while the division of the property in a ship was into 64 shares,

2. "English Historical Documents" Volume III Page 512

3. 9 Hen. 5 C. 10

4. "Ship Names - Origins and Usages During 45 Centuries" Don H. Kennedy, University of Virginia, Charlottesville, 1974

5. 4 Geo. 4 C.41

not more than 32 persons were entitled to be registered as legal owners at one time, but ownership of fractional parts above the statutory 64 shares was permitted, although they could not be registered. The reason for the choice of 64 shares is shrouded in mystery. You may well think that there is some significance in the fact that there were eight persons who entered upon the Ark, presumably as part owners, since the book of Genesis says ⁶. "In the self-same day entered Noah, and Shem, and Ham, and Japheth, the sons of Noah, and Noah's wife, and the three wives of the sons with them, into the Ark". In truth, it was probably found convenient to divide property in a ship into moieties, originally an eighth, and as ships increased in size and part owners became more numerous, it was necessary to subdivide the property into sixteenths, thirty-seconds (32 owners holding 64 shares in 1823) and finally in the 1880 amendment to the Merchant Shipping Act of 1854 (United Kingdom) ⁷. sixty-fourths.

18. The history of ship registration in New Zealand began with bitter dispute between New South Wales and New Zealand. Until New Zealand became a British colony in 1840, ships built in New Zealand did not qualify for registration as a British ship, since by a British Act of 1825 entitled "an Act for the registering of British vessels" ⁸. a ship must have been wholly built in Britain or its colonies. On 18 November 1830, the "Sir George Murray" built at Horeke on the Hokianga harbour in Northland by Sydney merchants Thomas Raine and Gordon Browne, arrived in Sydney on her maiden voyage. It was immediately seized by customs officers for sailing without a Register. The matter was referred to the British authorities, but in the meantime Raine and Browne went bankrupt and the "Sir George Murray" and the Horeke shipyard were sold by auction to Captain Thomas McDonnell for 1300 pounds on 20 January 1831. McDonnell had the vessel overhauled and sailed for Hokianga on 13 March, risking the want of register. When the "The Sir George Murray" returned later that year to Sydney, her master was able to produce a "register" which read as follows:

"To all whom these Presents shall come.

We the Principal Chiefs of Hokianga in the Island of New Zealand PATUONE and TAO NUI send greeting to say that Thomas McDonnell, a Resident and Land holder in our Country, is the sole Owner of the Barque or Vessel called the "Sir George Murray", whereof he the said Thomas McDonnell now is Master, that the said Barque or Vessel called the "Sir George Murray" was built in OUR TERRITORIES of our Timber.

- 6. Chapter 7 Verse 13
- 7. 43 and 44 Vic. C. 18
- 8. 6 Geo. 4 C.110

Be it known unto all Men that the aforesaid Barque or Vessel is three hundred and ninety two 64/94 Tons English Measurement, has two decks and three masts, is built at Hokianga in OUR TERRITORIES, that her length from the fore part of the main stem to the after part of the stern post aloft, is one hundred and nine English feet.

Her breadth at the broadest part above the main wales twenty eight feet eight inches, that she is built by Andrew Sommerhill, an Englishman, is Barque rigged with a standing Bowsprit, is square sterned, Carvel built, has no Galleries and a scroll figure-head, was launched on the second day of September, one thousand eight hundred and thirty and the two Principal Chiefs, PATUONE and TAO NUI do hereby Certify that the several particulars set forth in the above description and Measurement, are true and correct, and we further Certify that the aforesaid Thomas McDonnell is entitled to all the privileges and immunities of a Chief at Hokianga in the Island of New Zealand.

Hokianga New Zealand 2nd June 1831.

	Patuone)	Seal
) Chiefs	
Witness	Tao Nui)	
	Robert Williamson)	
) Residents	
)	
	W.H. Russell)	9.

In New Zealand, at least, registration procedures have become slightly less haphazard since 1831.

19. The New Zealand legislation on ship registration at present descends, as did the Australian legislation, from the United Kingdom Merchant Shipping Act of 1894. Its somewhat involved procedures and, nowadays, archaic record keeping were at least well understood round the Commonwealth and in major financing countries such as the United States, and were in practice reasonably flexible and reliable, at least when compared, say, with the United States or Liberia.¹⁰ As time passed, though, it was gradually felt that the legislation was inadequate, particularly given the growing separation of ownership by investors, banks, partnerships, trusts and other financiers, and operation of the vessels, and the rise of the movement for cargo sharing by vessels owned in, or carrying the flag of, the importer's or exporter's own country. There was, too, considered to be

9. Mitchell Library Manuscripts Sydney - See also "The Ship's Register", R.D. Campbell, Wellington 1980

10. See, for example, Mahla, 1972-3 Tulane Law Review 629, 649-650

a difference in the standards required for crew accommodation and fire safety between New Zealand (where most vessels trading in New Zealand waters were officered and crewed) and many another country of registration (for example the United Kingdom). There were other minor irritants such as inconsistencies in pilotage exemptions between vessels flying the New Zealand flag and other vessels, yet engaged in the same trades, for example across the Tasman to Australia. 11..

20. This disquiet was brought to a head by the abandonment of the Commonwealth merchant shipping agreement of 1931, which provided common principles for the ship registry legislation throughout the British commonwealth. Just as Australia has done, New Zealand is moving towards an exclusive registration scheme, the effect of which will be that ownership by a British subject or a corporate body domiciled in a commonwealth other than New Zealand will no longer in itself be a sufficient and acceptable qualification for registering a ship in New Zealand. A working party has been set up by the New Zealand Government comprising representatives from a cross-section of interested groups to consider a new system. The Government has said:

"it seems likely that the new arrangements will incorporate three important changes to existing principles:

- That the qualification for registration should be based on predominant New Zealand ownership - as distinct from the previous 100 percent British ownership;
- That in certain circumstances New Zealand should accommodate under its registry ships which are on long term demise charter or lease to New Zealand operators notwithstanding that there may be no New Zealand participation in ownership of the property;
- That the present registration system providing national identity for pleasure craft proceeding overseas should be simplified.

"2.7 The working party is currently working on the basis that New Zealand registration should consist of three separate registers:

"Register A will initially embrace all ships currently entered on the New Zealand register and this register will be the only one which will continue to provide a registered title to property in the ship and facilities for the registration of transactions, such

11. See Maxwell, "The Registration of Ships in New Zealand", a paper presented to the New Zealand Branch of the Maritime Law Association of Australia and New Zealand's Annual Meeting at Tokaanu in 1982

as sale or mortgage, affecting that property. It will be of the same permanent nature as the present registration system and will not differ from it in any substantial respect. Ships whose registration will be compulsory are those exceeding a certain minimum size and in which more than 50 percent of the total interest in the ship is owned by:

- (a) New Zealand citizens; or
- (b) Corporate bodies established under and subject to the law of New Zealand and having their principal place of business in New Zealand; or
- (c) Collectively or by any association of (a) and (b).

"Register B will involve registration of certain ships not registered elsewhere where an interest of fifty percent or less is owned by:

- (a) New Zealand citizens; or
- (b) Corporate bodies established under and subject to the law of New Zealand and having their principal place of business in New Zealand; or
- (c) Collectively or by any association of (a) and (b).

and effective control and responsibility for the operation of the ship are vested in persons or a corporate body subject to the law of New Zealand either permanently or for a minimum specified period.

"The availability of this registration to New Zealand operators will depend largely upon the legal requirements of the state in which beneficial ownership of the ship is domiciled. Such ships would not qualify for New Zealand registration on the basis of ownership but such registration would be appropriate on the basis of disponent ownership by persons or corporate bodies subject to the law of New Zealand. Proposed changes to legislation in other areas of the Shipping and Seamen Act will in fact be placing the normal responsibilities of "owner" upon the person having possession and use of the ship.

"Register C will be only for pleasure vessels and will provide a simplified registration system for such ships. ¹².

21. There is now under consideration by the New Zealand Government a draft Shipping Registration Act to incorporate the conclusions of the Working Party mentioned in the White Paper. It is at this point, of course, a confidential

12. White Paper on New Zealand Shipping Policy, December 1983, pages 7-8.

document, but it closely resembles the 1981 Australian legislation, as you will have gathered from the excerpt from the White Paper I have quoted. The New Zealand draft will specify separately the three proposed parts for the Register. Part A will comprise ships required to be registered by virtue of clause 16 of the draft bill (to correspond with sections 8 and 12 of the Australian Act), Part B, ships entitled or required to be registered by virtue of clause 18 of the draft bill (to correspond with section 14 in Australia), and Part C, pleasure vessels. There is provision in the draft for the Minister to appoint any organisation to maintain any part of the Register, a feature which may perhaps be aimed at the keeping of registers with respect to pleasure craft (certain vessels belonging to particular yacht squadrons or yacht clubs are currently exempted from the existing legislation). Ships engaged solely on inland waters of New Zealand, and barges, lighters and other vessels that are used solely on the coast of New Zealand and are not self-propelled, are intended by the draft New Zealand bill to be exempted from the requirement to register under clause 16, though they will be entitled to be registered in Part B of the Register. There does not yet appear in the draft any provision closely corresponding to the new sections 47A to 47E introduced into the Australian legislation by the 1984 Amendment Act, relating to caveats which may be lodged forbidding registration of certain instruments.

22. The New Zealand draft bill contains in clause 53 a vestigial remnant of the rather lengthy, and unused, provisions in sections 424 to 430 of the Shipping and Seamen Act 1952 permitting the sale or mortgage of a ship out of New Zealand. While that is permitted under the clause, it is intended that no New Zealand ship exceeding 500 gross tonnes, or a share in any such ship, can be disposed of in that fashion at any place out of New Zealand except with the written consent of the Minister, though the Minister is not to withhold his consent unreasonably. Perhaps reflecting the different approaches desired, or required, to be taken to the making of regulations (and perhaps administrative law generally) in each country, the regulation-making provision of the draft New Zealand bill is far shorter in terms of the explicit powers and topics for the making of regulations than is the equivalent section 83 of the 1981 Australian Act. It appears to be intended in the draft legislation in New Zealand that regulations other than on topics of qualifications for registered agents, and fees and expenses, if required, are to be permitted by the general power which is in words equivalent to the wording contained in section 83(1) of the Australian legislation.

23. It looks, therefore, as if there are high prospects for a registration statute in New Zealand reasonably parallel to that which has been in place in Australia since 1981. The

Australian experience will therefore be relevant in New Zealand also, though presumably that will essentially be because problems faced in Australia are also likely to be problems in New Zealand. For example, the difficulties perceived by Logaraj and Colinard^{13.}, first that there is no entitlement to registration of certain ships on demise charter to Australian residents, where their owners retain the right to appoint particular officers or crew, and second that the phrase "Australian-based operator" is misleading in that the test is one of control, not residence, are also likely to be true under the draft New Zealand legislation (clauses 2,3 and 18(2)). The uncertainties about the exact transitional provisions which were voiced in Australia may also be relevant in New Zealand if the proposed legislation is in fact enacted in the present draft form or close to that form.

24. It should not be thought, of course, that a desire for the accurate registration of interests in ships is confined to Australia and New Zealand, or indeed to members of the British Commonwealth. I understand that in Saudi Arabia, for instance, ship mortgages are one of the few ways of taking an effective security. The form of the mortgage law is a registration system created under Saudi regulations, not a mortgage of a possessory nature, as is possible under the Islamic theory of pledge. While this itself is undoubtedly a relief for practitioners dealing with loans in respect of Saudi Arabian ships (since the Islamic theory would require actual physical delivery to the mortgagee of possession of the vessel itself), it is apparently necessary, and has been since early 1983, to obtain individual approval of the terms of each proposed mortgage from the Saudi Arabian Deputy Minister of Communications with responsibility for marine transport affairs. This entails a review of the proposed documentation by the legal advisers to the Ministry of Communications in Riyadh. Once the mortgage format has been agreed - and the process is said to require some negotiation - a written instruction is issued by the Deputy Minister of Communications to the Department of Marine Inspection in Jeddah and Damman, the ports of registration, ordering that registration should take place. It is only then that registration of the mortgage, conferring effective rights on the mortgagee, can occur.^{14.} Perhaps we in Australia and New Zealand have much to be thankful for.

13. Paper published in MLAANZ Newsletter Volume 4 No. 1, December 1981 (page 2)

14. McNair, International Financial Law Review, April 1985, page 30

The Impact of Trade Regulation

25. It is impossible to forget, of course, that the arrangement of vessel financing takes place against a background of the expected use of a vessel, or continued use of that vessel, in a particular trade or series of trades, or for particular purposes. Where the owners or operators of vessels are based in New Zealand or Australia, they must consider the proposals for ship financing against the likelihood of economic operation of the particular vessel, when the proposed financing is in place. The competitive position of the vessel and its operators is extremely important. The effect, too, of general legislation providing for enforced or increased competition among providers of goods or services (as with the Commerce Act 1975, to be replaced by a Commerce Bill now before the New Zealand House of Representatives, in New Zealand and the Trade Practices Act 1974 in Australia), is not always appropriate in the rather different competitive situation which exists in international shipping at least, particularly when the importance of adequate transportation of imports and exports to or from each country is considered. As the 1983 New Zealand White Paper said:

"3.2 International liner shipping is characterised by elements of monopoly and oligopoly. In many New Zealand trades this takes the form of associations of shipowners in liner conferences offering common freight rates and negotiating with New Zealand shippers on a collective basis. In some other trades it is a result of the pre-eminence of one or two independent carriers. In these circumstances, the Government's competition policy aims to promote and protect New Zealand trading interests in liner shipping.

"3.3 The Government's shipping competition policy is also concerned to safeguard New Zealand trading interests, whether shipper or shipowner, against protectionist and discriminatory measures imposed by foreign governments. While New Zealand has not yet been widely affected by such actions, there is a growing worldwide incidence of protectionist measures, often in the form of unilateral cargo reservation. For trading nations like New Zealand, the implications may be serious. Not only would New Zealand vessels find their ability to compete for cargoes restricted, but New Zealand shippers could face higher freight charges with a consequent loss of competitive advantage for New Zealand exports, depending on the basis on which they are sold."

26. Accordingly, the New Zealand Minister of Transport, Mr Prebble, on 25 June 1985 introduced a Shipping Bill in the New Zealand House of Representatives, the object of which was "to provide limited and basic ground rules for the conduct of shipper and carrier relations and to establish a balance of advantage between the parties" and to embody "for the first time a New Zealand competition policy regarding the carriage of goods by sea", to bring New Zealand into

line with its main trading partners. The long title of the Bill when introduced was "An Act to Promote Negotiation and Consultation between Shippers and Carriers, to Facilitate Competition in International Shipping Services, and to Discourage Discrimination against New Zealand Shipping Trading Interests by Foreign Governments". The new legislation would, in respect of outward shipping, require carriers to discuss changes in freight rates with shippers, to negotiate with prospective shippers, and to disclose information (of essentially any kind) to shippers. It would give considerable powers to the Government to intervene in shipper/carrier disputes, and to designate "national flag carriers" in freight rate negotiation.

Recurrent Problems of Financing

27. Ship financing today around the world, not least in Australia and New Zealand, is facing new problems, not just because of the relative lessening in importance of lease financing as a method of obtaining finance, at least on a cross-border basis. The battle to stay competitive, reflected in the New Zealand Shipping Bill which I have mentioned, drives merchant banks, financiers, and financing packagers to new efforts to obtain the most beneficial, efficient, and cheap form of financing for particular vessels, having regard to the competitive situation which will prevail in the expected trade for the vessels. There are, though, a number of inescapable problems which, it seems, will always be with us in ship financing, just like the poor. For example:

27.1 Newbuildings are commonly financed while they are under construction, perhaps on an interim basis, with different arrangements to take effect from the time of delivery. That interim financing may involve unsecured loans, multiple lenders to be protected by a trust deed, bonds or debtor's letters to be converted into a mortgage on delivery, assignments of an owner's right to borrow from an intended long-term lender to the interim financiers, and, of course, competition as to priority of interests between lenders, owners of vessels under construction (where title passes in part before delivery) and separate creditors of the builder. Complications can arise if a vessel is being substantially modified or "jumboised";

27.2 For completed vessels, the arrangements often involve, not only specific registered mortgages, but charter assignments, personal guarantees, mortgages of other vessels owned by other related companies or entities, and negotiation of insurance contracts to which financiers will be parties, and often loss payees;

27.3 Assignments of charter hire have to be dealt with in different ways as between bareboat charters and time charters, where, in the latter case, there are potential problems with off-hire periods and variations in operating costs;

27.4 Assignments of contracts of affreightment have their own difficulties, in that they involve potential conflicts of claim between owners of vessels (who would customarily have liens on freights and sub-freights) and lenders;

27.5 Other problems can involve substitution clauses, where vessels not owned by the assigning owner can be substituted to perform the charter, and the existence of collateral letters of credit opened by charterers to cover charter hire which, if they are in favour of a lender, can cause disputes and litigation;

27.6 Concern is often felt by lenders when there are "multiple vessels" financings, where the vessels are owned, in each case, by a separate company. If the group mortgages all the ships owned by the various companies, essentially as security for guarantees given by the separate companies, in respect of a loan which is not required by all of those companies, but which is intended, perhaps, to be taken up by only one of them, lenders will sometimes raise the question of whether adequate corporate benefit has been given to each of the owning and guaranteeing, but not borrowing, companies;

27.7 In New Zealand, too, the amendments made in 1980 to our Companies Act 1955 by sections 315A, 315B and 315C, which permit, in certain circumstances, the protection of limited liability to be lifted in favour of creditors, and which allow other companies in the same group to become liable for the debts of the first company, can cause wariness on the part of a lender to the second company;

27.8 Lastly, you will all be familiar with the necessity to ensure that a lender is adequately protected by insurance, not just in respect of the hull, but also under the protection and indemnity coverage. Not just the usual range of perils must be covered, but also, if possible, losses caused or security negated on requisition for title or for use, or by forfeiture or delay and arrest as a result, say, of fishing vessels or fleets transgressing local fishing zone laws, or, as recently has become a danger in Libya, as a result of not having the "ship's documents" transcribed in the Arabic language. Of course, while lenders like to have the protection of

being named assureds, they occasionally object to paying the premiums on insurance, and require waiver of premium liability clauses and protection against breach of warranty by the ship operator invalidating any of the insurance or P. & I. cover. The loss payable clause, too, has to provide sufficient reinsurance to a lender that, in case of disaster, the lender will have a prior right to insurance proceeds, and will not have to dispute with others over the apportionment of proceeds.

Taxation

28. There is one dimension to financing that overshadows all else in Australia, New Zealand and other countries, having more importance even than stamp duties seem to have to Australian lawyers. That is the treatment of financing flows for taxation purposes. Even before we deal with the treatment of the specific types of payment used to service financing, such as interest, dividends, royalties, charter hire and so on, it is necessary to consider the impact of taxation upon the trading profits received by an operator or by an owner of ships. That treatment is substantially influenced by the terms of the double taxation agreements existing between countries which may be involved in the operation of the vessels or in the financing structure. And when these treaties are examined, they display a surprising, and perhaps alarming, lack of consistency in important details.

29. Most double taxation agreements to which Australia and New Zealand are parties deal with the question of taxation of profits derived from ships, it would seem, in the same broad way. The primary rule is that the profits of an enterprise arising from shipping operations will be taxed only in the state in which the enterprise is located, so long as those profits arise from shipping operations conducted in "international traffic". The term "international traffic" is defined in a negative way so that transport will be in "international traffic" unless it is conducted "solely between places in the other state [that is, the state in which the enterprise is not located]". A number of treaties negotiated by Australia go on to say that "profits" from operation of ships "in international traffic" will not include "the profits derived from the carriage by ships or aircraft of passengers, livestock, mail, goods or merchandise shipping in a Contracting State for discharge in another place in that State". In most treaties, though, the word "profits" is undefined. The majority of the relevant treaties do stipulate that the term includes a share of profits arising from "participation in a pool, a joint business or an international operating agency" though none of these concepts is normally defined. Recent double taxation agreements, though, are beginning to include

specific articles covering the treatment of charter rentals with respect to ships and containers (the practice appearing to stem from the conclusion of the agreement between the United Kingdom and the United States in 1980). For example, New Zealand has in agreements negotiated within the last two years agreed to this wording:

"(3) Profits of an enterprise of a Contracting State referred to in paragraphs (1) and (2) of the Article from the rental of ships or aircraft or from the use, maintenance or rental of containers (including trailers, barges and related equipment for the transport of containers) shall be taxable only in that State to the extent that those ships, aircraft or containers are used in international traffic and such profits are incidental to the profits of the enterprise". 15.

Similar wording has appeared in at least one recent Australian agreement, in Article 8(1) of the Australia-United States Agreement signed in August 1982.

30. There are at least three important aspects of this wording. First, the phrase "rental of ships" draws no distinction between time charters, voyage charters, or bareboat charters. The United Kingdom - United States 1980 agreement referred to above, in Article 8(3), specifically refers to the rental of ships only in respect of ships rented on a bareboat basis (though the Australia-United States Agreement does distinguish between leases on a "full" basis and on a "bareboat" basis). Second, the key concept again is "international traffic", when the profits arising from the rental of ships and containers by an enterprise located in the first state will be taxed only in that state except where those ships or containers are used in a way which falls outside the definition of "international traffic". Third, to escape double taxation, the profits derived from the rental of ships or containers by the particular enterprise must be "incidental to the profits of the enterprise" - a single purpose enterprise or company, therefore, would not qualify for this beneficial treatment under the double taxation agreement.

31. A close scrutiny of relevant double taxation agreements is therefore essential if financiers and owners and operators are to be sure that the minimum necessary taxation deductions are made, or are chargeable on the flows of financing. Particularly is this important in the case of assignments of charter hire in respect of a financed vessel, where a lender receiving those funds, whether as security or simply as a cash flow arrangement, is anxious to ensure that no unforeseen taxation deductions will be levied by the country in which the vessel is partly or wholly used and operated.

15. Article 9(3) New Zealand-United Kingdom agreement

32. One must not overlook, either, that recent amendments to the income tax legislation, both New Zealand and Australia have widened the definition of taxable royalties under those acts. Unless protected by a double taxation agreement (and that protection is not at all clear in many agreements to which New Zealand and Australia are parties - see, for example Articles 12(3)(a)(ii) and 12(3) of the Agreements which the two countries respectively have with Canada), non-resident withholding tax may be levied in New Zealand or Australia on charter rentals, rentals, or similar payments on the grounds that they are "royalties". Careful study of these over-wide definitions is therefore required.

33. Most financings involve loans in one form or another, and thus generate flows of servicing payments which can usually be described as interest, within common law meanings, or within enlarged definitions contained in taxation statutes. Quite apart from the application of double taxation agreements (which normally limit, but do not prevent, the charging of tax on interest paid to off-shore lenders by residents of a contracting state), there are non-resident withholding tax provisions in both Australia and New Zealand which are of supreme importance to the assessment of any financing transactions. A great deal of energy and thought is applied in modern financings to the minimisation of unnecessary non-resident withholding tax. The Australian position is set out in Division 11A of the Part III of the 1936 Act, where the basic rule of the liability of interest to withholding tax is set out in section 128B, with very limited exemptions for foreign currency borrowings outside Australia through debentures issued "with a view to public subscription or purchase or other wide distribution among investors" under section 128F(4), for non-resident borrowing subsidiaries under section 128F(6), and for off-shore loans by Australian entities in respect of which the Commissioner is prepared to give a certificate under sections 128G and 128H. In New Zealand, the position is complicated by a wide definition of "interest" which arises from "money lent", introduced to section 2 of the 1976 Act in 1983, and which also applies to interest which is "non-resident withholding income". Those definitions, though, are in some respects limited in their effect, and they display, on close analysis, potential inconsistencies with other provisions of the Act. Those difficulties and inconsistencies, and in particular those limitations, have given rise to a number of financing structures involving the payment of interest, in effect from New Zealand borrowers to off-shore lenders, for the financing of ships among other assets (including working capital), without any liability being acknowledged, or as yet demanded, for the payment of withholding tax. Financing structures are therefore heavily influenced by the need to comply with what are seen as the requirements to enable the

structures to fall outside the withholding tax net. The Government is undoubtedly aware of the limited application of the 1983 withholding tax amendments, and has hinted that it is considering whether the law ought to be amended, perhaps by the abolition of the liability for withholding tax, or perhaps by strengthening the Act's provisions. It may be that it intends to make a specific announcement on the point in the near future, or possibly that it intends to sweep up the question with the concept of a general withholding tax on interest, announced in the Minister of Finance's Taxation and Benefit Reform Statement on 20 August 1985, to take effect from the income year commencing 1 April 1987. Ship financing arrangements in the near future involving New Zealand parties cannot be put together except against the background of some uncertainty as to the Government's intentions in this area.

Second Stage Financing Structures: Swaps

34. It must not be forgotten, either, that financing arrangements, complicated as they might be, involving New Zealand or Australian owners or operators of ships, are often only the necessary raw materials for other secondary, but highly sophisticated, financing arrangements. Those secondary arrangements are designed to give to the financing the real desired liability and payment profile. Chief among the "secondary" arrangements currently in use are currency and interest rate swap transactions. There are, in theory at least, three kinds of swaps:

34.1 Interest rate, or coupon, swaps - that is, an exchange in the same currency between liabilities for fixed rate debt and floating rate debt;

34.2 Cross currency swaps, fixed to floating - where there are exchanges of liabilities, expressed in different currencies, and where one liability is fixed rate debt and the other is floating rate; and

34.3 Fixed rate swaps in cross currencies - where the two liabilities are each of a fixed rate basis (though obviously at different rates), but expressed in different currencies.

It is important, of course, to realise that in many transactions there is no full exchange of liabilities. Sometimes, only portions of the servicing payment liabilities are exchanged, and even then, those liabilities may be exchanged only on a "net difference" basis. Furthermore, the underlying or original loan transactions are not exchanged, so that there is normally no question of an assignment or novation affecting the original liability transactions. They are merely the building blocks upon which the swaps are based. The swap markets originally grew

up around the exploitation of a credit anomaly, so that by the swaps there could be an effective arbitrage of the credit spread differentials which existed between the public capital market and the bank credit market. Although in recent times there has been no particular magic in the "bank" or "non-bank" status of parties to swap transactions, the original basis was that banks were quite willing to lend the less creditworthy borrowers floating rate funds on a term basis, whereas many such borrowers could not raise funds through fixed rate bonds, or could do so only at unacceptably high costs. Banks, on the other hand, could not, or were not willing to, fund themselves for their fixed rate lending by borrowing on a fixed rate basis. Now, with the advent of the interest rate, or coupon, swap at least, it is regular practice for strong borrowers to borrow on a fixed rate basis, via, for example, a public eurobond issue (a significant factor behind the recent surge of borrowing on the eurobond market by a number of companies, in New Zealand and, especially, in other countries, in financings denominated in New Zealand dollars), and turn such borrowings into cheap floating rate finance. Conversely, less credit-worthy borrowers can borrow medium term bank funds on a floating rate basis and transform this funding to a fixed rate basis by entering into a coupon swap with a fixed rate issuer or through an intermediating bank. 16.

35. More and more, swap operations are being put together by intermediating banks or merchant banks, often without some of the counterparties knowing the identity of all other counterparties to the matching transaction or transactions. Commonly, a financial institution will effectively guarantee, by taking the intermediate position, the performance of one or both parties to the swap. The contracts entered into with the other swap parties by the intermediary banks are separate but substantially identical. Intermediation, of course, allows the intermediary bank to take a portion of the arbitrage for itself. 17.

36. In short, ship financing arrangements, put together with such care and with a cautious eye to all kinds of unforeseeable risks attaching to the creditworthiness of borrowers, the risks of the trade, the interference with that trade by governments or other competing ship owners or operators, the taxation position in relevant countries, the double taxation agreements between those countries, the validity and enforceability of security arrangements underlying the financings, and the ever present possibility

16. See Price, Keller and Neilson, "The Delicate Art of Swaps" *Euromoney*, April 1983 at page 120

17. See Gelardin and Swensen, "The Changing World of Swaps" *Euromoney*, June 1983 page 33

of God being moved to "act", are being relegated by financial markets, and by constructors of financing packages for vessels, merely to being their raw material upon which swap arrangements can be constructed in the international markets. Because so many swap arrangements are now being constructed, the original financing markets are being effected, in that financings are being entered into essentially for the swap benefits, rather than for their intrinsic benefits. ¹⁸. Truly, no ship financing transaction is an island entire of itself.

Envoi

37. Australia and New Zealand, as two countries in the Pacific vitally interested in the obtaining and providing of shipping services, are, I think, fully part of the world financing scene, so far as it can apply to ships. They face some problems undoubtedly peculiar to themselves, but at least most of their difficulties are of a general nature suffered by other countries and by financiers, ship owners, or ship operators in those countries. Nothing is, or can be, constant. Those of us who have an interest in ship finance are constantly, like Cortez, having to stare at the Pacific with eagle eyes. I hope, though, that I do not leave you, like Cortez' men, looking "at each other with a wild surmise". Ship financing in our two countries is at least unlikely to be tedious.

18. See Gelardin and Swensen at page 35.