

## VESSEL FINANCING

This paper addresses vessel financing at a very basic practical level. It deals primarily with documentation required by lenders when the security for a loan includes a mortgage on a vessel.

### I DOCUMENTATION

As in any financing transaction, documentation must be negotiated between the parties. Most vessel financing transactions will include the documentation described below.

#### 1. Letter of Offer/Commitment Letter

It is quite usual for the lender to provide to the borrower for acceptance, a letter of offer or commitment letter outlining the terms of the loan and the security to be provided in support of the loan. Unfortunately, often the letter is presented by the lender and accepted by the borrower without receiving legal input. It is important that upon retention and before proceeding to prepare documentation that legal counsel review the letter of offer or commitment letter. Only then can legal counsel satisfy himself or herself that the transaction can be effected from a legal perspective and identify issues which need to be addressed. It may be necessary to clarify what is intended by the parties and on occasion to suggest alternate solutions if what is contained in the letter of offer or commitment letter does not work from a legal perspective.

#### 2. Vessel Mortgage

##### (a) Unregistered Vessels

If dealing with a vessel which is not registered or recorded under the *Canada Shipping Act* (the "CSA"), and if the lender does not insist on registration or recording of the

vessel so that a mortgage can be obtained within the scope of the CSA, provincial legislation must be complied with to protect the interest of the lender.

The *Personal Property Security Act* (the "PPSA") came into force in Nova Scotia on November 3, 1997, and provides for the filing of a financing statement to give notice of a secured party's interest in collateral. Subsection 5(j) of the PPSA takes into account the fact navigation and shipping are matters of federal jurisdiction and provides as follows:

"5 Except as otherwise provided in this Act, this Act does not apply to

- (j) a mortgage or sale registered pursuant to the *Canada Shipping Act (Canada)*."

A security interest may be granted to the lender by any instrument used to mortgage, charge or retain an interest in a chattel. This would include a chattel mortgage, a conditional sale agreement, a debenture and a general security agreement. A financing statement must be filed under the PPSA in respect of the granting of the security interest in the vessel.

The PPSA also has provisions specifically pertaining to serial numbered goods which may apply to a vessel financing transaction. These provisions should be considered by legal counsel to ensure that the necessary financing statements are properly filed.

(b) Registered Vessels

The statutory form of marine mortgage provided for under the CSA will be used where the vessel or share therein which is to constitute the security for the loan is registered under the CSA. This is based on Section 47(1) of the CSA which reads as follows:

"47(1) A registered ship or a share therein may be made a security for a loan or other valuable consideration, and the instrument creating the security (in this Act called a mortgage)

shall be in the form prescribed by the Governor in Council, and on the production of such instrument the registrar of the ship's port of registry shall record it in the register book."

Section 47(1) specifically states that the mortgage must be in the form prescribed by Governor in Council. Attached as Appendix A is Form No. 7, the current prescribed form, together with information provided by the Ship Registration Office in Dartmouth.

The contents for insertion in the substantive part of the mortgage (paragraph b of Form 7) are not prescribed and must be drafted in accordance with the terms of the agreement reached between the borrower and the lender. Appendix A, by way of example, has been drafted so as to provide security for an account current. In many transactions, however, the substantive part of the mortgage will provide for a debt in a specified amount, together with interest and other costs as set forth in a promissory note or a deed of covenants. When completing paragraph (b) of Form 7, it is important to refer to the deed of covenants, promissory note and other documents setting forth particulars of the loan, so that third parties are put on notice that there are relevant documents requiring examination.

It is good practice and can avoid some last minute panic to submit the mortgage in draft form to the Registrar of Ships prior to the closing of the financing to ensure that it is satisfactory to the Registrar.

The Registrar is required to record mortgages in the order in which they are produced for recording. The priority of competing mortgages in respect of the same vessel or share in a vessel is determined by the order of the registration of the mortgages and not according to date of each mortgage.

An interesting and largely unresolved issue is the application of the PPSA to an unregistered mortgage of a registered vessel. In *Re Doucet* (1984), 150 D.L.R. (3d) 53 (Ont. S.C. in Bankruptcy) it was held that a chattel mortgage of a registered ship in respect of which

a financing statement had been registered under the Ontario *Personal Property Security Act* could be enforced against the mortgagor and his trustee in bankruptcy. The issue of whether the chattel mortgage would have been enforceable against the trustee had a financing statement not been registered did not need to be determined. In *Ford v. Petford* (1996), 11 P.P.S.A.C. (2d) 227 (B.C.S.C.) the plaintiff purchased a motor yacht registered under the CSA from the defendant. The defendant was paid a non-refundable deposit and possession of the ship was given to the plaintiff. It was agreed that the defendant would hold the registration papers until the balance of the purchase price was paid in full and that the ship could not be resold until that time. The balance of the purchase price was not paid on the closing date and the ship was repossessed by the defendant. Owen-Flood, J., held that although there was no mortgage under the CSA, the defendant was a secured party and held a security interest within the meaning of the British Columbia *Personal Property Security Act* and, accordingly, the repossession provisions of the latter statute were applicable.

(c) Recorded Vessels

The CSA authorizes a pre-registration procedure, recording, for vessels under construction and permits mortgages to be entered against recorded vessels. Sections 45 and 46 of the CSA provide that recorded vessels may be the subject of a builder's mortgage and read as follows:

\*45.(1) A recorded vessel may be made security for the repayment of a debt or the discharge of any other obligation.

(2) A builder's mortgage shall be in Form C in Schedule IV and may be filed with the registrar at the port at which the vessel is recorded.

(3) On receipt of a builder's mortgage in the required form, the registrar shall enter the particulars thereof in the record book.

46. Every builder's mortgage

- (a) binds the recorded vessel to which it relates during the period from the commencement of building until launching;
- (b) binds the recorded vessel to which it relates at and from the time of its launching until its registration in Canada as a British ship; and
- (c) operates in all respects as if it were a mortgage made after the registration of the recorded vessel to which it relates as a British ship pursuant to this Part, and subsection 47(2) and sections 48 to 54 respecting a registered mortgage apply *mutatis mutandis* to a builder's mortgage."

A copy of a form of builder's mortgage, Form C, together with information provided by the Ship Registration Office in Dartmouth is attached as Appendix B.

(d) Fishing Vessels/Section 427 Security

Chartered banks making loans to fisherman can take security pursuant to Section 427(1)(o) of the *Bank Act* which reads as follows:

"427.(1) A bank may lend money and make advances

(o) to any fisherman, on the security of fishing vessels, fishing equipment and supplies or products of the sea, lakes and rivers, but security taken under this paragraph is not effective in respect of any such property that, at the time the security is taken, by any statutory law that is then in force, is exempt from seizure under writs of execution and the fisherman is prevented from giving as security for money lent to the fisherman, ..."

This form of security allows a bank not only to take a charge on the fishing vessel but also on the fishing equipment and on the catch and other "supplies or products of the sea".

To protect the priority of the bank, the notice of intention to give the security signed by or on behalf of the borrower must be registered in accordance with the provisions of the *Bank Act* before the security is taken. If the fishing vessel is a registered or recorded vessel under the CSA, notice of the Section 427 security must be also filed with the appropriate

registrar of ships or the lender will risk losing priority to other mortgagees with mortgages under the CSA.

A copy of Section 427 of the *Bank Act* is attached as Appendix C for ease of reference.

### 3. Deed of Covenants

It is customary practice for the lender to insist on a collateral loan agreement or what is commonly referred to as a deed of covenants setting forth the details of the loan. This is understandable in view of the very small amount of space on the statutory form of mortgage to set forth such details.

The contents of the deed of covenants are negotiated between the borrower and the lender and normally include covenants, representations, warranties, events of default and remedies similar to those found in other financings. The deed of covenants, however, also includes a number of additional provisions which pertain specifically to vessels such as the following:

- all 64 shares of the vessel are and will be kept free from encumbrances;
- the vessel is and will continue to be registered under Canadian flag at a specified Canadian port of registry, unless the lender otherwise agrees;
- there are and will be no charterparties or similar arrangements in respect of the vessel;
- the borrower will keep the vessel in a state of complete seaworthiness;
- the vessel will comply at all times with relevant safety requirements;

- the borrower will give notice of any claims pertaining to the vessel;
- the vessel will not be put in the possession of any third party for repairs without the approval of the lender;
- provisions dealing with insurance requirements relating specifically to the vessel;
- a covenant to pay protective disbursements and an acknowledgement and agreement from the borrower that the mortgage and deed of covenants constitute security for such obligation.

As deeds of covenants generally include assignments of insurances, requisition proceeds and other receivables, they were registered pursuant to the *Assignment of Book Debts Act* prior to the coming into force of the PPSA. Under the PPSA regime, a financing statement must be filed in respect of deeds of covenants.

#### 4. Promissory Note

It is usual for the borrower to sign a promissory note to evidence the debt to the lender. If the loan is by way of a revolving line of credit or instalments, the lender often arranges for a series of promissory notes to be executed.

#### 5. Assignment of Charterparty or Hire/Earnings

If the vessel is chartered or leased to third parties, the charterparty or lease is often assigned to the lender or, in the alternative, the receivables arising under such charterparty or lease are assigned to the lender. Acknowledgements should be obtained from the charterer or lessee in connection with any assignments. A financing statement must be filed in respect of such assignments under the PPSA regime.

6. Assignment of Insurances

The deed of covenants usually addresses the lender's requirements insofar as insurance is concerned and includes provisions respecting assignment and/or naming the lender as a loss payee. It is not unusual, however, for a separate assignment of insurances to be obtained by the lender. Consideration should be given, regardless of the form of documentation, as to the obtaining of adequate insurance coverage, the distribution of proceeds in various circumstances and clearly identifying the interest of the lender in such insurances. It is prudent to obtain an acknowledgement from the insurers in respect of the lender's interest and the distribution of proceeds.

7. Fishing Licenses

If the vessel is a fishing vessel and licenses are associated with it, the lender often obtains a covenant from the borrower that it will cooperate with the lender in attempting to have the license transferred to the lender or its nominee in the event of default. The issues relating to fishing licenses as security are presumably being addressed in a separate session and are not addressed in this paper. It should be borne in mind, however, that the issuance of fishing licenses and the transfer thereof is at the discretion of the Minister of Fisheries & Oceans and the lender's security will be subject to the exercise of such discretion.

8. Corporate Documentation

As with any transaction, if the borrower is a corporation, the necessary corporate documentation must be in place. The corporate documentation required will vary from transaction to transaction.

In all transactions, legal counsel must determine whether the Borrower has the ability under its jurisdiction of incorporation to borrow funds and grant the contemplated security. The *Companies Act* or other relevant legislation and the Memorandum of Association

and Articles of Association and all amendments thereto (or comparable documents if the *Companies Act* does not apply) must be carefully examined. If the borrower is incorporated under the *Companies Act*, it is prudent to check the records at the Office of the Registrar of Joint Stock Companies to ensure that all necessary special resolutions have been filed pursuant to the *Companies Act* and that there are no documents on record, including security filed pursuant to the *Corporations Securities Registration Act*, which cause concern.

Legal counsel must also ensure that the directors of a corporate borrower authorize the entering into, execution and delivery of the security documents. As well, there are often additional corporate documents utilized in vessel financings such as certificates of incumbency and officer's certificates.

## 9. Special Documentation

### (a) Postponement Agreements

While there is no provision in the CSA for registration of postponement agreements, Registrars of Ships (at least in Halifax) have been entering postponement agreements as a "column 14 notation" in the register books and noting them on transcripts of registry. Certain registries of ships (including Halifax as of October 14, 1997) now utilize an electronic filing system and although an entry similar to a column 14 entry can apparently be made electronically, transcripts of registry show only the current owner of the vessel and outstanding mortgages. Accordingly, a postponement agreement may be in existence but not disclosed in the transcript of registry.

### (b) Guarantees

It is not unusual for a mortgage to be obtained on a vessel as security for a guarantee, i.e., the mortgagor is a party other than the borrower. The mortgage should make specific reference to the guarantee and in particular, if the mortgage is in statutory form under

the CSA, paragraph (b) should incorporate by reference the guarantee. If the guarantor is a corporation, care must be taken to ensure that there is no contravention of the financial assistance provisions of the *Companies Act* or other relevant legislation.

## 10. Opinions

Opinions are generally provided in vessel financing transactions as with other financings. The lender will want to be satisfied that the borrower has the ability to provide the security, that the vessel is properly registered and mortgaged, that the lender has a first charge (or other agreed upon charge) on the vessel, that all other necessary registrations have been effected. Opinions generally set forth results of searches and inquiries of public officials.

If there is an international aspect to the transaction, care must be taken to obtain an appropriate opinion from counsel in the foreign jurisdiction. The lender will want to know that if it has to realize on its security that there are not going to be problems in doing so. If there are potential problems, these should be specified in the opinion.

## II SEARCHES

The searches referred to in Richard Southcott's paper on vessel conveyancing also apply to vessel financings. As well, searches should be conducted under the *Assignment of Book Debts Act* during the three year transition period provided for under the PPSA due primarily to the fact that it was customary for lenders to register deeds of covenants under the *Assignment of Book Debts Act*.

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