



## NEWSLETTER

## FINANCING OF GERMAN SHIPOWNERS BY FOREIGN BANKS

### INTRODUCTION

In recent years, interest among foreign banks in financing German shipowners has increased significantly. Compared to traditional international ship financings, transactions involving German shipping companies present some structural and legal particularities that are relevant for foreign lenders.

The German ship finance landscape has fundamentally changed since the onset of the global shipping crisis in 2008 and subsequent significant market disruptions. Previously, numerous vessels were financed with equity raised from retail investors by so-called fund houses. This source of equity has largely disappeared. Today, shipping companies rely more heavily on their own capital or involve professional investors as equity providers. It remains common, however, to hold the vessel in a special purpose vehicle that acts

as borrower – typically in the legal form of a German GmbH & Co. KG (KG).

A KG is a limited partnership with limited partners whose liability is restricted to their capital contributions, and a general partner, with unlimited liability, who represents the partnership. In order to limit liability, the general partner is typically a limited liability company (GmbH), so that the otherwise unlimited liability is effectively confined to the assets of the GmbH.

Tax treatment is of central importance to German shipowners. Under certain conditions, profits of the KG from operating the vessel may be subject to the German tonnage tax regime. This special tax regime replaces the regular profit determination with a lump-sum, tonnage-based calculation. The effective ongoing tax burden typically ranges between approximately 0.5%

### EXECUTIVE SUMMARY

Foreign lenders are showing growing interest in financing German shipowners, whose vessels are typically owned through single-purpose entities structured as GmbH & Co. KG.

The German ship finance market changed significantly after the 2008 crisis, with the disappearance of retail investor ship funds and increased reliance on shipowners' equity and professional investors.

German shipowners frequently rely on the tonnage tax regime, which results in a very low effective tax burden (approx. 0.5%–2% of operating profit) if certain requirements such as German registration and management are satisfied.

Vessels may be reflagged through bareboat charter structures to foreign subsidiaries (e.g., Liberia or Marshall Islands) while remaining registered in Germany for mortgage purposes.

Overall, German ship financings involving international lenders are typically entered into under English law and documented using internationally accepted LMA standards, with the exception of certain security elements – most notably the ship mortgage and, where applicable, account pledges and, depending on the circumstances of the individual case, guarantees – which are governed by German law.

and 2% of the actual operating profit, depending inter alia on vessel size and earnings. The applicability of the German tonnage tax regime includes, among other things, registration of the vessel in the German ship register and management in Germany in accordance with administrative requirements, i.e. sufficient operational substance, and management activities in Germany.

If a vessel is registered in the German shipping register, it generally flies the German flag, which determines applicable crewing, social and regulatory requirements. To align with international operating standards and cost structures, German shipowners frequently reflag their vessels via bareboat arrangement so the vessel can fly a flag other than the German flag. In such cases, the German KG chartered the vessel under a bareboat charter to a subsidiary incorporated in a flag jurisdiction. Common choices include Antigua & Barbuda, Liberia, the Marshall Islands and Portugal. The bareboat charterer registers the vessel in the local bareboat register, enabling her to fly the flag of that jurisdiction. The registration in the German shipping register remains as the underlying registry, and the ship mortgage also continues to be recorded there (see below). Typically, a back bareboat charter is concluded between the bareboat charterer and the KG so the KG can operate the vessel, for example by chartering it out to a time charterer. Reflagging requires approval from the German Federal Maritime and Hydrographic Agency (BSH), which is granted for a

period of two years and may be renewed. Where the vessel is subject to a ship mortgage (therefore, encumbered), the mortgagee's consent to the bareboat registration is required.

## FACILITY AGREEMENT

Prior to the global shipping crisis, facility agreements with German shipowners were generally governed by German law. They were comparatively short and drafted in German. During the crisis, structural weaknesses in this documentation became apparent.

Under German law, standard terms and conditions („boilerplate“ clauses used routinely by one party) are subject to strict statutory content control intended to protect consumers. If such standard terms deviate from the statutory model (i.e. the default rule provided by law), the terms may be invalid. A particular feature of German law is that these statutory content controls can also apply in business-to-business transactions, including agreements between banks and shipowners. As a result, certain clauses used in standardised German law facility agreements may be void. In particular, the validity of loan-to-value clauses and fee provisions has been debated. In addition, traditional German-law facility documentation was not structured to allow for transferability to international investors or secondary market participants, which became particularly relevant during the crisis when banks sold non-performing loans.

German-language documentation also complicated due diligence for foreign purchasers of loans.

Today, it is widely accepted in the German market that financings for German shipowners – especially where foreign lenders are involved – are documented under English law, predominantly using Loan Market Association (LMA) standards. This approach enhances international marketability.



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## SECURITY

### Ship Mortgage

A German ship mortgage is documented differently from ship mortgages governed by Anglo-American law (such as Marshall Islands or Liberian mortgages). A German mortgage requires a notarial deed to create the mortgage and to register it in the German ship register. Note, even where a vessel is reflagged, the mortgage remains registered in the German register.

The mortgage is typically supplemented by a notarial „abstract acknowledgment of debt“ (abstraktes Schuldversprechen) by the vessel owner and a „submission to immediate enforcement“. The „abstract acknowledgment of debt“ provides the mortgagee with an independent claim against the KG, legally separate from the facility agreement. This significantly reduces the KG's ability to raise defences arising from the underlying loan relationship. The „submission to immediate enforcement“ has the effect of an immediately enforceable court judgment and allows the mortgagee to enforce its claim without the need for obtain a title in prior court proceedings.

Unlike Anglo-American ship mortgages, which provide additional self-help remedies such as a power of sale or the right of a mortgagee in possession, a German mortgage does not provide for such self-help rights. In practice, however, the importance of such self-help rights under Anglo-American mortgages is often overstated, as they are only exercised with

considerable caution. In particular, acting as mortgagee in possession entails significant liability, environmental, and commercial risks for the mortgagee.

During the global shipping crisis, banks and KGs agreed on consensual sales in the vast majority of cases. If sale proceeds were insufficient to repay the loan after satisfying other creditors, the bank typically agreed to a partial waiver against issuance of a recovery certificate (Besserungsschein), followed by liquidation of the KG. If no agreement could be reached, the management of the KG was obliged to file for insolvency if the statutory insolvency grounds were met; failure to do so gives rise to criminal and civil liability risks of the management. In insolvency proceedings, the insolvency administrator assumes control and typically sells the vessel in coordination with the bank, in return for payment of a fee.

Only in rare cases is formal enforcement of a German ship mortgage pursued as a last resort, for example where a maritime lien(s) exists and no consensual solution can be achieved with the parties involved. German ship mortgages can be enforced in mortgagee-friendly jurisdictions such as the United Kingdom, Gibraltar, Singapore, and Malta just as easily as an Anglo-American mortgage. An advantage of the German mortgage over Anglo-American mortgages is that the notarial „submission to immediate enforcement“ creates an enforceable title. This makes enforcement efficient in continental European jurisdictions such as the

Netherlands or Germany. By contrast, enforcement of a purely Anglo-American mortgage in a continental jurisdiction such as Germany is less practical, because a separate enforceable title is required, which an Anglo-American mortgage does not inherently provide.

### Tripartite Agreement

In the context of reflagging structures, a tripartite agreement between lender, borrower and bareboat charterer constitutes an important additional security. It allows the lender, upon an event of default under the facility agreement, to terminate the bareboat charter and arrange deletion of the vessel from the bareboat register. This structure was extensively tested during the last shipping crisis and proved robust in practice.

### Share Pledge

For borrowers incorporated under Anglo-American law (e.g. Marshall Islands or Liberia), a share pledge is a standard market practice. An Anglo-American share pledge allows the bank, upon enforcement, to transfer the shares to a third party – for example, a so-called white knight – by means of a share transfer certificate. Existing contracts of the borrower, such as shipbuilding contracts or long-term charterparties, can then continue with the borrower now having a new shareholder. This may be attractive to lenders in the context of shipbuilding contracts or profitable

charters (although the existence of a profitable charter may raise questions as to why the borrower experiences financial distress).

Shares in a German KG may also be pledged; such a pledge is mandatorily governed by German law. Enforcement, however, differs from Anglo-American structures. The bank cannot simply transfer the shares to a third party but must realise them through a formal auction process. This formalised enforcement constitutes a practical disadvantage compared to Anglo-American share pledges. In practice, German banks and many international banks often do not require a share pledge in German KG structures, particularly because German insolvency law may allow continuation of contracts.

There are also discussions about the risk that, in the case of a German law share pledge in favour of the lender, the lender could be considered an „atypical shareholder,” potentially resulting in subordination of the loan in insolvency of the KG as quasi-equity. In practice, this risk is negligible where financing documentation is properly structured. The hurdles to be regarded as an „atypical shareholder” are very high: it would require granting the lender additional shareholder-like control rights beyond market standards. Such quasi-shareholder rights are typically not granted. A share pledge over KG interests may therefore be agreed if required, but its enforcement mechanics are not comparable to those of an Anglo-American share pledge. At a minimum, it operates as a negative pledge preventing uncontrolled trans-

fers of shares.

Pledging the shares in the general partner GmbH may also be considered. However, this typically meets strong resistance from owners, as a pledge of GmbH shares requires notarisation and entails significant costs. Market practice is therefore to limit the share pledge to the KG and not require a pledge over the GmbH shares. Since the KG is represented by the GmbH, lenders are typically protected by appropriate powers of attorney.

### Assignments of Earnings and Insurances

Assignments of earnings and insurance claims form part of the standard security package. In the past, it was not uncommon for these to be governed by German law even whe-

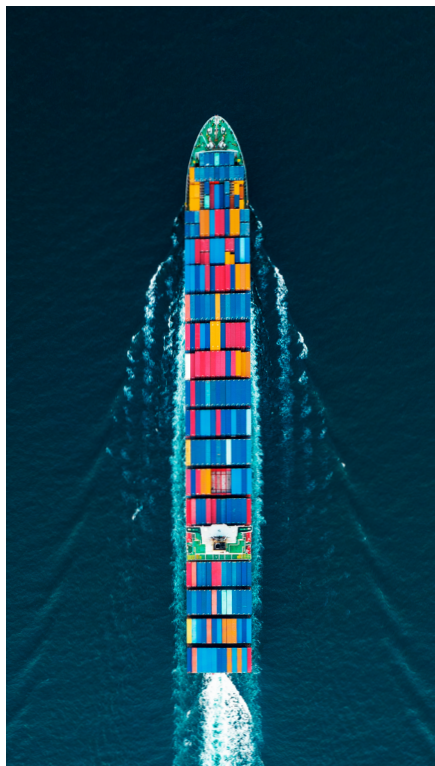
re the underlying charterparties or insurance contracts were governed by English law. While this is generally possible, best practice is for the assignment to be governed by the same law as the underlying contract. Where charters or insurance contracts are governed by English law, the assignment should also be governed by English law, which generally facilitates enforcement.

### Account Pledge

An account pledge must be governed by the law of the jurisdiction where the account is located. As German KGs typically maintain accounts with German banks, such pledges are governed by German law. If accounts are held outside Germany in the context of a financing by a foreign bank, the account pledge must be governed by the law of the relevant account jurisdiction.

### Managers' Subordination Undertaking

Managers' subordination undertakings are also part of the standard security package. Depending on the structure, they may be governed by English or German law. It must be considered that technical managers may be liable under FuelEU regulations for deficits and, where they act as responsible entity under the EU ETS, for surrendering allowances. Managers therefore increasingly insist that their recourse claims against the KG as owner are excluded from contractual subordination in favour of the bank.



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## Guarantees

Guarantees (or sureties), for example, from a German holding company, supplement the security package in recourse financings. The question arises as to what law should govern such guarantee. There is no general answer; relevant factors include the guarantor's seat, the location of assets, the jurisdiction clause or arbitration agreement of the guarantee and the intended enforcement strategy.

In cross-border financings, best practice is often for the guarantee to be governed by the law of the jurisdiction where enforcement is expected. If an enforceable title exists in that jurisdiction, assets can be seized without

additional recognition proceedings.

If the guarantor is a German entity and its principal assets are located in Germany, German law and a German jurisdiction clause may be advisable. However, a court judgment is still required; once obtained, however, enforcement in Germany is straightforward.

By contrast, an English law guarantee can often be drafted in a more lender-friendly manner. However, for enforcement in Germany, an English judgement must first be obtained. Since Brexit, recognition of an English judgement is no longer automatic under EU law but governed by German recognition rules; which remains possible

but involves more formalities, time, and costs.

Alternatively, arbitration may be agreed upon. An arbitral award is generally enforceable in Germany under the New York Convention, subject only to limited review (including *ordre public*), the threshold for which is high.

In summary, the choice of law for guarantees involves a strategic balance between substantive lender-friendliness (tending toward English law) and procedural efficiency in obtaining and enforcing a title in Germany (tending toward German law or arbitration).

## CONCLUSION

Financing documentation for German borrowers complies with international standards. While certain particularities of German law must be considered, they are well-tested, robust, and accepted by international banks. We are able to advise under both German and English law from our Hamburg office and to issue the relevant legal opinions, providing added value as a one-stop shop.

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