



Maritime briefing: the advantages of choosing the Cayman Islands as the Flag State

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At the end of July 2021 it was estimated that the global orderbook for new ships stood at around 20% of the current global fleet. Some analysts have suggested that this is largely due to increased orders of containerships in response to soaring freight rates as the global economy starts to recover in the aftermath of COVID-19.

A key concern for shipowners and lenders will be where to register these new vessels. In this briefing, we consider three factors that usually influence the choice of flag state: (1) financing considerations, (2) recognition for the flag and (3) speed, responsiveness and certainty.

Introduction

Choosing the flag state where a ship will be registered requires balancing different factors. The final choice is likely to influence financing terms, trading flexibility and marketability of the ship and also potentially mitigate the risk of detention from port state inspections.

The world's largest ship registries (by deadweight tonnage) include Panama, Liberia, the Marshall Islands, Hong Kong and Singapore. The decision as to the flag state may be taken based on a range of factors including simply choosing a flag used previously by a shipowner, choosing a flag based on the part of the world in which the ship is expect to be deployed and choosing a flag on account of the type of ship and/or other operational reasons. Certain registries also have threshold requirements relating to nationality of the shipowner

and/or size and type of ship which may require the owner to choose a register different from the register that might otherwise seem a more obvious choice.

The appeal of certain smaller registries, such as the Cayman Islands will typically be due to a number of factors. This briefing reviews three topics that our clients have highlighted as leading considerations when assessing the suitability of the Cayman Islands as a flag state.

Factor 1: Financing considerations

When it comes to new-builds our clients' questions typically include the following:

- Firstly, what collateral can be provided for a new construction project?
- Secondly, can any steps be taken to protect the shipowner and/or its lender from the insolvency of the shipyard?
- Thirdly, how does a ship mortgage protect a lender?

Under the Merchant Shipping Act, 2016 (the "Act") a ship may be registered in the Cayman Islands on an "under construction" basis. This option is not available in all shipping registries and does not require the vessel to remain registered in the Cayman Islands after it is delivered by the yard meaning that the registration can be in place solely for the period of construction. Registering a vessel under construction allows for a mortgage to be registered over the vessel. The mortgage

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can be given as security for a lender or purchaser and can also mitigate some of the concerns regarding yard insolvency (a very real risk in shipbuilding as a consequence of the capital intensive nature of the business and highly cyclical nature of the shipping industry).

Vessel registration is possible as soon as the keel is laid. Once registered, title to the partly constructed vessel will be recognised as held by the registered owner. If title to the partly-constructed vessel is registered in the name of the shipowner then, without any further steps being taken and subject to any conflicting terms in the shipbuilding contract, in the event of yard insolvency the shipowner should have a claim to possession of the new-build in addition to any other claims it has against the insolvent yard.

Once a ship is registered, a statutory ship mortgage can be granted over it and registered in the register of ship mortgages maintained by the Cayman Islands Shipping Registry. Any such mortgage will have the same priority as a registered mortgage for a fully constructed vessel and remain in the register and continue to be treated as such until it is discharged (even if the ship under construction ceases to be registered in the Cayman Islands during construction or at completion). By registering the partly-constructed vessel in the name of the yard a mortgage over the vessel can be granted by the yard with a view to giving the purchaser recourse to the vessel in priority to claims of other creditors of the yard. A mortgage over a vessel under construction may also form part of the collateral package for a secured lender. In all cases it will be necessary to consider the laws of the country in which the yard is situated and all other relevant laws, to assess whether the required outcome is likely to be achieved.

Under Cayman Islands law, the Act provides a mortgagee with certainty as to the priority of competing mortgages with priority given to the mortgagee whose mortgage was registered first.

The Act contains several other provisions for the benefit of a mortgagee including an express confirmation that the mortgage is unaffected by the mortgagor's bankruptcy and a requirement that if the mortgage instrument contains a clause prohibiting a transfer of ownership, the Cayman Islands Shipping Registry still not register a transfer of title without the consent of the mortgagee.

If a mortgagee needs to enforce its mortgage then the Act provides the mortgagee with a statutory power of sale that entitles the mortgagee to sell the vessel privately and without a court order.

Choosing a flag state with a good reputation for effective regulatory oversight can enhance a vessel's ability to trade

and may help to preserve the value of the vessel in the secondary market. Consequently, selecting the Cayman Islands as a flag state may send a positive message to prospective lenders that the vessel presents less asset and operational risk than a comparable vessel flagged in a different jurisdiction, we discuss this in more detail below.

Factor 2: Recognition, regulation and Port State control

Shipowners face a trade-off between the degree and cost of flag state regulation versus the level of recognition that flag is afforded by other maritime nations where the vessel may call (port states).

Regulation and compliance is a pervasive topic in the shipping industry. A vessel must be maintained and audited to a certain standard to mitigate a variety of risks. To some extent, the auditing burden is born by classification societies and driven by insurers; safe, clean vessels with well-trained crews tend to encounter fewer maritime perils or at least have better outcomes when faced with maritime perils beyond their control. Naturally, such maritime assets are more attractive to lenders and insurers. Shipowners are commercially incentivised to maintain their vessels in prime condition (to attract more frequent and better paying charters) and to an optimal performance standard (to increase fuel efficiency as fuel represents 40 to 50% of vessel operating costs). Commercial incentives for compliance include market factors such as supply and demand in the charter and freight markets and the cost of bunkers (or indeed alternative fuel sources as the industry seeks to move towards decarbonisation).

One of the most important functions of a flag state is to regulate its fleet's compliance with international maritime laws and conventions. Flag states need to ensure that their fleet complies with the laws binding on that state. Some flag states impose very low levels of regulation, and as a consequence their fleet may be subject to greater scrutiny by other port states. This can result in detentions and additional inspections with a clear impact on the vessel's ability to trade and meet on-time performance targets. Conversely, vessels from a highly regarded flag state can be expected to transit more easily through other port states.

The Cayman Islands flag is a highly ranked flag on the white lists published pursuant to the Paris Memorandum of Understanding on Port State Control 1982 and the Tokyo Memorandum of Understanding on Port State Control in the Asia-Pacific Region 1994. Compared to all flags globally, those on the white list have been assessed to be quality flags that adhere to high regulatory standards and exercise effective oversight of their fleets.

Continued

An example of the advantages of effective compliance is demonstrated by the United States' Qualship 21 vessel quality monitoring program. It identifies high-quality ships which are subject to less intensive scrutiny when entering US waters and ports. As a threshold requirement, a vessel seeking Qualship 21 status must be flagged in a jurisdiction with a detention ratio of less than 1% over a three year rolling average (the detention ratio measures the percentage of port state inspections that result in a vessel being detained (usually, so that remedial work can be effected to the vessel)). The detention ratio is a key performance indicator of the efficacy of the flag state's regulatory regime; the less its vessels are detained, the more likely it is that the regime is working and vessels are being kept in a safe and compliant condition. The Cayman Islands has had a detention ratio of less than 1% for the last 11 years – less than 1% of inspections of Cayman vessels result in a detention – and the Cayman Islands has been granted Qualship 21 status in recognition of its high standard of regulatory oversight.

Factor 3: Speed, responsiveness & certainty

In the shipping business, time is quite literally money. The shipowner will incur significant costs for every day that a vessel is unable to trade so it is critical to ensure that a vessel is ready for service at the earliest opportunity following delivery from the yard or transfer of title to a new owner. For new builds certainty of registration criteria and procedure and access to a responsive registry should help minimise non-revenue days resulting from delays in the delivery and/or registration process.

In the Cayman Islands, assuming that appropriate advance work is undertaken, it is possible to achieve registration within 24 hours of submitting an application to the Cayman Islands Shipping Registry (CISR). The CISR has a number of international offices where such applications are processed, including London, Hong Kong and Singapore, which provide access to the Registry team during working hours in several different time zones. In addition, by special arrangement, the CISR will attend to registration applications outside of office hours including recording mortgages immediately following funding rather than waiting for the next business day.

The COVID-19 pandemic has illustrated the CSIR's ability to respond to industry needs. Responsive measures have included adaptability in both technical requirements (such as conducting vessel surveys remotely) and formal legal requirements (such as permitting notarial acts by video call).

Conclusion

The Cayman Islands' robust regulatory environment, creditor friendly ship mortgage regime, designation as a Red Ensign state (by which its flagged vessels have access to British consular services and may be protected by the Royal Navy) and its Qualship 21 status will continue to provide an attractive option for owners of both commercial vessels and yachts.

This briefing note is intended as a high-level review of key considerations surrounding vessel registration. For further guidance on ship registrations, financing, acquisitions, construction and regulatory concerns in the Cayman Islands, please contact our team.



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