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A GUIDE TO TAKING SECURITY OVER VESSELS IN MALAYSIA

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Introduction

Malaysia is a maritime nation situated at the crossroads of major international shipping routes and bordering the strategically significant Straits of Malacca, and has long been an important jurisdiction for ship finance and maritime commerce. The country's ports handle a substantial volume of international trade, and its maritime industry encompasses vessel ownership, chartering, shipbuilding, and offshore operations.

For financiers providing credit facilities secured against vessels, taking effective security over ships is fundamental to managing credit risk. A vessel is a high-value, mobile asset that may traverse multiple jurisdictions during its operational life.

The Merchant Shipping Ordinance 1952 ("MSO 1952") is the principal legislation governing the registration of ships in Malaysia and the creation, registration, and enforcement of mortgages over Malaysian-registered ships. The MSO 1952 is modelled on the United Kingdom's Merchant Shipping Act 1894 and retains many of the features of that earlier English statute. The MSO 1952 establishes the framework for the Malaysian Ship Registry, prescribes the form of statutory ship mortgage, and sets out the rules governing the priority of registered mortgages and the rights of mortgagees.

By virtue of section 44 of the MSO 1952, only a registered ship may be made a security for the repayment of a loan or the discharge of any other obligation under the MSO 1952. Under section 2 of the MSO 1952, a “ship” is defined to include every description of vessel used in navigation and not propelled by oars, whilst “vessel” is defined to include any ship, boat or any other description of vessel used in navigation. The phrase “used in navigation” is therefore central in determining whether a vessel falls within the statutory definition of a “ship”. Given that the MSO 1952 was modelled on the United Kingdom’s Merchant Shipping Acts, English authorities provide persuasive guidance on the meaning of "ship" and "used in navigation".

In the English case of *R v Goodwin [2006] 2 All ER 519*, the Court of Appeal considered the meaning of "used in navigation" and held that the expression does not require a vessel to be engaged in the transportation of persons or property to a particular destination. Instead, the relevant consideration is whether the vessel is used to make ordered progression over water from one place to another. The Court further recognised that craft used merely for recreational purposes without the object of going anywhere would fall outside the scope of the expression "used in navigation".

Similarly in the Irish case of *The Von Rocks [1998] 2 Lloyd's Rep 198*, the Supreme Court held that the carriage of cargo or passengers need not be the exclusive or primary purpose for which a craft is used in order for it to qualify as a "ship." Where a craft is designed and constructed to operate on water, is regularly moved from one place to another across water in the performance of its function, and does so as a matter of course, it may be classified as a "ship," notwithstanding the absence of self-propulsion or a steering mechanism.

In the case of *Clark (Inspector of Taxes) v Perks [2001] EWCA Civ 1228*, the Court of Appeal held that where navigation forms a significant part of the function of a structure, the fact that navigation is incidental to a specialised function does not prevent the structure from being classified as a "ship". Applying this principle, jack-up drilling rigs were held to fall within the definition of "ships" for the purposes of the Income and Corporation Taxes Act 1988.

A vessel need not necessarily carry passengers or cargo nor must it be capable of navigating under its own power in order to fall within the definition of a "ship". The determining factor is whether the vessel is used in navigation and this is significant in the context of ship finance, as only vessels falling within the statutory definition of a "ship" and capable of registration under the MSO 1952 may be made security by way of registered ship mortgage.

Also, the MSO's use of "include" rather than "means" in the definition for "ship" indicates that the definition is not exhaustive as brings in the listed categories but does not necessarily exclude others. As an example, floating liquefied natural gas (LNG) which do not have onboard self-propulsion machinery (like engines and propellers) to sail independently and rely on external support for transit and positioning being accepted by Malaysian ship registry for registration.

For a lender taking security over offshore assets in Malaysia, the combined effect of these authorities and the Marine Department's registration practice is that a statutory ship mortgage under the MSO is likely available for any ship-shaped floating structure that has navigated or is capable of navigating even under tow provided it is not propelled by oars.

Ship Registration in Malaysia

Malaysia maintains two ship registration regimes namely the Malaysian Ship Registry ("MSR") and the Malaysia International Ship Registry ("MISR").

Malaysian Ship Registry (MSR)

Under section 19(a) of the MSO 1952, a ship may only be registered under the MSR if it is owned by Malaysian citizens or by a corporation incorporated in Malaysia which satisfies the prescribed Malaysian ownership requirements.

Malaysia International Ship Registry (MISR)

Section 19(b) of the MSO 1952 provides an alternative registration regime for ships to be registered in Malaysia. Unlike the MSR, the MISR permits ships to be registered under the Malaysian flag where they are owned by a non-Malaysian citizen or a corporation incorporated outside Malaysia subject to the requirements under section 20(3) of the MSO 1952, i.e. having a representative person who is either a Malaysian citizen having his permanent residence in Malaysia or a body corporate incorporated in Malaysia and having its principal place of business in Malaysia.

Both registries are administered by the Marine Department Malaysia. The MSR is administered through the ports of registry at Port Klang, Penang, Kota Kinabalu and Kuching whilst Labuan serves as the port of registry for the MISR. On making an application for registration of a ship, the applicant must apply to one of the ports of registry which it is intended will be the ship's port of registry.

Upon registration with either the MSR or MISR, the ship will be issued a certificate of registry. The ship registry may also issue a provisional certificate of registry as provided under section 26 of the MSO 1952. Based on past deals, we note that ship registry would typically require a letter of intention to convert to permanent registration from the vessel owner before they would process the registration of its vessel mortgage.

Statutory Ship Mortgage

The statutory ship mortgage is the primary form of security over a ship registered in Malaysia. A registered ship mortgage creates a statutory charge over the ship and confers upon the mortgagee certain rights, including the power of sale and the right to take possession. The requirements for a valid mortgage are discussed in detail below.

Under section 44 of the MSO 1952, a registered ship or any share therein may be mortgaged as security for a loan or other valuable consideration. The property of a ship is divided into sixty-four shares and a mortgage may be created over the whole ship or any share in it. It is further provided under section 26 of the MSO 1952 that upon the issuance of such provisional certificate of registry, the provisional certificate of registry shall have the same effect as a certificate of registry, and that the provisions of the MSO 1952 and other written laws relating to a certificate of registry shall apply to such provisionally registered ship in the same manner as they apply to a Malaysian ship. Based on this, it is possible to register a mortgage over a provisionally registered ship. We also note from past deals that the Malaysian ship registry would typically require an additional letter from the ship owner to confirm the intention to convert to permanent registration before the registration of the ship mortgage over a provisionally registered ship is allowed.

<u>Registration of the Statutory Ship Mortgage with the Ship Registry</u>

A statutory mortgage is created using the prescribed forms under the MSO 1952 which must be lodged with the Registrar at the ship's port of registry for registration. The types of prescribed forms are as follows:

(i) Marine 247 – mortgage (to Secure Account Current, & c.) for body corporate;

(ii) Marine 249 – mortgage (to secure Principal Sum and Interest) for body corporate; and

(iii) Marine 251 – mortgage (to Secure Account Current, & c.) or mortgage (to secure Principal Sum and Interest) for individuals or joint owners.

Whilst the statutory mortgage itself is created using the prescribed form, the detailed commercial terms of the security arrangement are typically contained in a separate Deed of Covenants setting out the rights and obligations of the parties, maintenance obligations, events of default and the mortgagee's enforcement rights.

Upon lodgement, the registrar of the ship’s port of registry will record the mortgage in the register book maintained. Registration is significant as it confers statutory status on the mortgage and determines the priority of competing registered mortgages. Pursuant to section 45 of the MSO 1952, where multiple mortgages are registered against the same ship or share therein, the mortgages rank in priority according to the order in which they are entered in the register book irrespective of the date on which the mortgage instrument was executed. Where a second or subsequent mortgage is to be registered, a letter of consent from the existing mortgagee must first be obtained and submitted to the relevant ship registry before the subsequent mortgage may be registered.

Currently, applications for the registration of ship mortgages are required to be submitted through the Malaysia Marine Department Information System ("MMDIS"). The following documents having first been verified by the relevant ship registry must be uploaded to the MMDIS.

- Form Marine 247, Marine 249 or Marine 251;
- Original and a certified true copy of the Deed of Covenants;
- Letter of Authorisation – Typically, the lender's counsel would attend to the perfection of the mortgage and this letter of authorisation is granted by the ship owner to such counsel to attend to the necessary mortgage registration formalities;
- Latest notification of change in the register of directors, managers and secretaries of the ship owner;
- Power of Attorney – Where the mortgage form is executed by an attorney, a copy of the instrument creating the power of attorney must be submitted; and
- Letter of Consent issued by the existing mortgagee (where applicable).

Upon verification and approval of the application, the applicable registration fee calculated based on the gross tonnage of the ship shall be paid through the MMDIS following which a new mortgage slip stating the date and time of registration of the mortgage will be available for extraction.

A failure to register a statutory mortgage does not automatically extinguish the mortgagee's rights. As illustrated by the decision in *Malayan Banking Berhad v Premier Expand Sdn Bhd & Ors (The owners of and/or any other persons interested in the ship or ships the 'Zuhairi' and 'Nasuha') [2013] 8 MLJ 32*, notwithstanding the failure to register the statutory mortgage, the court recognised that the plaintiff had acquired an equitable mortgage over the ships arising from the grant of the loan facility. On this basis, where the formal requirements for registration have not been complied with, the mortgage instrument nevertheless remains effective as between the mortgagor and the mortgagee and continues to create an equitable interest in favour of the mortgagee.

However, an equitable mortgage does not enjoy the same statutory protection as a registered statutory mortgage. The mortgagee will not have the statutory priority afforded to registered mortgages under the MSO 1952 as against third parties and an earlier equitable interest may be defeated by a subsequent legal interest acquired by a bona fide purchaser for value without notice of the prior equitable interest.

Stamping

Before the prescribed form can be submitted to the relevant ship registry for registration, it is required to be duly stamped under the Stamp Act 1949 ("Stamp Act") within thirty (30) days of execution if executed in Malaysia or within thirty (30) days of first receipt in Malaysia if executed outside Malaysia failing which late stamping penalty as stipulated under section 47A of the Stamp Act shall be payable in addition to the unpaid duty between 10% to 20% of the amount of deficient duty. Under Item 27 of the First Schedule to the Stamp Act, where the mortgage constitutes the only and principal security for the repayment of the loan, it is chargeable with ad valorem stamp duty at the rate of 0.5%. Where the mortgage is executed as collateral security and the principal security has been duly stamped with ad valorem duty, the mortgage is chargeable with nominal stamp duty of RM10 provided that the principal instrument evidencing payment of the ad valorem duty is produced to the Inland Revenue Board of Malaysia ("IRB"). The stamping process typically takes between 5 and 7 working days, subject to IRB's processing time.

Lodgement of company charges under Companies Act 2016 or Labuan Companies Act 1990

Where the ship owner providing the mortgage is a company incorporated under the Companies Act 2016 ("CA"), the prescribed statutory charge form namely the Statement of Particulars to be Lodged with Charge must be lodged with the Companies Commission of Malaysia ("CCM") within thirty (30) days from the creation of the charge pursuant to section 352(1) of the CA.

Where the ship owner is a Labuan company incorporated under the Labuan Companies Act 1990 ("LCA"), the prescribed statutory charge form namely Form 21 must be lodged with the Labuan Financial Services Authority within one (1) month from the creation of the charge pursuant to section 84(1) of the LCA.

Discharge of Statutory Ship Mortgage

Where a registered mortgage is to be discharged, the Memorandum of Discharge on the prescribed mortgage form must be executed by the existing mortgagee. Thereafter, an application for registration of the discharge of the mortgage shall be submitted to the ship registry together with the following documents for verification before being uploaded to the MMDIS:

- Original mortgage form (Marine 247, Marine 249 or Marine 251) with the duly executed Memorandum of Discharge;
- Deed of discharge (if applicable);
- Consent release letter from the mortgagee; and
- Power of attorney.

Similar to the registration, following the payment of the discharge fee calculated based on the gross tonnage of the ship through the MMDIS, a slip for discharge of mortgage stating the date and time of registration of the discharge of mortgage will be available for extraction.

Transfer of Ownership where there is registered mortgage

Under the MSO 1952, the transfer of ownership of a registered Malaysian ship is effected by a bill of sale. However, in order to effect such transfer, any existing registered mortgage over the ship must first be discharged as provided by the Marine Department Malaysia's Guidelines for the Application for Amendment of Ship Registration Information.

Other types of Security over Ships

In a typical ship finance transaction involving a Malaysian-registered ship, a lender will customarily take a package of security instruments, other than the statutory ship mortgage, the types of security instruments taken in relation to ships are as follows:

(a) Deed of Covenants

A deed of covenants is entered into alongside the statutory mortgage. It contains detailed covenants from the ship owner in favour of the lender, covering matters such as ship maintenance, insurance, classification, trading restrictions, and negative pledge undertakings.

(b) Assignment of Insurances

The lender will typically take an assignment of all insurances maintained in respect of the ship, including hull and machinery (H&M) insurance and protection and indemnity (P&I) club cover.

Notice of assignment is given to the relevant insurers and P&I club, and the lender is noted as loss payee and assignee on the relevant policies. The ship owner typically assigns by way of security all rights, title and interest in the ship's insurances in favour of the lender. This enables the lender to receive insurance proceeds directly in the event of damage to the ship.

(c) **Assignment of Earnings and Charterparties**

Where the ship is employed under a charterparty or other contract of affreightment, the lender will take an assignment of the borrower's rights to freight, hire, and other earnings arising thereunder. Notice of assignment is given to the charterer or other relevant counterparties. This assignment ensures that the income stream generated by the ship is directed to the lender upon the occurrence of an event of default.

Where earnings from the ship are credited into a designated account, the lender may also take an assignment and charge over that account.

(d) **Assignment of Requisition Compensation**

This assignment covers any compensation payable in the event that the ship is requisitioned for use or title by any government authority. Whilst requisition is a rare occurrence in practice, lenders prudently secure this contingent entitlement as part of the overall security package.

(e) **Corporate and Personal Guarantees**

Depending on the credit profile of the borrower and the structure of the transaction, the lender may require corporate guarantees from the borrower's parent company or other group entities, and personal guarantees from the beneficial owners or directors of the borrowing entity. These guarantees provide the lender with recourse beyond the ship itself.

Valuation report

Before deciding to take security over a ship, lenders will generally require an independent valuation or appraisal report to determine the value of the ship as collateral. In practice, lenders often maintain a panel of approved appraisers and may prescribe the format or content of the valuation report. Accordingly, it is advisable for the mortgagor to confirm the lender's preferred appraiser and reporting requirements before commissioning the valuation to avoid the need for a replacement or supplementary valuation report.

Ship search

Lenders may also conduct a search against the ship to verify ownership and to ascertain whether there are any existing registered mortgages or other encumbrances over the ship. Such search may be conducted with the relevant ship registry upon payment of a search fee of RM15. A ship transcript issued by the registry will contain information relating to the ship including but not limited to the registered owner, particulars of any registered mortgage, the ship's specifications, gross tonnage, port of registry.

Conclusion

While the process for creating and registering a statutory mortgage is relatively straightforward, the liaising with the relevant ship registry is important to ensure that it can be done within the required time frame for such financing purposes. The statutory mortgage can also be complemented by a suite of other collateral security instruments to provide the lender with adequate protection.

By adopting a comprehensive approach to security documentation and perfection, lenders can maximise the protection afforded by their security package and ensure that they are well-positioned to enforce their rights in the event of default under the relevant statutory and common law provisions available under Malaysian law.

This article was written by our Shipping Finance partners, Putri Norlisa Najib and Wong Mei Ting. It contains general information only. It does not constitute legal advice or an expression of legal opinion and should not be relied upon as such.