

SHIPBUILDING DISPUTES: SELECTING AND TAILORING ARBITRATION TO SUIT

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I. INTRODUCTION

The resolution of shipbuilding disputes is attended by some irony and seeming contradictions. According to recently published statistics, there is no meaningful commercial shipbuilding underway in the United Kingdom,¹ yet a large number of shipyard contract disputes are apparently decided by LMAA (London Maritime Arbitrators Association) arbitration under English law. There are a modest number of commercial ships under construction in the United States² and a modest number of shipbuilding contracts worldwide which provide for arbitration under U.S. governing law in the United States.

As the concentration of shipbuilding projects has moved through the developed and then developing world over time, China, as a relative newcomer to this industry, has seen the greatest number of vessels built in the past decade.³ However, it is believed that not many non-Chinese owners, if any, have agreed to arbitrate shipyard disputes under Chinese law under the rules of the China Maritime Arbitration Commission (“CMAC”). With recent announcements that China intends to expand financing of China-built vessels⁴ and to engage in a leasing finance model,⁵ it remains to be seen if such inducements will work pressure on foreign owners (or lessees) to agree to the CMAC arbitration process, let alone the new form of shipbuilding contract known as the Shanghai Form, produced by the CMAC.⁶

Also in the picture is Singapore, ever the cross-trader, which seeks to capitalize on the concentration of East Asian shipbuilding activity by promoting the use of Singapore arbitration. Singapore is able to claim both institutional integrity and a neutral’s disinterest in arbitration outcomes, as well as experience in the heritage of English law. Recent reports that LMAA arbitrators are registering as arbitrators in Singapore bear witness to the threat that Singapore represents to London’s recent domination in shipbuilding arbitration.⁷

Finally, consideration should be given to the involvement of other persons who are not parties to the shipbuilding contract but who are critical to the process. Equity and debt investors often have their own views on what is acceptable by way of dispute resolution. In more and more cases, these views differ from what is otherwise acceptable to a shipyard or a traditional shipowner.

These developments suggest it is a good moment to consider the basis on which governing law and dispute resolution provisions should be decided, particularly from the point of view of the shipowning interests.

II. THE VARIETY OF SHIPBUILDING DISPUTES

Disputes arising out of ship construction can appear at various phases of the shipbuilding process and involve widely differing concerns. To a great extent, shipbuilding disputes can be usefully divided between pre-delivery disputes and post-delivery disputes.

Pre-delivery disputes usually involve disagreements over the ongoing construction process, for example, whether or not the builder's work conforms to specifications, regulatory or class requirements or good shipbuilding practice. A builder may claim that the owner's requirements constitute upgrades or change orders that entitle the builder to increased compensation and extensions of time to perform. On occasion, parties may agree to performance of contested owner demands, subject to post-delivery judicial or arbitral determination of whether the items were, in fact, required by contract, or constituted changes. Other pre-delivery disputes may require more immediate intervention in order to avoid delay or disruption in the shipbuilding process.

More profound pre-delivery disputes involve the consequences of a party's insolvency or other barriers to performance, or the right of a party (usually the buyer) to terminate the contract based on the builder's failure to complete the vessel by a contractually-agreed date. The resolution of these disputes will often affect not only the immediate contract parties, but also callability of refund guaranties issued by those entities which underwrite the builder's obligation to refund installments of the contract paid by the buyer to the point of builder's alleged breach or failure.

Post-delivery disputes often arise out of guaranty claims or the buyer's claims for indemnity based on third-party claims against the buyer by those not in privity with the builder. Given that the ship is by then delivered to the owner or its order, the same pressures for expedited arbitration do not exist. And, in most cases, the refund guaranty is no longer at issue, while guaranty claims, if they are secured, are usually backed by smaller purchase price retentions and guaranties by engine suppliers and other major equipment manufacturers.

The indecent haste with which many of the last decade's newbuilding contracts were concluded has left a variety of practical obstacles to realization on refund guaranties. Some of the problems arise out of the fact that payments under the refund guaranty agreements require either acquiescence of the builder or a final judgment of a court before payment. In other cases, the refund guaranties had fixed dates of expiry that did not extend to take into account dispute resolution periods or even construction contract delivery extensions. Unlike evergreen clauses in standby letters of credit, or certain performance bonds or European bank guaranties, these refund guaranties were drafted and accepted in complete disregard of the variety of outcomes historically seen in the shipbuilding process. In many cases, lenders or equity funds financing construction projects have found that the refund guaranties they relied upon in the case of a builder default were illusory.

III. CONTROLLING THE DISPUTE RESOLUTION PROCESS

Parties choose arbitration for a variety of reasons of varying significance, ranging from lower cost, commercially knowledgeable arbitrators, speed of resolution and confidentiality. They may choose one arbitration institution over another based on its rules, history of performance, neutrality, stable of arbitrators and the reliability of the legal system in the seat of arbitration for enforcement purposes. Parties with more extensive experience in arbitration have often developed contract clauses which either create their own set of arbitration rules or supplement those of an established institution.

IV. INVESTOR VIEWS

As the shipping industry has bled out its capital base over the past years, some new sources of equity and debt have begun to emerge. Many of these sources are new to shipping and not wholly at ease about their investments in faraway places with strange-sounding names. Oftentimes, these parties invest under extensive documentation structured as joint venture agreements, with dispute resolution clauses calling for New York law and jurisdiction of New York courts. They can usually be persuaded to accept arbitration for speed and commercial expertise but are not keen to have their rights and obligations under investment agreements decided in one place, but the very intertwined issues in a shipbuilding project determined elsewhere in a framework unfamiliar to them.

This issue may not impact shipbuilding projects that are wholly or largely financed by Chinese banks, by post-delivery term debt or by leasing products, but it will affect others financed with new capital, particularly equity.

V. CHOOSING AN ARBITRATION MODEL

A. Governing Law

Parties to a shipbuilding or other international commercial contract should keep a number of factors in mind. The first and foremost is choice of governing law. Too many commercial negotiators treat this issue as a tradable item, without considering the implications. Every provision of a shipbuilding contract, from first to last, may later be read by a judge or arbitrators against a backdrop of a system of law informed by public policies, commercial code provisions, interpretive presumptions and perhaps prior constructions of the same or similar provisions and contextual events. To draft a contract without settling governing law is to get this process exactly backwards.

In the United States, moreover, simply stating in a dispute resolution clause that “arbitration is to be conducted under New York law” is insufficient to invoke the substantive law of the State of New York, but rather only the procedural law relating to the conduct of arbitration. Instead the agreement should state that the contract is to be interpreted and construed in accordance with the laws of New York.

As in many countries, New York arbitrators have extensive latitude to do equity and meet commercial standards, as they perceive them, in their awards, notwithstanding governing selections. The contractual text may change this, of course, by calling for strict construction or fencing off certain arbitral prerogatives. So, for example, if the parties wish that attorney fees follow the award, or that no award be given for punitive or consequential damages, that should be stated explicitly in the dispute resolution clause as a limit on the contractual authority of the arbitrators to rule.⁸

Each governing law option has its own partisans, benefits and drawbacks. The value of precedent in common law systems is available through choosing the law of a common law system in the contract and is assured by also selecting an arbitral institution which is familiar with such choices and can be relied upon to apply the appropriate principles. The seat, or location, of the hearings is distinct from governing law and need not, in fact, restrict the choice of individual arbitrators. Witness LMAA members enlisting in Singapore.⁹ The author has personally arbitrated shipbuilding disputes in New York proceedings chaired by London-based solicitors.

Parties should be wary of accepting the governing law of jurisdictions which have no longstanding familiarity with shipbuilding disputes but rather have only recently imported whole codes or bodies of rules and procedures from other jurisdictions. In such cases, the adopting jurisdiction would likely have no familiarity with the traditions, mechanics and implications of the provisions it is taking on. There are examples of new regimes which have attempted to bridge this shortcoming, such as the maritime laws in Liberia,¹⁰ the Marshall Islands¹¹ and Vanuatu,¹² all of which specifically reference the general maritime laws of the United States for reference and jurisprudential context.

In selecting any body of substantive law, the parties should pay particular attention to the degree such law allows freedom of contract to deviate from code or common law. This is a particular advantage of U.S. substantive law generally, and New York law in particular.¹³

In the United States, contracts to build ships are regarded as hybrid agreements, with features of sales of goods as well as personal service contracts. Nevertheless, the freedom of contract principles embodied in the Uniform Commercial Code (“UCC”) will apply to shipbuilding. Perhaps the most commonly expressed phrase in the UCC is “unless the parties otherwise agree.”¹⁴

B. Seat of Arbitration

Parties should select a location or “seat” of arbitration in the dispute resolution clause for the practical reason that the jurisdiction where the seat is located should have a satisfactory court system for enforcement of the duty to arbitrate, should that be necessary. Otherwise, there is no reason that the parties must necessarily accept a specific location for hearings in order to invoke that seat’s governing law or the arbitrators most identified with it. In fact, some rules of arbitration tribunals even specify the appointment of arbitrators with a nationality other than those of the parties.¹⁵

VI. ELEMENTS OF A DISPUTE RESOLUTION CLAUSE

Parties should, but often do not, clearly set forth the place, or seat, of arbitration, number of arbitrators, interrelationship of mediation and arbitration, the rules to apply, the nationality and experience required of arbitrators or those features which should disqualify arbitrators, language of the proceedings, requirements for reasoned awards, exclusions of any issues from arbitrability and any appeal process or discovery limitations. No set of institutional arbitration rules covers all these issues. For that reason, a fully fleshed out dispute resolution clause should be of utmost concern, second only to the choice of governing law. At the end of the day, it is in the parties' interests to resolve upon provisions which expand the bromides of the standard form contracts into specifics with real meaning in the shipbuilding context.

VII. THE RANGE OF CHOICES IN PRE-DELIVERY ARBITRATION

There are a number of national, regional and trade association shipbuilding contract forms in circulation, as well as a larger number of more proprietary versions developed by individual shipyards based on the various forms. Some of the newbuilding contract forms in use include the following:

Standard Shipbuilding Contract, adopted by the Association of European Shipbuilders and Shiprepairers ("AWES")

Japanese Standard Shipbuilding Contract ("Jcon")(English version)

MARAD Form of Shipbuilding Contract

Newbuildcon – Standard Newbuilding Contract BIMCO

China Maritime Arbitration Commission ("CMAC") Standard Newbuilding Contract (Shanghai Form) (English Version)

A. AWES

Not surprisingly, this pan-European form is silent on which body of substantive law applies to the agreement.¹⁶ It refers construction disputes to an expert agreed by the parties and contemplates resort to a standby appointment if the parties fail to agree to a specific person for a particular dispute.¹⁷ Disputes not resolved by the Technical Expert may be referred to a three-member Arbitration Tribunal. Arbitration would be final.¹⁸

B. JCon

Traditionally used in other East Asia countries as well as Japan, this form calls for application of the substantive law of the place of building.¹⁹ Disputes would be arbitrated under the rules of the Japan Commercial Arbitration Association. A three-member tribunal would deliver a final award.²⁰ There is no separate provision for technical or expedited arbitration in the contract form itself.

C. MARAD Form

This form originated with the Maritime Subsidy Board of the U.S. Department of Transportation Maritime Administration (“MARAD”) to standardize construction contracts for vessels built with Construction-Differential Subsidy (“CDS”). The form incorporated many contract provisions then current in U.S. shipbuilding. Even though CDS programs are moribund, many of the form contract provisions, with modifications, survive in the forms used by U.S. shipbuilders. Most of the successor contracts contain provisions for expedited technical arbitration.

D. BIMCO’s Newbuildcon

This recently offered form provides for the default election of English governing law if parties do not enter another choice in Box 23(a), Clause 41. Dispute Resolution, Clause 42, provides for final resolution as follows:

1. Class and regulatory issues – by class or the Regulatory Body. Cl. 42(a) (explanatory notes state that class decision does not mean local class surveyor or representative in yard).
2. If the dispute is not appropriate for the foregoing process, then either reference to a single, independent, third-party expert or to arbitration in selected venue. Box 23(b), Cl. 42(b).
3. “Either party may at any time and from time to time” call for mediation, following commencement of arbitration proceedings. Cl. 42(b). If the other party rejects mediation, the requesting party may cite that refusal to the arbitrators, who may award costs in the arbitration taking such refusal into account.

Overall, the mediation process seems vulnerable to delays and imprecision in timing.

E. CMAC Newbuilding (Shanghai Form)

As far as this author knows, the Shanghai Form is the only form of shipbuilding contract produced by a body of commercial arbitrators. This form calls for a contract to be “governed by and interpreted in accordance with the Laws of the People’s Republic of China or the laws of other state agreed by the two parties.”²¹ Article XXVI of the Shanghai Form outlines steps in dispute resolutions, some of which do not appear to be crisply delineated.

VIII. EXPEDITED ARBITRATION

In the construction process, there are ample opportunities for parties in the project to encounter disagreements. Most of these are technical in nature, having to do with materials required, processes and sequences involved, or interpretation of class and regulatory requirements. To the extent that rules or requirements of class or regulatory bodies are at issue, resolution can only come from the rulemaking entity itself. Most often, this is addressed in building contracts by specifically deferring to the determination of class or

regulatory body, as the case may be. However, the class or regulatory representative on site or otherwise designated may not be the ultimate authority from whom no appeal may be taken.

Oftentimes, disputed items are intertwined matters of class requirements, good shipbuilding practice and non-class contract requirements. To the extent that such items can only be resolved by an authority which addresses all three aspects, reliance on a class representative can be unsatisfactory. An obvious example of this situation presents itself when the first issue is whether or not work must be done or redone to conform to class requirements, and such additional work would delay delivery. Class societies are not in the business of determining appropriate extensions of time and are even less qualified to determine whether or not any associated delay can trigger an owner's right to terminate. Expedited arbitration provisions should be adopted with a pool of pre-designated, technically competent and respected people or institutions.²² The trick in creating a workable, expedited arbitration provision is to be clear on what is reserved for traditional three-member arbitration panels. The concept is to create a triage center for urgent decision-making, generally as to technical disputes which threaten to disrupt construction. Parties should resist the temptation to use rough claim value thresholds, thus creating a sort of "small claims court." This is, in large part, because dollar value of technical disputes and delay consequences are not always certain of measurement.

IX. CONFIDENTIALITY

When cataloguing advantages of arbitration, proponents often reflexively cite confidentiality as a benefit. Although the degree of confidentiality varies somewhat by the rules and process involved²³, it has largely become, as one commentator noted, "porous."²⁴ Where reasoned awards are published, the industry will learn of them. When awards are appealed, the courts may disclose the dispute particulars. Even where there is prescribed confidentiality and no appeal, word travels in industry circles, often motivated by triumphalism of the prevailing party or counsel or simple Schadenfreude at the plight of the losing party. In the case of parties who are public issuers, various reporting and disclosure statutes can also drill holes in confidentiality. While arbitration may not be as overtly public as judicial proceedings, the arbitration process at best hides behind a sheer curtain.

X. DISCOVERY

Discovery can be critical to avoid the perversion of justice by a party which asserts specious claims or defenses while sitting on the evidence to refute them. When not reasonably controlled, discovery can be shamefully abused as an expensive and pointless delaying tactic. In shipbuilding disputes, the best evidence of what occurred can often only be found with reasonable discovery. Most often, this involves production of documents in paper or electronic form. Occasionally, site inspections, depositions or testing of materials may be required or useful. In U.S. practice, arbitration tribunals and sometimes counsel may issue

subpoenas and subpoenas duces tecum of third parties to discover evidence.²⁵ Targets of these subpoenas often include suppliers, class societies, flag agencies and departed employees of one party or another. One solution to discovery abuse is to appoint a chair who is a lawyer comfortable with narrowing and focusing overly-broad discovery attempts.

XI. REASONED AWARDS

The case against reasoned awards appears to be that they are time consuming and expensive to produce, as opposed to an award more closely resembling a tally sheet on which arbitrators list an amount of award per claim and counterclaim. Parties should bear in mind that the need to justify awards by reasoned decisions perforce causes arbitrators to think through their analysis and avoid blatant compromises. There is also no guidance or precedential value in unexplained awards. In the United States, reasoned awards in SMA (Society of Maritime Arbitrators) or ad hoc proceedings are often available and often cited in subsequent arbitral proceedings as precedent. Where individual arbitrators are perceived to have issued misguided or incompetent rulings, parties can avoid those individuals in the future.

XII. COST

No issue affords more room for partisan fabulists to spread disinformation on the comparative merits of arbitration in different jurisdictions than the subject of the overall cost of arbitration. It is not often that any two shipbuilding disputes would be so alike as to support a cost comparison. The only soft target for critics might be the filing charges scheduled by some of the arbitration institutions which assess fees by size of claim and counterclaim on the theory that there is a correlation. There may or may not be.

CONCLUSION

Not all arbitration systems are created equal. Parties to shipbuilding transactions have access to more than one body of highly developed modern commercial law and the ability to tailor their agreements to control and maximize value from arbitration by adding, subtracting and modifying the powers granted to the arbitrators. Parties also need not be slaves to a limited menu of arbitrators or locations. By adopting governing law which respects freedom of contract, and selecting a seat of arbitration in a jurisdiction with an arbitration-friendly judiciary, parties can assure that arbitration will be responsive to their dispute resolution needs.

NOTES

1. Shipbuilding Statistics, March 2011, www.sajn.or.jp/e/statistics/shipbuilding_statistics_Sep2011e.pdf, The Shipbuilders' Association of Japan, citing IHS (formerly Lloyd's Register) "World Shipbuilding Statistics." This report sets forth figures for vessels of at least 100 Gross Tons ordered or completed for each year from 2004 through 2010 by country of build and by region. 2010 orders are reported for Japan (385 vessels, 13.6% of world gross tonnage); South Korea (467 vessels, 35.6%); China (926 vessels, 43.0%); United Kingdom (1 vessel, 0.0%); Singapore (3 vessels, 0.1%); and United States (40 vessels, 0.1%). Vessels completed are reported for 2010 as Japan (577 vessels, 21.0%); South Korea (524 vessels, 32.9%); China (1,402 vessels, 37.7%); United Kingdom (6 vessels, 0.0%); Singapore (40 vessels, 0.1%); and United States (74 vessels, 0.2%). In 2010, East Asia as a region had 1,789 vessels ordered, or 93.2% of the world order book by gross tonnage, and vessels completed were 2,657 or 92.3% of worldwide delivered gross tonnage.
 2. *Id.*
 3. *Id.*
 4. "Chinese Ship Financing to Help Rescue Global Shipping Industry." May 13, 2011, PR Newswire; <http://en.prnasia.com>.
 5. "Yangzijiang eyes ship leasing arena." March 7, 2012. Fairplay Online News, www.fairplay.co.uk.
 6. Available at www.cmac-sh.org/en/model-contract.asp.
 7. "Singapore is making headway towards becoming a maritime arbitration hub." Daily News E-mail, March 20, 2012, www.fairplay.co.uk.
 8. Federal Arbitration Act, 9 U.S.C. Section 10(a)(4). See *Katz v. Feinberg*, 290 F.3d 95 (2d Cir. 2002).
 9. Note 7, *supra*.
 10. Liberian Code of Laws of 1956, as amended, Section 30.
 11. Republic of the Marshall Islands, Maritime Act of 1980, Section 14.
 12. Republic of Vanuatu, Maritime Act, Cap. 131 (as amended), Section 11.
 13. See N.Y. U.C.C. Section 2-303. "Where this Article [Article 2 Sales] allocates a risk or a burden as between the parties 'unless otherwise agreed,' the agreement may not only shift the allocation but may also divide the risk or burden."
 14. *Id.*
 15. See, e.g., American Arbitration Association (AAA) Commercial Arbitration Rule R-19.
 16. AWES, Art. 15(a).
 17. AWES, Art. 15(b).
 18. AWES, Art. 15(c).
 19. JCon, Article X.1.
 20. JCon, Article XIII.
 21. Shanghai Form, Section 5, Article XXI.
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22. An example of such a provision is attached to the author's submission, Nolan, "Legal Principles Applied to United States Arbitration of Shipyard Disputes – Workmanship Standards, Vendor Selection and Design Responsibility," delivered at ICMA VIII, Madrid, in 1987, Appendix A, Article B.
 23. See, e.g., Society of Maritime Arbitrators, Inc., Maritime Arbitration Rules, Section 1, permitting parties to stipulate in advance to confidentiality. www.smany.org.
 24. See Confidentiality, 2010 International Arbitration Survey: Choices in International Arbitration, School of International Arbitration, Centre for Commercial Law Studies, Queen Mary, University of London; available at <http://choices.whitecase.com>
 25. The Federal Arbitration Act empowers arbitrators, or a majority of them, to issue subpoenas to compel the attendance of witnesses "and in a proper case to bring . . . [such records] as may be deemed material." 9 USC Section 7. The corresponding provision of New York law, CPLR Rule 7505, confers "the power to issue subpoenas" on "[a]n arbitrator and any attorney of record in the arbitration proceeding."