Global Arbitration Review

The Guide to Energy Arbitrations - Sixth Edition

Offshore Vessel Construction Disputes

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Generated: May 24, 2024

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Offshore Vessel Construction Disputes

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Summary

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It was not until the late 1970s that deep-water offshore oil and gas exploration became significantly viable. The driver was the ever-increasing demand for oil and gas products, which provided the opportunity to raise the capital necessary to design and then build the incredibly complex floating assets needed to explore for, and then produce, oil and gas in such hostile environments.

Today, it is not unusual for oil and gas drilling and production to be undertaken in water to depths in excess of 10,000 feet. The units that undertake this work are incredibly complex feats of engineering and may take up to three years to construct. Certainly at the peak of the market, the most complex and technologically advanced new build units cost at least US$1 billion to construct.

The offshore oil and gas industry today, however, requires more than merely the deployment of drilling units for its operation. The industry now requires a full range of vessels to support it, including floating production storage offloading (FPSO), floating storage units (FSUs), accommodation vessels (floatels), heavy-lift vessels, pipe-laying vessels and myriad support vessels.

Perhaps unsurprisingly, it is the largest and most sophisticated commercial ship-building yards that moved into the construction of offshore oil and gas floating units. Incentivised by the potentially lucrative nature of building these types of assets, it has tended to be the shipyards of South Korea, China and Singapore that have been the pre-eminent builders.

Being a development from commercial shipbuilding, projects tend to be undertaken on similar contractual terms and to incorporate aspects of both construction and sale of goods contracts.

Since the last edition of this guide, the market for the construction of these units has remained depressed, and particularly so when compared to the previous highs seen in the first half of the previous decade, when sky-high charter rates for offshore units supported massive demand for new build units. This is despite oil, at the time of writing, trading at around US$80. While this is less than the US$100 per barrel at the time of the last edition, due to increased demand following the lifting of worldwide lockdown restrictions, the release of the pent-up demand that ensued and the war in Ukraine, this is far from a depressed price. However, that this has not yet translated to increased demand for new build offshore units is due, in part, to the glut of offshore units available to the market, and the considerable global economic uncertainty that persists, as well as the uncertainty that relates to the place of carbon fuels in the energy transition.

Time will tell whether there will be a considerable uplift in offshore oil and gas projects. The West's reappraisal of its willingness to rely on Russian oil and gas – despite trends towards greener sources of energy – does appear to be driving significantly more new offshore projects as Western nations in particular seek to secure alternative supplies. If so, then increased demand for the construction of the marine assets utilised in the offshore exploration and production of oil and gas could again lead to the types of disputes that arise in a 'hot' market (which we detail below). For now, however, it remains the case that ongoing proceedings (usually arbitration) tend to concern cancellation disputes (often related to new build contracts for deepwater units).

This chapter provides an overview as to why arbitration is the typical method of dispute resolution relating to new building projects, and the types of disputes that commonly arise and how they are usually resolved, and considers some common strategies for their successful resolution by arbitration.

WHY PARTIES CHOOSE TO ARBITRATE

EASE OF ENFORCEMENT

That disputes should be resolved by way of arbitration[2] is usually a simple choice for the parties.

With the builder and the buyer of the unit usually in separate countries, and agreeing for their disputes to be resolved in the forum of a neutral third country, the ease of enforcing a legal determination made in one country against the assets of the other party in another will be at the forefront of the parties' minds when negotiating their contract. Arbitration will therefore usually be the preferred method of dispute resolution, given the relative simplicity with which awards can be enforced between contracting states to the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958 (New York Convention).

CONFIDENTIALITY

A belief that arbitration provides for a confidential method of dispute resolution is usually a further important factor in the parties' decision to choose it. This is particularly relevant when the matters in dispute are commercially sensitive, which is often the case in the context of offshore construction disputes.

As a matter of English law, an English court will uphold the implied duty on the parties to treat the arbitration as confidential, unless there are valid reasons not to, for example, because disclosure is in the interests of justice. However, parties will often wish to make express provision for the extent to which the process is to be confidential, and the circumstances in which the outcome of an arbitral process may be disclosed to others (e.g., providing for the outcome of the proceedings to be disclosed to the parties' bankers or auditors).

Parties should recognise the limits on the confidentiality of the arbitral process. Failure to adhere to the terms of an award will usually permit the other party to have the award recognised as a court judgment, which will be a public document.

ABILITY TO CHOOSE THE MEMBERS OF THE TRIBUNAL AND THE PROCEDURE

Specifying arbitration will also usually allow the parties to provide for the qualifications and characteristics of the person or persons who will determine their disputes, and the manner in which they will do so. We consider these issues below as part of our discussion of the terms promulgated by the London Maritime Arbitrators Association (LMAA).

London arbitration is the procedure of choice, and English law is often the governing law of choice for these types of disputes for a number of reasons, best summarised as follows.

First, London is historically the pre-eminent forum for international maritime (including shipbuilding) disputes, and it has more recently developed a strong reputation in international construction disputes. This is in no small part a result of the advent of the Arbitration Act 1996, which provides an effective framework for the conduct of international arbitrations.

Second, there is a substantial and very well-advanced body of English contract law, much of which has developed in the context of maritime and construction disputes, so English law is well-suited to governing these types of projects.

Third, London has a number of specialist legal practitioners in the field of shipbuilding.

Finally, and perhaps of most significance to international parties with acute concerns about the neutrality of the chosen jurisdiction, London arbitrators (and the English courts) have a reputation for impartiality and integrity.

ARBITRATING UNDER THE LMAA TERMS

Although the LMAA is the most popular arbitration body for the determination of offshore vessel construction disputes, it does not administer or supervise the conduct of its arbitrations or provide institutional help in the traditional sense. Instead it provides a set of rules, referred to as Terms, that the parties agree will govern any arbitration proceedings. LMAA arbitrations are, therefore, not dissimilar to ad hoc arbitrations.

The current LMAA Terms, issued in 2021, are applicable to arbitrations commenced on or after 1 May 2021 and replace the LMAA Terms 2017.[3] The LMAA indicates that its Terms-[4] provide for a light touch approach covering key aspects of the arbitration but leaving considerable scope for the parties to adopt procedures to suit the case. To some extent, the LMAA Terms do not add a great deal to the structure already in place under the Arbitration Act 1996, but they do provide a tried and tested framework for the resolution of disputes relating to shipbuilding (including offshore vessel construction).

Therefore, procedures that require the input of the arbitration body (for example, emergency arbitrator provisions as found in the rules of many of the major arbitral institutions[5] or the procedure for the scrutiny of awards as found in the International Chamber of Commerce's Arbitration Rules (ICC Rules)) are absent from the LMAA Terms precisely because they are not appropriate for the ad hoc style of the LMAA environment.

ESTABLISHMENT OF THE TRIBUNAL

The LMAA Terms provide for a simple mechanism for the establishment of the tribunal. The default position is for a tribunal of three arbitrators, with each party choosing one arbitrator at the outset of the arbitration and the two party-appointed arbitrators choosing a chairperson. In practice, it is very often the case in LMAA arbitration that the preliminary stages – up to, and occasionally beyond, any procedural hearings following the exchange of initial written submissions – are conducted by the party-appointed arbitrators alone. Provided that the two arbitrators can agree, the parties and their counsel are generally content with this approach, and it reflects the flexibility inherent in LMAA arbitrations. This can be contrasted with the rules of some of the institutional arbitral bodies whereby the parties, and their appointed arbitrators, have less autonomy.[6]

Although LMAA members are capable of hearing a broad range of disputes, including offshore shipbuilding disputes, unless the parties agree otherwise in the arbitration clause (which is rare in offshore construction projects), the LMAA Terms themselves place no restrictions on the parties' choices of arbitrator. Hence, the expertise of the LMAA members is supplemented by a number of senior English lawyers (including retired judges) with significant experience of, and expertise in, arbitrating disputes in the offshore construction sector and who are available for appointment as arbitrator whether or not they are members of the LMAA. It is common, therefore, to find tribunals made up of at least two senior English lawyers, with the third member sometimes having a technical industry background depending on the nature of the dispute.

PROCEDURE

Following the constitution of the tribunal, the procedure in LMAA arbitrations tends to follow that adopted in the English courts, with the exchange of written submissions followed by disclosure and thereafter factual and expert evidence. Parties are not bound to a particular approach, and the procedural steps (such as disclosure and the provision of expert evidence) can be tailored to the particular characteristics of the dispute. Furthermore, and particularly in the context of the construction of a complex offshore vessel, which must adhere in operation to stringent regulatory requirements, it is not unusual for parties to fall into dispute (during the course of the project) about how the vessel is being constructed in a specific respect. Resolving these issues at the time could be critical, depending on the nature of the dispute and the extent to which adjustments to the construction of the unit can be made at a later time. In this event, the parties are often assisted by the use of an expedited procedure that, although not formally provided for in the LMAA Terms, can be raised with the tribunal at the outset of the arbitration as soon as the party-appointed arbitrators are chosen and, therefore, before any steps are taken.

In our experience, LMAA tribunals are always alive, and responsive, to the procedural needs of the parties, a characteristic that was highlighted during the covid-19 pandemic. We were involved in a number of LMAA arbitrations for which the hearings have had to proceed on a remote or virtual basis, including one rig construction dispute that was adjourned part heard at the outset of the pandemic but that was rescheduled on a remote basis within weeks thereafter. The LMAA also published guidelines for remote and semi-remote hearings (see the Sixth Schedule to the LMAA Terms 2021), which it rightly anticipated woul be of assistance even after the effects of the pandemic were behind us, given that parties and tribunals alike are now very much alive to the potential benefits.

RELATED PROCEEDINGS

Although the LMAA Terms set out no formal provisions for the consolidation of arbitrations, this is rarely a consideration, in part because most offshore construction contracts significantly restrict the post-delivery liability of the builder (as discussed below), and, with the possible exception of guarantee agreements (see below), invariably the only relevant protagonists are the builder and its buyer. The LMAA Terms, however, expressly permit the tribunal to deal with two or more arbitrations raising common issues of fact or law concurrently (i.e., the proceedings are still separate), which can be helpful in offshore vessel construction disputes in which sister units are under construction at the same shipyard.

Guarantee agreements between the buyer and the builder's bank, providing for pre-paid delivery instalments to be refunded in the event of cancellation of the shipbuilding contract by the buyer, are often made subject to English law and English court jurisdiction. In normal circumstances, this is of no consequence because these guarantees will not respond until the arbitration between the buyer and the builder is concluded. In the event of related guarantee proceedings taking place in the English courts at the same time as the underlying arbitration, although this could lead to the risk of conflicting decisions, there may be scope to stay the court proceedings pending the outcome of the arbitration.

THE AWARD

The LMAA Terms provide that the award should normally be available within six weeks from the close of proceedings. Although this is rarely realistic in the case of a substantial offshore vessel delivery dispute, in our experience LMAA arbitration tribunals are diligent in the production of their awards, and in all but the most complex cases the award can be expected within approximately three months following the conclusion of the hearing. The pedigree of the tribunals appointed in these arbitrations also maintains a high standard of awards, such that practitioners and parties involved in these disputes have not sought to lobby for the introduction of a scrutiny process similar to that found in the ICC Rules.

TYPES OF DISPUTES ARISING FROM THESE PROJECTS

Disputes relating to offshore vessel construction projects can be divided broadly into two groups: those relating to events before the vessel is delivered, and those relating to events after delivery.

Dealing first with pre-delivery disputes, the type of dispute that is likely to arise is often determined by the state of the market. The period between when the contract is signed and the contractual date of delivery of the vessel is often in the region of two-and-a-half to three years. The state of the offshore market can change dramatically during this time. This will affect the market value of the vessel at delivery and, therefore, whether the buyer is paying more or less than the current market value. The state of the offshore market at delivery may also affect whether the buyer has an operating contract for the vessel after delivery.

These two factors may significantly affect how the buyer will view its contractual rights and, in particular, its right to cancel the contract. In a falling market, a buyer is more likely to be prepared to exercise any contractual cancellation right that accrues. In a rising market, a buyer will seek to hold the builder to its contractual obligations, but will probably be reluctant to cancel the construction contract and place a replacement construction contract with another builder, which will almost certainly be for a higher price and with a significantly later delivery date.

LIKELY PRE-DELIVERY DISPUTES IN A FALLING OFFSHORE MARKET

In a poor offshore market, cancellation disputes are much more common.

Normally, the construction contract will provide for a contractual delivery date. If the builder does not deliver the vessel by that date, the builder will become liable, after a few days of grace, for liquidated damages for delay. If the delay in delivery continues for a specified period through the fault of the builder, normally between 180 and 210 days (the cancelling date for builder delay), the buyer may cancel the construction contract and obtain a refund of the pre-delivery instalments of the contract price, plus interest.

The buyer may also be entitled to claim damages for its losses, although these are often excluded under the terms of the contract.

Even without a claim for damages, however, in circumstances where the market value of the vessel is substantially less than the contract price, a full refund of the pre-delivery instalments plus interest will normally adequately compensate the buyer.

In addition, if the total delay, including certain types of permissible delay such as *force majeure*, exceeds a specified period (the drop-dead date), the buyer will normally have an additional contractual right to cancel the contract.

The buyer's remedy for cancellation on the drop-dead date is normally the same as cancellation on the cancelling date for builder delay; namely, the buyer obtains a refund of the pre-delivery instalments of the contract price, although the buyer normally only receives interest at a lower rate, or even no interest at all.

The key issue in these cancellation disputes is generally whether the builder is entitled to an extension of time, and therefore whether the relevant cancellation date had arisen when the buyer purported to cancel.

If the cancelling date had not yet arisen, then the purported cancellation by the buyer is likely to be a repudiatory breach of contract, entitling the builder to accept that cancellation as bringing the contract to an end, and to claim damages.

The circumstances under which the builder is entitled to an extension of time will vary, depending on the terms of the contract and which cancellation right has been exercised by the buyer. It is likely, though, that variations ordered by the buyer, or other delays for which the buyer is responsible, will entitle the builder, in theory, to an extension of time. Bearing in mind that these are highly complex construction projects spanning a number of years, these disputes also can be complex and time-consuming, particularly if the builder is adopting the approach of claiming every conceivable potential extension of time and hoping that at least some of these claims will be upheld.

These types of disputes are likely to involve a substantial amount of factual evidence as to the causes of the potential delay. They are also likely to require technical expert evidence on, for example, whether the claimed causes of delay were the responsibility of the buyer, or simply part of the builder's scope of work in developing the design to produce a vessel that complies with the contract. There is also likely to be expert evidence from delay experts on whether the alleged causes of delay were on the critical path and, therefore, did result in overall delay to the delivery of the vessel.

The complexity of the arbitration will be increased substantially if the builder purported to tender the vessel for delivery before the buyer served its cancellation notice.

In offshore construction contracts, one of the most difficult issues is to determine precisely when the vessel is in a deliverable condition and, therefore, can be tendered for delivery by the builder. Normally, the contract does not require every minor defect in the vessel to be rectified before delivery. This is because a delay in delivery of the vessel can have significant financial consequences for the builder, not only as a result of its liability to pay liquidated damages for delay under the contract, but also because of the delay to the payment of the delivery instalment by the buyer. As such, the contract normally specifies that the vessel can be delivered with minor defects, provided they do not affect the safety or operability of the vessel and are remedied by the builder as soon as possible after delivery.

If the builder has purported to tender the vessel for delivery before the buyer tries to cancel, then in addition to arguments as to whether the builder was entitled to an extension of time, and therefore the buyer cancelled too early, there will also be an argument whether the vessel was in a deliverable condition when tendered for delivery.

The deliverability issue will involve factual evidence as to the existence of the defects, as well as expert evidence on the consequences of any such defects. Again, if the buyer adopts a scattergun approach as to which defect or defects prevented the vessel from being in a deliverable condition, this can greatly increase the time and cost involved in the arbitration.

LIKELY PRE-DELIVERY DISPUTES IN A RISING OFFSHORE MARKET

In a rising market, it is very unlikely that a buyer will want to cancel a contract. In these circumstances, it is often the case that the offshore construction market will also be over-heating and the builder will have experienced significant cost overruns and delays. The builder may therefore attempt to claim extensions of time to avoid liability for liquidated damages for delay, or to claim an entitlement to additional payment in respect of alleged variations to the work or for implementing measures to accelerate the project. These disputes are generally less substantial than cancellation disputes.

This assumes, however, that the construction contract has limited the buyer's claims for damages for delay in delivery to a fixed amount of daily liquidated damages. In a rising market, these are unlikely to compensate the buyer fully for its real losses flowing from the delay in delivery, particularly if the buyer is not only losing out on revenue from the vessel, but is also itself subject to liquidated damages for delay payable to its client under the operating contract for the vessel. If the exclusion provisions in the contract are not watertight, the buyer may well seek to bring a very significant claim for damages for delay.

POST-DELIVERY WARRANTY DISPUTES

Given the complexity of construction projects for offshore vessels, it is inevitable that these vessels will sometimes not be built to the contractually required standards. Therefore, irrespective of the oil price at any one time, disputes will arise after delivery in respect of perceived construction defects.

Given the enormous revenue-earning capacity of these units, the financial consequences for a buyer of a post-delivery defect may be severe. The buyer will wish to pass on to the builder as much of its losses as possible. The builder, however, is invariably unwilling to assume the full risk of the buyer's losses.

The parties' competing interests will typically be reconciled within the warranty of quality provision that can be found in almost all such construction contracts, and which generally adopt a standard approach.

THE WARRANTY PERIOD

A warranty period will usually be provided (often for 12 months), typically running from the date the unit is delivered to the buyer, during which, if a defect materialises, the builder's warranty obligations will be invoked.

The contract will specify what parts of the unit the builder warrants against defects during the warranty period – typically the vessel and all parts, and the machinery and equipment designed, manufactured or furnished by the builder.

The warranty will usually provide that these will be free of defects resulting from causes such as defective materials, miscalculation, poor workmanship or failure to construct in conformity with the contract, as well as specifying the types of defects that are not covered. These may include defects arising from 'perils of the sea, rivers or navigation', normal wear and tear, improper operation, or any alteration or addition by the buyer not previously approved by the builder.

A great many arbitrations involve determining whether a defect falls within the warranty provisions.

NATURE OF THE BUYER'S AND THE BUILDER'S OBLIGATIONS

The warranty provision will usually require the buyer to make prompt notification when a defect is discovered. Depending on the clarity of the drafting, failure to do so may give rise to a dispute about whether this sounds only in a claim for damages by the builder (i.e., in the event that it has increased the builder's ultimate cost of repair) or whether the buyer's right to a repair is lost.

There will usually be a longstop date (often a specified number of days beyond the end of the warranty period) by which the occurrence of a defect must be notified. Failure to do so will usually expressly absolve the builder of any responsibility. Given the contractual significance of serving a valid defect notice, there are frequently disputes as to whether the buyer served a valid notice in time and in compliance with all the requirements of the contract.

Assuming that proper notice has been given, the builder's primary obligation will usually be to remedy at its shipyard and at its expense, whether by repair or replacement, any defect against which the vessel is under warranty.

As it is very likely to be impractical for the vessel to return to the builder's shipyard, the contract will almost always entitle the buyer to have repairs undertaken elsewhere, subject to the builder's right to inspect the defect prior to repair. The builder will be obliged to reimburse the buyer's costs of carrying out the repair (or to pay some other measure of reimbursement, such as the costs that would have been incurred if the work had been undertaken at the builder's yard).

EXTENT OF THE BUILDER'S LIABILITY

The warranty provisions will typically seek to limit the entitlement of a buyer to recover compensation in respect of losses suffered and costs incurred as a result of defects.

A critical issue is often whether the warranty provision should be construed as a 'complete code' of the parties' obligations for post-delivery defects (i.e., setting out the entire extent of the builder's obligations (and the buyer's rights) with all obligations otherwise arising excluded) or whether it is intended to provide additional rights to those arising under common law for defects in the vessel.

As post-delivery defects may often result in significant financial consequences for a buyer, the builder will wish to provide for the warranty provisions in the construction contract to stand as a complete code of the parties' rights and obligations, and to curtail any entitlement of the buyer to recover financial losses resulting from post-delivery defects. The builder will want to confine the buyer's rights solely to rectification of the defect (whether at the builder's shipyard or elsewhere) but with no other compensation being payable.

Having positively defined its obligations in respect of defects, a builder will normally seek to provide that all the buyer's other rights, whether under the contract or otherwise, will be excluded, and that the buyer's rights will be confined to those set out in the warranty provision. The builder will wish, in particular, to ensure that any liability arising by law as to the quality of the unit, in particular under the UK's Sale of Goods Act 1979, is excluded. Further, the builder will typically then seek to ensure that all other financial consequences resulting from defects are accounted for by the buyer.

In light of the frequent significant disparity between the cost of repairing a defect and a buyer's overall losses resulting from a defect, disputes often arise as to whether the builder's liability for the buyer's losses over and above the cost of repairing the defect have been effectively excluded.

STRATEGIES FOR SUCCESS IN THE ARBITRATION OF DISPUTES

Only foolhardy practitioners would believe that they alone are able to determine the outcome of an arbitral process. Rather, myriad decisions and factors will affect the outcome of any arbitration. The experienced and pragmatic practitioner will recognise this and, while ensuring that the client is always reminded of the risk inherent in the arbitral process, will seek to minimise that risk as far as possible by the adoption of sensible strategies and practices for the resolution by arbitration of the highly complex disputes that commonly arise from these types of projects.

It is beyond the limits of this chapter to provide a full analysis of how best these disputes may be resolved by way of arbitration. We, however, highlight below some of the key ways in which a party may be able to maximise its prospects of success in a complex offshore unit construction-related arbitration.

In our experience, a primary strategic objective, whether pursuing or defending a claim, is to identify as early as possible what will be the narrative of the case to be advanced on behalf of the party in question. Doing so allows for effort and resources to be focused on the pursuit of the party's case through to the conclusion of the proceedings.

A number of steps can be taken to achieve this objective.

For example, a key early step in any arbitral process is to ensure that all potentially relevant documents are gathered and collated as soon as possible. Any document destruction policies should be promptly suspended and a full and considered analysis undertaken as to the location and nature of documents that may be held by the party relating to the dispute. In an age of electronic documents, which has hugely increased the burden of undertaking disclosure, the key is to ensure that all relevant material is captured. Failing to do so will lead to failures to disclose relevant documentation and perhaps, in the worst possible outcome, to an inability to do so if the material is subsequently lost or destroyed. The resulting effect on a party's credibility in the eyes of the tribunal may be sufficient to turn the outcome of the arbitral process.

Care should be taken early to identify a party's key factual witnesses, who should be briefed on what is required of them, with resources being committed early to working with the witnesses to ascertain and record the relevant facts. A case will often be won or lost based on the performance of a party's factual witnesses in cross-examination. It is therefore always a sound investment of time and money to ensure that witnesses are advised about the level of detail that they will be required to provide in their witness evidence and the extent to which, ideally, they will need to substantiate their evidence with contemporaneous documentation.

Similarly, early identification of the relevant expert issues that are at the core of the dispute, and then the prompt and careful identification and appointment of appropriate experts, can significantly enhance the prospects of success in arbitration. Further, the early involvement of an expert allows for the prospect of it being determined earlier in the process that the case is likely to turn on matters of expert evidence rather than the factual evidence. If so, the experts may be able to provide guidance as to the nature of the factual evidence that is required, and so avoid a more extensive and costly process of gathering factual evidence. The early appointment of experts may similarly allow for a 'sense check' to be performed in respect of the factual evidence provided by the witnesses and can be a check against partisan factual witnesses, who would be susceptible to being discredited during cross-examination at the final hearing.

In arbitrations as complex as those that often arise in these substantial construction projects, organisation and the early determination of a party's case will often be key. This will also tend to be effective in giving rise to the possibility of exploring an early settlement that would avoid the substantial costs involved in a full and final arbitral hearing.

ENDNOTES

[1] James Brown, William Cecil and Andreas Dracoulis are partners at Haynes and Boone CDG LLP.

[2] The contract may sometimes specify, however, for preliminary steps of alternative dispute resolution: for example, meetings of senior managers, or mediation before arbitration.

[3] For present purposes, the focus is purely on the main body of the LMAA Terms. Although the London Maritime Arbitrators Association also has intermediate and small claims procedures, these are unlikely to apply in an offshore vessel construction dispute.

[4] Refer to the LMAA's commentary on the LMAA Terms 2021.

[5] See, for example, LCIA Rules, 2020 edition (at Article 9B) and ICC Rules, 2021 edition (at Article 29).

[6] See, for example, the LCIA Rules pursuant to which all appointments are made by the London Court of International Arbitration.

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