International Convergence on Flags of Convenience

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Graph showing foreign-registered, flagged vessels of the "flag of convenience" states compared to the rest of the countries. Taken from John Konra, Maritime Flags of Convenience Visualized, GCAPTAIN.COM (Oct. 18 2007) available at

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“The fact that a national chose to form the company in the member state whose rules of company law seemed to him the least restrictive... could not in and of itself constitute an abuse of the right of establishment.”

-Case C-212/97 Centros Ltd v Erhvervs- og Selskabsstyrelsen, 1999 E.C.R. I-01459.

In maritime law, a ship follows the laws of the flag that it flies.¹ Ship owners, however, are not constrained to fly the flag of the country that they are from. Instead, they can choose what flag they will sail under, and thus have their pick of laws among all of the countries in the world. Much like the corporate “internal affairs rule” of common law countries that regulates a business at its place of incorporation instead of its primary source of business, a vessel is governed by the country whose flag it flies, regardless of where the ship conducts its business operations. Some of these countries, such as China, have laws that closely regulate the shipping industry, and have proven to be very unpopular among ship owners. Out of China’s 2010 registered flag-flying vessels, only 18 are foreign-owned, suggesting that there is little reason to choose China’s maritime laws unless you are from the country.²

The flags of some other countries, however, are very popular. These flags are known as flags of convenience (“FOC”) because of the “convenience” that the countries’ laws offer the ship owners. These countries may have lower registration fees, less stringent labor standards, fewer required maintenance checks on the ship, or less strenuous environmental regulations. The countries that offer flags of convenience are unlikely players in the shipping industry, ranging from the tiny Central American nation

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¹ See United Nations Convention on the Law of the Sea (UNCLOS) Article 91: “Every State shall fix the conditions for the grant of its nationality to ships, for the registration of ships in its territory, and for the right to fly its flag. Ships have the nationality of the State whose flag they are entitled to fly...; Article 94.1: “Every state shall effectively exercise its jurisdiction and control in administrative, technical and social matters over ships flying its flag;” Article 94.2: “In particular ever State shall: ... (b) assume jurisdiction under its internal law over each ship flying its flag and its master, officers and crew in respect of administrative, technical and social matters in the ship.”

of Panama, to the poverty-stricken West African nation of Liberia, to the landlocked nation of Mongolia. But in the same way that Delaware has emerged as an unlikely leader as a jurisdiction of incorporation, these nations have become *de facto* leaders in maritime law by “selling” their sets of laws to shipping companies around the world. In exchange, the FOC states receive a very lucrative set of shipping fees.

This term paper seeks to frame this emergence of FOC states in the lens of international corporate governance. When it is so easy to select a set of maritime laws from any country in the world, when a ship owner need only change the flag flying above his ship to change his jurisdiction, the international community is set to quickly converge on a set of laws that is best for ship owners.

However, while the laws of a FOC state are sure to benefit the ship owner, the laws may present negative externalities to the employees of the shipping company and the public at large. Does the emergence of the FOC states represent a “race to the top,” where the ship owners are truly choosing the best law “package?” Or do the FOC states represent a “race to the bottom,” where the ship owners are choosing laws that only satisfy their self-interest to the detriment of the public?

First, this paper will explain the history of the emergence of some of these FOC states through independent case studies and conclude that the formation of FOCs is due to market convergence rather than path-dependant factors. Second, this paper will examine the market factors that pervasive in these case studies that push international convergence. Third, this paper will analyze these market factors under the “bonding” and “herding” doctrines in international corporate governance. Fourth, this paper will argue that the FOC policies represent a “race to the top” on matters where there are market forces to oppose the self-interest of the ship owners, but a “race to the bottom” on matters where there are no reasonable means to oppose the ship owners’ preferences.

1) The Emergence of the FOC States

Using several FOC states as case studies, we can see that the emergence of FOC states seems to be the result of functional convergence towards a norm of lower
shipping standards. The independent means that countries have reached the same lackadaisical conditions suggest that path-dependent factors are not the source of these less-stringent standards. Rather, countries seem to be responding to a “market for laws” by actively trying to meet the needs and wants of the merchants.

The emergence of FOC states starts with Panama, and was largely the result of a number of specific historical factors. However, as more and more states began to emerge as FOC states, it became clear that the FOC states were not path-dependent, historical anomalies, but rather independent jurisdictions filling a demand for less-restrictive shipping laws.

a. Panama

Panama emerged as an FOC state following a period of increased maritime regulation by the United States. In 1915, the United States passed the La Follette Seamen’s Act of 1915, which called for a number of labor reforms for seafarers including an eight-hour workday limit with at least one day off per week. In addition, the act mandated regular inspections of the hull and boiler, and added a 50% tax for all work done in foreign shipyards.

In response to these cost-increasing reforms, and also in an effort to smuggle alcohol during Prohibition, the first non-Panamanian ship was registered in Panama in 1919. At the onset, these Panamanian-flagged foreign vessels utilized labor standards far below the ones guaranteed in the Seaman’s Act, as the ship owners paid their crews based on a much lower Japanese wage scale, and kept them in fear that they would not be paid. Soon, entire fleets were being transferred to Panama not only from the United States, but from Europe as well, as Standard Oil of New Jersey and United Fruit Company both transferred their fleet registration to Panama. In 1925, Panama

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4 Id.
5 Id.
6 Id. at 76.
7 Id.
8 Id.
realized the lucrative nature of ship registration, and embraced a new set of reforms to codify the lower labor standards and to establish the Panamanian merchant marine.  

Since then, the Panamanian ship registration system has been a lucrative business for Panama. In 1995, ship registration fees and annual taxes accounted for 5% of the Panamanian budget. More ships are now registered under the Panamanian flag that any other nation in the world, making Panama the de facto leader of flag registration: the “Delaware” of maritime law. As of 2010, 6379 vessels were registered to Panama, and 5,244 of those were foreign-owned vessels.

b. Liberia

While the Panamanian ship registration service came to be through a combination of historical stimuli and later responded to market forces, the Liberian ship registration actually started as a business. It continues to exist with close ties to American corporations.

In 1947, an American company, Stenttinius Associates, formed a profit-sharing arrangement with the Liberian government, where 65% of the profits would go to the parent corporation and 35% would go to Liberia. Even at the very beginning, the head of the corporation, Edward Stettinius, Jr., planned a business slant to the establishing maritime law in Liberia: he concluded that with the right laws, American ships could remain competitive if they were “manned by officer personnel of some foreign nations such as Dutch, Scotch, etc., with the balance of the crew native

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13 See Sharife, infra note 16.
14 Rodney Carlisle, The “American Century” Implemented: Stettinius and the Liberian Flag of Convenience, 54 THE BUSINESS HISTORY REVIEW 177-181 (Summer 1980)
Liberian boys, who would receive in the neighborhood of a dollar a day.” \(^\text{15}\) When the final Liberian Maritime Code was drafted in 1948, Stettinius refused to forward it to the legislature until Standard Oil approved the draft. \(^\text{16}\)

The corporate influence was significant. Liberia’s registry was part-owned by the American International Bank, who marketed Liberia’s operations for most of the twentieth century and made Liberia’s maritime code very popular. \(^\text{17}\) By 1956, Liberia had become the primary flag of convenience because of political unrest surrounding Panama, and by 1969 Liberia bested the United States and the United Kingdom as the most popular country of registration in the world. \(^\text{18}\)

Liberia lost the lead in the 1990s, once the nation underwent a period of civil war. \(^\text{19}\) At this time, ship registry fees account for between 30 and 70 percent of the Liberian government’s revenue. Yet it still maintains its US corporate connection. \(^\text{20}\) In fact, the actual registry is not even located in Liberia – it is located in the Liberian International Ship and Corporate Registry in Vienna, Virginia. \(^\text{21}\)

As a result of Liberia’s attempts to adopt its laws to the market (or perhaps, a corporation’s attempt to adopt Liberia’s laws to its own needs), Liberia is now the

\(^{15}\) Id. at 181.

\(^{16}\) Id. at 182.

\(^{17}\) Khadija Sharife, *Flying a Questionable Flag: Liberia’s Lucrative Shipping Industry*, WORLD POLICY JOURNAL 4 (Winter 2010) available at http://findarticles.com/p/articles/mi_hb6669/is_4_27/ai_n56551667/pg_4/?tag=content;coll1


\(^{20}\) Khadija supra note 17 at 2 available at http://findarticles.com/p/articles/mi_hb6669/is_4_27/ai_n56551667/pg_2/?tag=content;coll1

\(^{21}\) Id. at 1, available at http://findarticles.com/p/articles/mi_hb6669/is_4_27/ai_n56551667/?tag=content;coll1
second most popular choice to register vessels, right after Panama.\textsuperscript{22} To date, there are 2512 vessels registered under the Liberian flag, and 2356 of those are foreign-owned.\textsuperscript{23}

c. Cambodia

By 1994, many nations had jumped on the flag of convenience bandwagon, including the third most-popular flag of convenience state, the Marshall Islands.\textsuperscript{24} Cambodia needed to do something different in order to stand out from the crowd. It faced a FOC market that was largely dominated with Panama, Liberia, and the Marshall Islands, but also included Honduras, Costa Rica, Lebanon, Cyprus, Malta, Somalia, Morocco, San Marino, Haiti, Sierra Leone, and possibly even more, though some organizations disagree.\textsuperscript{25}

To compete with the other flags on the market, Cambodia tried to look and see what it could offer that the others could not. It saw a business opportunity that many others saw in the commercial world in the mid-1990s: the Internet.\textsuperscript{26} Though Cambodia lacked a communications infrastructure to support an Internet-based registration system, it established the Cambodian Shipping Corporation (CSC) in Singapore, and immediately began flagging vessels of other countries.\textsuperscript{27} Starting in 1994, if a ship owner had an Internet connection and the money for a modest fee, he could register his vessel online and receive official registration within twenty-four hours, no questions

\textsuperscript{25} Rex S. Toh and Sock-Yong Phang, Quasi-Flag of Convenience Shipping: the Wave of the Future, TRANSPORTATION JOURNAL 1 (Winter 1993) available at http://findarticles.com/p/articles/mi_hb6647/is_n2_v33/ai_n28633419/.
\textsuperscript{26} Robert Neff, Flags that Hide the Dirty Truth, ASIA TIMES ONLINE (Apr. 20 2007) available at http://www.atimes.com/atimes/Korea/ID20Dg03.html.
\textsuperscript{27} Id.
asked. Over the next 6 years, officials estimate the number of ships registered with the company to have been between 400 and 1200 vessels.

The Cambodian ship registry, however, attracted a lot of negative press. As a result of the “phantom registration” system that required only a bank account and a few clicks of a mouse to register a ship, many drug smugglers and arms traffickers opted to use the Cambodian system of registration. One of Cambodia’s more notable clients was North Korea, which came to international attention when a North Korean ship, the Song Sang, was caught flying the Cambodian flag and hiding 15 Scud missiles underneath a cargo of cement. After the attacks on the World Trade Center brought international terrorism to the global agenda, the international community began to put pressure on Cambodia to reign in the CRC. It was found in 2002 that 14.9% of all port detentions in that year had been Cambodian ships, an enormous percentage compared to the size of Cambodia’s fleet, and soon after the Cambodian government decided to take action before ships under its flag committed acts of terrorism. The government of Cambodia revoked CSC’s authority to register vessels and gave the authority to a new organization, the International Ship Registry of Cambodia (ISROC), in hopes that the organization would exert more discretion over the ships that it registers.

The Cambodian case illustrates a balancing of competing forces in the marketplace for flags of convenience. Initially, Cambodia embraced a de facto plan of complete deregulation, allowing ships to register with nothing other than a fee and an Internet connection. This plan was extremely favorable to the ship-owners, but less

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28 Id.
29 Id.
31 Id.
32 Neff supra note 23.
33 Id.
34 Id.
35 Neff supra note 23.
so to the public. When the international community responded and complained of the side-effects of such a deregulated system, Cambodia responded to the “market” for its laws and enforced stricter regulations.

However, Cambodia is still identified as a “flag of convenience.” As of 2010, the Cambodian flag flew on 620 ships, with 426 of them foreign-owned.

d. Mongolia

With only 3000 km of paved roads, 580 km of semi-frozen waterways, and exactly zero kilometers of coastline due to the country’s landlocked location, the desert nation of Mongolia seems like a very unlikely place to have an established foreign merchant marine.\(^37\) In fact, in the 1980s, the country of Mongolia had seven-man navy, consisting of one tugboat used to patrol the nation’s largest lake, Hovsgol.\(^38\)

Yet, in February of 2003, Mongolia opened the Mongolia Ship Registry (MSR), right after the Cambodian registry closed.\(^39\) Under Mongolia’s laws, a vessel can be given a 6-month provisional registration entirely through facsimile, and offers “low initial registration and annual tonnage taxes,” “no hidden costs,” and a completed registration “in approximately 24 hours.”\(^40\) Registrants can receive a provisional registration by facsimile, without ever showing their ship to any authority. The Mongolian ship registry is located in Singapore and like many other ship registries it is managed by a private corporation, Mongolia Ship Registry Pte, Ltd.\(^41\)

When the MSR was born, critics were very curious about its effect on international commerce. In 2004, the MSR registered 260 ships at sea, with “20 to 30 new registrations

\(^{39}\) Id.
every month. “42 However, the Mongolian-flagged ships did not receive a good reputation. On November 21, 13 Russian sailors were rescued from a sinking Mongolian vessel called the Fest, which was doomed with a failed uninspected engine and a 40-year old rusted hull.43 On December 19th, the Indonesian Navy seized a Mongolian-flagged ship that was transporting illegally harvested lumber. In addition, Mongolia has been accused of flagging North Korean ships to hide arms trading.44

Despite Mongolia’s lack of selectivity, however, Mongolia has extensive manning requirements, including a minimum number of deck officers, a minimum number of engineers, and a minimum number of crew.45 Mongolia also mandates that the labor standards “in conformity with relevant international conventions.” 46 Thus, while Mongolia does not have especially stringent standards for vehicle maintenance, the protections for crew conditions are not negligible.

Yet, Mongolia has not become a popular FOC state, and in fact, in 2011 it hardly competes amongst the other flag states. Its rapid growth was only temporary, and its fleet has dwindled down to a mere 58 vessels, 44 of which are foreign-owned.47

2) Conclusions on Market Gravitation of FOC states

Whether the FOC states began their enterprises as business ventures or simply sought to accommodate market demand later, there is no question that the FOC states adjusted their laws to make a “business” out of ship registrations. Most of the time, these businesses actually are businesses, as the nations have outsourced their administrative functions to private corporations in charge of assigning flag status.

While the reasons for the existence of the various FOCs are clearly not based on purely historical, path-dependent reasons, there is some obscurity as to what market

42 Brooke, supra note 38.
43 Id.
44 Id.
47 The World Factbook: Mongolia supra note 37.
interests the FOCs are actually responding. Based on preceding historical analysis based on the emergence and effect some of the FOC states, I deduce three primary motivating factors that a ship owner takes into account before registering his vessel with a flag of convenience: labor expenses, low taxes and transaction costs, and the flag’s reputation.

a. Cheap Labor

The first market factor that FOC users take into consideration seems to be the low wage and labor restrictions that the FOC state offers ship owners: indeed, that was the reason why countries began to move to Panama in the first place, and why the Liberian registry was created.

Just looking at wages, the cost of labor in the shipping industry varies tremendously. For an American able bodied seaman, the average salary is $35,810 a year.\(^{48}\) Meanwhile, for a Filipino able bodied seaman, the average salary is only 9,945 Philippine pesos a month – or $2,749.25 a year.\(^{49}\) It is for this reason that people of the Philippines, a sizable but not enormous country, compose 36.6% of all seafarers.\(^{50}\) The International Ship Registry of Cambodia make it clear that in order to register with the country, there is no restriction on the ship owner’s crew nationality,\(^{51}\) which could be an reason for Cambodia’s success. In a publication put out by the International Transport Workers’ Federation (ITF), the international trade union and interest group stated:

The ITF notes a clear correlation between sub-standard (labor conditions) and... owners who register their vessels with FOCs... low cost and ease of registration, low taxes, protection of anonymity for owners, ability to employ cheaper foreign crew and lower minimum manning levels, resulting in lower operational costs,


high work-load, more pressure, inadequate resources for on-going ship maintenance.\textsuperscript{52}

Meanwhile, one has to wonder if the reason why Mongolia’s registry ultimately dwindled is because of their adherence to international labor standards.

b. Few Transactional Barriers to Registration

The second market factor that FOC users take into consideration is how easy it is to get a vessel registered. Low taxes, low fees, fewer yearly maintenance inspections, and sometimes relaxed standards for what exactly is “seaworthy” have led many ship owners to fly flags of convenience.\textsuperscript{53}

Both Cambodia and Mongolia have promised 24-hour processing of a provisional registrations, and advertise on their websites “competitive registration fee,” “speedy registration process,”\textsuperscript{54} “online services accessible 24 hours a day, 7 days a week, and 365 days a year,” “one-stop service for ship registration, radio license, survey and certification,” “no hidden costs,” “low initial registration and annual tonnage taxes,” and of course, “no lawyer’s fees.”\textsuperscript{55} Malta, another popular flag of convenience, offers “super yacht incentives,” “24/7 One Stop Shop,” and a “flourishing international shipping centre.”\textsuperscript{56}

But on the other side of the spectrum away from the “super yachts” are the ugly, old freighters that must be registered under FOCs because no other country will take them. These states provide a “market for () old tonnage” because the regulatory barriers in other countries are too high for them to remain at sea.\textsuperscript{57} Of course, this is usually done intentionally: many times, these ships cannot adequately guarantee the

\textsuperscript{53} Id.
\textsuperscript{54} Advantage supra note 51.
\textsuperscript{55} Features and Benefits supra note 40.
\textsuperscript{57} Gianni, supra note 52 at 12.
safety of workers or the environment. The *Erika*, the 37,000 ton oil tanker that caused an environmental catastrophe on the coast of France in 1999, was registered to the FOC state of Malta. It was 25 years old at the time, and a lack of routine inspections had caused its hull to rust to a point where a rough storm broke it in half.\(^{58}\) In 2008, a French court awarded the plaintiffs 192 million euro from the ship owner, but the French court could not hold Malta liable because of immunity of jurisdiction.\(^ {59}\) No matter how bad a sovereign state’s standards are, the international community must go after the transporters that fly the flags, not the nation itself.

c. Reputational Concerns

The third market factor that FOC users take into consideration is the reputation of the flag itself. In other words, the flag can be considered a brand or trademark, a recognizable symbol that tells the world what kind of ship sails beneath it.

i. The Flag as Representing a Country of Origin

Sometimes, a ship owner may decline to choose a flag based on the country or ideal that the flag represents. It may either be a motivated decision to stray far from a country for which a ship owner has animosity, or an inclination to fly a flag of a country to which the ship owner has some connection. In the mid-1990s, when Liberia was in the period of civil war, Panama noticeably outpaced Liberia as the leading FOC state in the world.\(^{60}\) There is no doubt that this is partly because ship owners recognize that registering their ship with a country in the midst of a civil war is very imprudent: in fact, the war is one of the reasons why the Liberian registry moved to Vienna, VA.\(^ {61}\) But some ship owners did not fly the Liberian flag for a different reason: because fees that were created from registering a Liberian vessel went directly to the brutal Liberian dictator.

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59 Gianni, supra note 52 at 21.
60 See *Country Comparison* supra note 21.
Charles Taylor. No ship owner wanted his vessel to be affiliated with such a regime, or worse, lend it monetary support.

Likewise, sometimes the opposite can occur, where an affinity for a certain flag would motivate a ship owner to choose a flag that is averse to his interests. In 2008, the company Planktos was investigating a business venture wherein the *Weatherbird* would travel through the ocean and “seed” the seas with iron dust in order to engender plankton growth. The plankton would then absorb carbon dioxide, and Planktos could sell the carbon-reducing effects in the form of carbon “credits” to U.S.-based companies. The *Weatherbird* wished to fly the flag of its home port, in the United States, but soon ran into trouble. Ironically, their green business model was actually impermissible under the U.S. Ocean Dumping Act, meaning that the *Weatherbird* could not legally dump the iron dust while sailing a U.S. flag. Planktos considered opting for a flag of convenience, but before they had the opportunity Planktos ran out of money and lost the support of their NGOs.

### ii. Network Externalities of Other Flag-Flying Ships

More important, however, is the situation when a ship owner has to take into account not only the *nation* that the flag represents, but the *fleet of ships* that the flag represents. If a given flag is used by other ships in drug smuggling operations, illegal arms dealing, human trafficking, or anything else unsavory, the world remembers the flag that the ship flies. As more and more ships use this same flag and perform illegal acts, the value of the flag is in and of itself a consideration.

This is an example of a negative network externality that comes with having such low standards for flag registration. As more unsavory ships join a given flag, their illegal acts will cast a shadow on the rest of the fleet, lowering the perceived value of that flag. As Cambodia found out, if the world believes that you are helping North Korea

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63 Gianni, *supra* note 52, at 31.

64 Id.
smuggle missiles, you may as well replace your flag with a Jolly Roger. It is because of these negative externalities that Cambodia tried to reformat its ship registry: because the Cambodian flag was becoming too devalued and they had to improve their “maritime safety record.”

Indeed, this “reputation” is actually codified in the form of “blacklisting” by nation port authorities: a rudimentary form of government for these otherwise ungovernable FOC states. When a ship enters a port, the country that it sails into performs inspections in order to make sure that the ship is in working order and to make sure that the ship is not smuggling anything. Two major unified Port State Control (PSC) international agreements, the Paris MOU and the Tokyo MOU, both have a “white list” and a “black list” of nation flags. Depending on what kind of experiences the PSC agents have with vessels particular flag, the PSC agents may record their findings and generalize about the rest of the ships bearing that flag. Under the Paris MOU, if a ship is on a “white list” and meets other low-risk factors, the ship only needs to be inspected every three years, rather than the usual six months. Meanwhile, if a flags is on the black list, ships flying that flag can be banned if it is detained on several occasions, but is generally subject to many more inspections.

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66 Alkis Corres and Thanos Pallis, Inquiry into the Quality of Registers: Questions and Answers Regarding Important Aspects Arising from the First Quantitative Analysis of their Quality Parameters, ECONOMIC OUTLOOK (September 2008).
67 According to the Paris Memorandum of Understanding Ship Risk Profile, “The Black Grey White list for flag state performance is established annually taking account of the inspection and detention history over the preceding three calendar years and is adopted by the Paris MOU Committee” Ship Risk Profile, PARIS MOU ON PORT STATE CONTROL (Jan. 1 2011) available at https://www.parismou.org/Content/PublishedMedia/8a663a6a-8980-45ee-a47d-e73d6c17cfa7/Paris%20MoU%20Annex%20Ship%20Risk%20Profile.pdf
68 Richard W. K. Schiferli, Paris MOU Rewards Quality Flags, PARIS MOU ON PORT STATE CONTROL (Nov. 2 2010) available at https://www.parismou.org/Content/PublishedMedia/1039b41c-e715-4b08-8f17-080dd9c7238d/Paris%20MoU%20Rewards%20Quality%20Flags%20(2%20November).pdf
The current Paris MOU black list puts North Korea as the nation with the very worst inspection record, with 73 detentions out of the 204 times that a North Korean-flagged ship was inspected. The remaining ships should look familiar, including Honduras, Costa Rica, Sierra Leone, Panama, Cambodia, Mongolia, and Bolivia. Yes, Bolivia: another landlocked country.

Not all FOCs are on the black list, however. Liberia, Malta, and the Marshall Islands, to name a few, all made it to the white list. Malta uses this to its advantage to advertise itself not as a flag of convenience, but a flag of “confidence,” stating that, “Dedicated legislation has spearheaded Malta’s determination to protect the reputation and image of the Register… Malta is not a flag of convenience but rather a flag of confidence… (a) white list flag…”

Thus, in the same way that “an American license is better than a Korean license,” a Maltese flag is better than a North Korean flag.

3) How Does a Ship Owner Choose?

With the choice of virtually any country in the world, how does a ship owner go about selecting the choice of laws where he would like to “incorporate” his vessel? Three theories come to mind when examining the market factors listed above. In the following section, I will compare and contrast international corporate governance doctrine to the case at hand.

   a. Bonding

   The bonding hypothesis, presented by John Coffee and confirmed by Darius Miller, suggested that the migration of foreign issuers to U.S. exchanges and NASDAQ

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71 Id.
72 Id.
73 Malta supra note 56.
is a form of voluntary bonding – a unilateral commitment by a foreign issuer to not exploit advantages that he receives under foreign law in exchange for a listing on a U.S. exchange. The theory is that the issuer will enjoy the capital-maximizing benefits of a dispersed ownership system as long as the shareholders and stock exchanges believe that the issuer will adapt to their system.

The same pattern could plausibly emerge in the FOC setting. If a shipping customer wanted to be sure that he was hiring a reputable transporter, the customer might like to make sure that the transporter had a respectable flag of convenience. Could the migration of various ships to the Panamanian flag of convenience in recent years be a form of bonding? In other words, is it credible that ship owners are gravitating towards certain FOCs in order to show their clients that they are serious about the laws that the particular country offers?

It seems that the answer is probably no. Panama, a nation whose flag is listed on both the Paris MOU black list and the U.S. Coast Guard target list, is nevertheless the most popular flag in the world. Meanwhile, 82% of Panama’s registered vessels are owned by foreigners, meaning that the foreigners chose to bypass its own laws in favor of Panama’s presumably less stringent laws. The United States, in contrast, has the most stringent registration requirements of any maritime nation. Yet, the United States commands a merchant marine fleet of only 418 vessels, with only 21% of those vessels foreign. Moreover, many of the advertising websites of the FOC registries emphasize

76 Coffee, supra note 74 at 691-692.
78 The World Factbook: Panama supra note 12.
79 Id.
the lack of restrictions to the ship owners, not the respect that one would get from embracing a stronger set of restrictions.\textsuperscript{82}

b. Herding

John Coffee\textsuperscript{83} also proposed that a reason why a foreign company would list on popular stock exchanges was because of a phenomenon called “herding.” John Coffee explains that herding happens when “(c)orporations may prefer to locate in a popular jurisdiction of incorporation for reasons that are simply based on its popularity, not the inherent superiority of the law.”\textsuperscript{84} Issuers, Coffee explains, will cross-list their company simply because everyone else is doing so.

Coffee describes the reasons for herding as being a risk-reducing, safe choice that comes at no expense. While issuers may become dissatisfied if the issuers lists late, if the issuers simply do what everyone else is doing, the issuers will not be singled out. Herding can also increase liquidity and access to new markets.\textsuperscript{85}

The “herding” analysis is much more convincing in a FOC case. Because of the network externalities involved in the reputational aspects of the shipping industry, such as those that caused the first Cambodian registry’s failure, one would expect a ship owner to fly the flag of an established, large ship registry.

As an established registry, this registry would most likely have enough standards for inspection and safety to make the registry credible, but not enough regulations to make it prohibitively expensive. Meanwhile, the size of the registry dilutes the negative externalities that are introduced by the few smugglers or traffickers that inevitably end up under the same flag as the ship owner.

In this way, perhaps herding provides a basis for the initial choice that a ship owner may take before the owner is aware of the details of the shipping businesses. It

\textsuperscript{82} Except for Malta, who emphasizes that they are respected and that they are cheap. See Malta supra note 56.
\textsuperscript{83} Coffee, supra note 74 at 702-703.
\textsuperscript{84} Id.
\textsuperscript{85} Id.
seems, however, that the effects of herding – of gravitating towards the most popular market – are met by opposing market forces, as twice Panama and Liberia switched placed in being the most popular FOC state, and none of the former primary flag states (ex: UK, USA) are even players in the market anymore. This may be a result of the ease of registration and de-registration: when it can be done within 24 hours through facsimile, why stay under a flag with which you are unhappy?

This factor can certainly be an important one, however, and more important when one considers the network externalities present in the fleet.

c. Race to the Top/Bottom

The current availability of FOC states and their respective shares in the world fleet are not the result of purely path dependent mechanisms that stem from a particular nation’s historical beginnings, nor is it a result of bonding or purely herding means. Rather, there is now a market of laws that are competing against one another to fill demand. These laws will show a level of convergence that favors low wages, low transaction costs, and high country and fleet reputation. Do these laws represent a race to the top, where the “best laws” win out: those that provide ample regulation for the lowest fee? Or do these laws represent a race to the bottom, where the FOC states instead cater to the self-interest of the ship owners?

i. Delaware Dispersed Ownership

The ease of selecting a jurisdiction to register a vessel should immediately remind the reader of the corporation-friendly laws in the state of Delaware. At the beginning of Delaware’s career as the leading state of incorporation, William L. Cary argued that the Delaware laws were an example of a “race to the bottom” in lawmaking because the statutory structure catered to the needs of individual managers rather than the shareholders.86 The individual managers were concentrated and strong, according the

Berle and Means, while the investors were dispersed and weak, powerless to change the actions of the manager.\textsuperscript{87}

However, later commentators argued that in fact the Delaware laws were an example of a “race to the top.”\textsuperscript{88} While the individual managers did choose their jurisdiction of incorporation out of self interest, they were directly accountable to their stockholders.\textsuperscript{89} If managers made a bad decision on the jurisdiction, the stockholders would take their capitol elsewhere, and the stock price of the corporation would fall. Thus, the market-stabilizing, price-correcting feature ensured that the set of laws that the manager chose would be the market-optimal set, or at least would be coupled with a proportional deduction in stock price.\textsuperscript{90}

\textit{ii. Accountability in FOC Vessels}

FOC vessels, however, do not have the same level of accountability. Ships owners do not have the same kind of dispersed ownership system that is arose in publicly-listed corporations.\textsuperscript{91} While some ships maintain clear connections with publicly-listed corporations, it is not these ships that we have to worry about: it is the ships that are “owned or managed by secretive one-ship companies so ghostly and unencumbered that they exist only on paper, or maybe as a brass plate on some faraway foreign door.”\textsuperscript{92}

\begin{flushleft}
\footnotesize{87 Adolph A. Berle, Jr. and Gardiner C. Means, \textit{The Modern Corporation and Private Property} (1933). \\
90 Id. \\
91 John C. Coffee, Jr., \textit{The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control}, 111 Yale L.J. 1 \\
\end{flushleft}
Accountability has been a problem for a very long time. In 1981, UNCTAD issued a report discussing several reasons why safety standards are less stringent under flags of convenience.\textsuperscript{93} In this report, UNCTAD stated, among other things:

(1) “Real owners are not readily identifiable… and are therefore in a good position to take risks by comparison with owners in normal registries who are living under the eyes of a maritime administration.”

(2) “Real owners can change their identities by manipulating brass-plate companies…”

(3) “Since the(y) are not nationals of the flag state, they have no need or incentive to visit the flag state and can avoid legal action” nor do they “feel the need to co-operate with inspectors of the flag state.”

(4) “Open-registry shipping lacks the union structure which is so essential to the application of safety and social standards in the countries of normal registry;” letting ship owners push dangerous activities on the crew “since there is no really appropriate government to which shipboard personnel can complain… Owners can suppress… militancy among crews by virtue of their freedom to change nationalities of crews at whim.”\textsuperscript{94}

Many FOC states, including Liberia and Panama, advertise anonymity of ownership in their ship registration processes.\textsuperscript{95} On top of this anonymous ship registration process, ship owners have the benefit of corporate mechanisms that can easily provide a second layer of corporate anonymity. A 2004 Report of the UN Secretary General’s Consultative Group on Flag State Implementation noted that “while some ship registers actively… promote anonymity…, the principal mechanisms are not the registers themselves, but the corporate mechanisms that are available to owners to cloak their identity.”\textsuperscript{96} Meanwhile, “it is very easy, and comparatively

\textsuperscript{93} See Anderson, supra note 80 at 163-64.
\textsuperscript{94} Id.
\textsuperscript{95} Gianni, note 52 at 20.
\textsuperscript{96} Id at 19.
inexpensive, to establish a complex web of corporate entities to provide very effective cover to the identities of beneficial owners who do not want to be known.” 97

Thus, without any accountability to any labor union, to the FOC state, to the other vessels in the FOC fleet, or to the public at large, we have to assume that the ship owners will act wholly in self-interest.

iii. Labor Standards: A Race to the Bottom

There seems to be no viable competing market check on a ship owner’s self-interest when trying to achieve his goal of the cheapest labor cost possible. Many of ships crews are multinational, multicultural, and multilingual, and stay on a ship for months at a time before moving to another one. 98 There is no impetus for unionizing because the ships have the bulk of the world’s population to choose from, making each individual actor powerless to assemble. 99 The prospects of assembling an international seafaring union amongst a collection of poorly-paid sea workers who all speak different languages and reside in the far corners of the world is far from bleak: it is impossible.

While a FOC state could easily ratify a treaty mandating certain international labor conditions on vessels, and while that state could ensure that these conditions are met through constant supervision and polling of workers, it would take the ratification of this treaty of every single nation in the world to make it the least bit authoritative. Even one hold out state would be enough to become the new leader in FOC registrations.

But perhaps this is not so different than the world that we live in every day. Why is it perfectly okay for an American company to hire a Filipino man for $2000 a year making Nike shoes in a factory in the Philippines, but not okay when that same Filipino man works under similar conditions in a U.S. harbor? Law and policy has a fixation on locality and proximity that is not always rational: it seems as if we are okay with bad

97 Id.
99 Id.
things that happen far away, but not okay with bad things that we can see. Perhaps the international race to the bottom of labor conditions on transport ships can one day serve as an impetus for increasing that international “bottom” in order to more fairly distribute wealth.

iv. Transaction Costs and Reputational Concerns: A Race to the Top

For the other two categories of market factors, however, there will most likely be convergence on a race to the top, because there are forms of accountability to keep the self-interest of the ship owners in line with the public interest.

The minimizing of transaction costs is in both the public’s interest and the self-interest of the ship owners. Reducing the maintenance fees, taxes, and registration fees to an economic minimum allows for the utilization of those resources in other, more competitive enterprises. However, the ship owners and the public may disagree over what costs are the mere “transaction costs,” of bureaucracy and which costs are necessary externality-minimizing “safety costs” in order to best protect the environment and national security.

To align the interests of the public with the self-interest of the ship owners, we have reputational concerns and negative network externalities that come into play when a FOC state registers ships that undergo illegal activity. Using the Paris MOU’s white and black listings as an example, the public tries to encourage ships to register with a reputable flag nation so that they will be subject to fewer port-side inspections and scrutiny in the future. Thus, by using a ship owner’s self-interest in decreasing the number of inspections it has to undergo, the public encourages FOC states to be more careful in accepting ships for their registry ex ante.

Another push to keep standards high for FOCs in the shipping industry is the criminal and civil liability for the effects of environmental harm or inadvertent terrorism support. A customer of a shipping company has a very real interest in ensuring that his cargo reaches its destination without any problems, and may look at a ship’s flag as a quantifier of its reliability. In the Erika case supra, the French court held not only the ship
owner liable, but also the classification society, the management company, and the charterer.\textsuperscript{100} Though outside director liability\textsuperscript{101} may be implausible given how easy it is to get anonymity in the FOC regimes, the fear of liability or even trade stoppages will keep the hirers of vessels cognizant of the flag they fly. FOC states thus may be on a “race to the top” with reliability standards.

4) Conclusion

Flags of convenience arose through a ship owner’s market demand for the relaxed labor laws of less-developed countries on the decks of a more developed country’s vessel. Through their own independent paths, the nations of Panama, Liberia, Cambodia, and even landlocked Mongolia created its own ship registry to compete with the rest of the world, usually with the help of corporations.

This paper examined the market factors that individual ship owners and corporate entities take into account when choosing a flag to fly, and how these corporate entities make their decision. Finally, this paper examined whether the laws of the FOC states will one day converge, and whether it will be a race to the top or a race to the bottom.

\textsuperscript{100} Gianni, \textit{ supra} note 52 at 21.