



ISSUES ARISING IN NEWBUILDING CONTRACTS

INTRODUCTION

Shipbuilding projects are a significant investment and it is essential that contractual terms avoid uncertainty and ambiguity. Changes in the market, technological developments and an evolving regulatory environment all have the potential to trigger issues in relation to newbuilding projects and the associated contracts.

In this publication, the Club takes a look at some of the issues that potential buyers should be aware of, as well as the legal pitfalls to be avoided when entering into newbuilding contracts.

SHIP DESIGN AND SPECIFICATION

The buyer will normally provide specifications for the ship, but the design itself is typically developed by the builder. The specifications and detailed drawings and plans are usually then incorporated into the contract itself.

Design risk

It is advisable for the parties to make express provision for the allocation of design risk at the outset in order to ensure clarity as to allocation of liability.

Certain standard form contracts place responsibility for design expressly on the builder (for instance, BIMCO NEWBUILDCON Clause 1, Norway SHIP 2000). The Shipbuilders Association of Japan ("SAJ") form, however, does not contain express references to design risk. The China Maritime Arbitration Commission ("CMAC") form adopts a hybrid approach, stating that the seller "agrees to design", but pursuant to a design undertaken by a third party designer based on the buyer's requirement.

If no express provision is made for the allocation of design risk, English law normally places responsibility on the builder to ensure that the ship is built to specification (including any performance criteria) and meets certain safety requirements. Case law has confirmed that terms implied by the Sale of Goods Act 1979 (such as fitness for purpose) will be incorporated into a shipbuilding contract in the absence of very clear wording excluding them (see, for example, *Neon Shipping Inc v Foreign Economic & Technical Cooperation Co of China* [2016] 2 LLR 158).

However, there are circumstances where the incorporation of implied terms could be displaced. Contractual wording may be used to limit the scope of the builder's workmanship standard. Further, if the original design had been provided by the buyer, the builder's position in rejecting liability would be stronger.

If the parties agree a modification, it is important that any consequential amendments to the contract are addressed, with the agreement being clearly recorded in a contractually compliant form.

One potentially problematic area concerns the interplay between different sets of initial designs relating to the ship and her equipment. For example, in the scenario of a pipe-laying crane barge, the crane and the barge itself may be designed by different organisations. Care must be taken to ensure that there is compatibility between the respective designs and there should be a clear allocation of responsibility for any design issues that may result.

Similarly, care needs to be taken when agreeing terms relating to ongoing buyer approval of plans and drawings. Normally, the buyer's right to approve the plans does not cause a transfer of responsibility for the design back to the buyer, but it is wise to express this explicitly (see, for example, clause 20(f) in the NEWBUILDCON form). Otherwise, the buyer might be faced with arguments that it is estopped from asserting any design flaws.

Modifications

Generally, the parties can agree modifications to the specifications by making mutual amendments to the contract. Standard forms display differing approaches as to the extent of the discretion contracting parties have to refuse consent to a proposed modification. The SAJ form, for instance, allows a builder to refuse the buyer's proposed modifications, although any such discretion should not be exercised unreasonably. The NEWBUILDCON form, on the other hand, provides for a mechanism whereby a buyer can challenge a builder's refusal to undertake a modification.

Modifications will often require corresponding changes to delivery date, the contract price and other contractual terms. If the parties do agree a modification, it is important that any consequential amendments to the contract are addressed, with the agreement being clearly recorded in a contractually compliant form. Arbitral tribunals have in the past rejected builders' arguments that modifications provide automatic extensions to delivery dates without express agreement (see, for example, London Arbitration 9/13).

SHIP DESIGN AND SPECIFICATION

However, it is preferable to avoid any ambiguity. Further difficulty may arise if the parties are unable to agree the time and price consequences for a modification sought by the buyer. Again, it is desirable to incorporate express contractual provisions stipulating a mechanism for the resolution of such a dispute. For instance, the NEWBUILDCON has a provision for expert determination (or indeed arbitration) of these issues.

Even in a case where a buyer has the right to impose modifications on the builder unilaterally, the buyer must give consideration to the knock-on contractual impact. For example, will the buyer itself lose rights if it fails to provide the builder with a reasonable extension of time in which to carry out modifications? Case law has stated that even in the absence of an express provision, the buyer must cooperate with the builder to agree price, performance and delivery terms, or to suggest a way forward in the event of a buyer-proposed modification (see *Swallowfalls Ltd v Monaco Yachting & Technologies* SAM [2014] 2 LLR 50).

Further difficulty may arise if the parties are unable to agree the time and price consequences for a modification sought by the buyer.



QUALITY CONTROL

Quality is of paramount importance. Clear provisions must be agreed in the contract to determine how the quality is to be verified and what should happen in the event of dispute.

Sea trials

Sea trials are a crucial step in the life of a newbuild, as deficiencies may well come to light during this stage. On completion of the trials, defects must be put right and the ship made "deliverable". What is required, as a matter of law, for a ship to be "deliverable" can be a complex question, which requires consideration not just of the terms of the specific contract, but potentially also of the terms of the Sale of Goods Act 1979 (for example, dealing with compliance with description, satisfactory quality and fitness for purpose).

The buyer's representatives should always attend the sea trials. Accurate and complete notes should be kept of trial results, particularly if there are matters of concern, as contemporaneous records may be required in the event of a subsequent dispute.

Normally, after receiving the results of the trial, the buyer has a short amount of time in which to decide whether to accept or reject the ship. If the buyer makes no decision, then it is generally deemed to have accepted the ship. Some contracts, such as the CMAC form, make express provision for such deemed acceptance. If the buyer does accept the ship, then it is committed to taking delivery of the ship when tendered. Delivery normally takes place at a scheduled meeting, when delivery documentation is provided against the payment of the final instalment of the price.

However, acceptance of the ship does not mean that the buyer is deprived of remedies should defects in the ship come to light. Shipbuilding contracts normally provide for a complex warranty framework.

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Warranties and the warranty period

Typically, the builder provides a warranty for the ship, her machinery and equipment for a fixed period running from the date of delivery and acceptance. This is frequently a period of at least twelve months (see, for example, Article IX of the SAJ form and clause 35 of the NEWBUILDCON). During this time, the builder will rectify deficiencies at its own expense, but incidental losses arising from the defect or repair are usually at the buyer's risk. The Norwegian SHIP 2000 form is somewhat more generous to the buyer in that it allows for claims in respect of consequential damage to other parts of the ship. Crucially, loss of use or business interruption losses are normally for the buyer to bear. This is frequently an area for dispute, which can be minimised by the use of clear and precise language.

As to scope, the builder typically warrants the quality of material, workmanship and sometimes design, although this may vary if design has been provided by the buyer or undertaken by a third party. Recent English case law has tended to adopt a more pro-shipyard approach, resisting arguments from buyers to extend the scope of warranties. The courts have taken care to confine the scope of warranties both as to content and as to time.

In *Neon Shipping Inc v Foreign Economic & Technical Corporation Co of China* [2016] 2 LLR 158, the court held that the buyer could not circumvent a twelve month time period for warranty claims provided by Article XI of the shipbuilding contract. The buyer sought to bring claims some two years after the expiration of the warranty clause, arguing that the time limit applied only to those claims brought directly under Article XI and not to those brought under other contractual clauses. The court rejected this argument, maintaining that the twelve month time bar applied to all claims under the shipbuilding contract. This is in line with previous case law to the effect that the purpose of the warranty clause is to limit the builder's exposure (particularly its temporal exposure) to claims for breach after delivery.

QUALITY CONTROL

In the *Star Polaris LLC v HHIC-Phil Inc "The Star Polaris"* [2016] EWHC 2941 (a case supported by the Club) the court was clear on the substantive limitations of warranties. The court found that the warranty provision (Article IX of an amended SAJ form) was a complete code and therefore excluded all liability of the builder after delivery, unless expressly provided for in the warranty. As Article IX did not contain any express agreement to cover the buyer's financial losses, consequential losses could not be claimed. The builder was only obliged to repair any defect, as expressly stated in Article IX, and the buyer's attempt to expand the scope of the warranty failed.

Certain other limitations on the builder's warranty also exist. Normally, it applies only to defects discovered after delivery and acceptance of the ship. So, there is an onus on a buyer either to reject or refuse delivery in the event of already known defects, or at least expressly qualify any acceptance so that it operates without prejudice to the buyer's rights in respect of the defect.

The temporal scope of warranties is normally interpreted strictly. Even if defects become apparent only after the end of the warranty period, the courts have generally found that the time bar will prevent any claim by the buyer. Buyers frequently advance complex arguments of contractual construction in an attempt to expand claims, particularly as regards consequential losses. At times the language of standard forms clearly precludes this; at other times, unclear language may give the buyer an opportunity for argument. However, the recent trend of decisions has been against the buyer.

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PRICE AND PAYMENT

Newbuilding contracts are generally based on a fixed price, with amendments only being possible in the event of modifications or to adjust for liquidated damages due from the builder for delay or deficiency.

Price escalation clauses

Price escalation clauses are found, for example, in the CMAC form, but are not included in the SAJ or NEWBUILDCON forms. If a newbuild contract incorporates a price escalation clause, parties should be clear both as to the trigger for escalation and the methodology of any calculation (see, for example, London Arbitration 21/06 in which a buyer failed in its argument that a price escalation clause had not been triggered).

Payments

Newbuilding contracts typically provide for staged payment arrangements between the buyer and the builder. A buyer's payments are usually tied to key milestone events in the construction process – such as commencement of steel-cutting, keel-laying and launching. On achievement of the milestone event, the buyer's payment falls due within a specified number of days after a notification from the buyer. Provisions may be built into the notification process to provide additional comfort to a buyer – such as the requirement for countersigning by the buyer's representative at the yard or confirmation by the classification society. Should a buyer's sign-off or similar be necessary, the buyer's representatives should cooperate with the builder so as not to delay the process in the buyer's own interest (see *Swallowfalls Ltd v Monaco Yachting & Technologies SAM* [2014] 2 LLR 50).

Refund guarantees

A buyer's payments are often secured by a refund guarantee, generally provided by a bank. Buyers are understandably concerned about their exposure in the event that the builder becomes unable to complete construction, for instance due to its financial collapse. The recovery of deposits or staged payments in the event that the builder defaults on its obligations is a frequent source of disputes and the wording of the refund guarantee can be of crucial importance in this respect.

Refund guarantees should clearly state that they remain valid even if the newbuilding contract is modified.

One particularly high profile dispute (which was supported by the Club) reached the Supreme Court in the case of *Rainy Sky v Kookmin Bank* ([2012] 1 LLR 34). Rainy Sky agreed to purchase a ship from a Korean yard. Payment of the first instalment was conditional upon provision of payment bonds guaranteeing the repayment of the buyer's money. However, the wording of the bonds did not match the wording of the underlying shipbuilding contract. The shipbuilding contract provided for the refund guarantee to be triggered in the event that the yard entered into an insolvency procedure, but the bonds did not.

The yard entered into insolvency proceedings before the ship was fully constructed and Rainy Sky attempted to trigger the refund from Kookmin, but this was denied on the grounds that no right to terminate, rescind or cancel had arisen in the absence of an express reference to insolvency in the bonds.

The dispute went all the way to the Supreme Court and involved lengthy consideration of the principles of contractual construction. The Supreme Court concluded that a commercial construction should be applied in resolving the ambiguity. Business sense dictated that insolvency should trigger the refund guarantee - indeed, this would be the most likely reason why a refund guarantee would be needed. Kookmin Bank was ordered to pay.

Another point to note is that refund guarantees should clearly state that they remain valid even if the newbuilding contract is modified. Any material variation of the contract that potentially prejudices the guarantor and are made without the guarantor's consent will invalidate the refund guarantee. Importantly, if there is a modification of the delivery date, the refund guarantees should be amended or re-issued accordingly.

Parties should exercise caution when drafting refund guarantees, ensuring that the contractual framework as a whole is reviewed as any disparity between contracts can lead to complex legal disputes.

CONTRACTUAL DEFAULT

Shipbuilding contracts usually define stipulated events which would place either the builder or the buyer in default. It is important that the scope and consequences of such events are clearly expressed.

Buyer's default

Provisions regarding the buyer's default will vary from contract to contract. Typically, however, a buyer will be in default if it fails to make timely payment of any instalment of the price or refuses to take delivery of the ship when properly tendered. The CMAC form requires written notice of default to the buyer, whereas under the SAJ form the placing of the buyer in default is automatic. The NEWBUILDCON does not set out a specific regime for the buyer's default, but deals with it under the remedies available to the builder.

Generally, the buyer becomes liable for interest and charges on late payments, but the builder is not excused from discharging its own obligations of construction. However, when the buyer's default continues for a specified period (for example, fifteen days in the SAJ form), the builder generally becomes entitled to terminate the contract against notice to the buyer. Rescission by the builder can give rise to complex situations regarding instalments already paid and those due to be paid.

Builder's default

A builder's default, as defined in the contract, may give the buyer a right to rescind. Such defaults will generally include serious technical deficiencies in the ship, delay in delivery (beyond a stated point), financial defaults by the builder (such as the builder entering into liquidation) and the total loss of the ship prior to delivery. The issue of financial defaults can be particularly complex, given the varying restructuring and insolvency regimes that exist in different jurisdictions.

In addition to general liability for damages, many standard form contracts oblige the builder to refund to the buyer all monies already paid under the contract in the event of the builder's default. Given the significant financial consequences for the builder (particularly if the builder is already in a financially stressed position), this can become highly contentious. Difficult issues can also arise about title to the ship and this should be provided for in advance in clear contractual terms.

Precise compliance with notification periods and time limits for providing notifications is very important, and non-compliance may prevent a party from asserting its rights.

Delay

Shipbuilding contracts normally provide detailed provisions for the timing of a ship's completion and delivery to the buyer. Delayed delivery is typically addressed by liquidated damages clauses, with varying amounts becoming payable depending upon the length of the delay.

The nature and complexity of shipbuilding is such that delay is likely and neither a builder nor a buyer will wish to assume all risks associated with it. To address this problem, shipbuilding contracts typically provide for both permissible and non-permissible delays. Permissible delays allow for the postponement of the delivery date. They are normally listed in the contract and are likely to relate to events outside the builder's control.

Normally a notification procedure must be followed if a builder wishes to rely on a stipulated event to postpone delivery. For instance, in the SAJ form, the builder must notify the buyer within 10 days of the occurrence of the event. The builder must then notify the buyer within a stated period of the end of the delaying event and advise the extent of the postponement with all reasonable despatch. The buyer has a set time within which to object and risks being found to have waived its rights unless it does so promptly. Precise compliance with notification periods and time limits for providing notifications is very important, and non-compliance may prevent a party from asserting its rights. In the case of non-permissible delays, the builder normally becomes liable for liquidated damages. These accrue after an initial grace period and, again, are normally subject to a long-stop date (180 days in NEWBUILDCON and the SAJ forms, for example). Once the maximum period is reached, the builder's liability to pay liquidated damages ends and the buyer may be able to rescind the contract. The buyer may also then seek recovery of the sums paid by way of advance payments.

Most shipbuilding contracts contain a drop-dead date or some form of long-stop provision. For example, in the SAJ form, the buyer may rescind the contract if the builder claims an extension in excess of 210 days in respect of specified events.

OTHER MATTERS

Option agreements

A newbuilding contract may contain options for further newbuilds to be exercised at contractually specified times. Such options are a fertile source for disputes in a changing market, as factors such as pricing and a yard's financial status may change between the negotiation of the contract and the exercise of the option.

The case of *Teekay Tankers Ltd v STX Offshore & Shipbuilding Co Ltd* [2017] 1 Lloyds Rep 387 illustrates the problems. Four shipbuilding contracts provided for options to build further ships, stating that best efforts would be used to deliver one ship in 2016 and the rest in 2017. The builder entered into a restructuring arrangement and was unable to secure sufficient credit for the required refund guarantees. The buyer rescinded the contracts and claimed damages for repudiation, but at the same time sought to exercise its option for a further eight ships.

The yard was unable to perform the option agreements, due to its financial situation, and the buyer sought to terminate them and claim damages against the builder for repudiatory breach. The court considered that the option agreements failed for uncertainty. The parties had intended them to be binding but had failed to specify delivery dates, the absence of which could not be overcome by the use of implied terms. Again, this shows the need for clear and specific contractual provisions.

Law and jurisdiction clauses

English law and jurisdiction, whether in court or arbitration, is a popular choice in newbuilding contracts. However, other choices are common and may be dictated by the location of the parties. In any event, it is important that clear provisions are included in order to avoid disputes over the question of which law or jurisdiction applies.

Other related contracts, for instance for the purchase, delivery and installation of marine equipment, may be subject to different legal and jurisdictional regimes to that of the shipbuilding contract. This means that disputes may not be back-to-back and added complexity and cost may arise.

A newbuilding contract may provide for options for further newbuilds, with the options to be exercised at contractually specified times.

Sub-contracting

Sub-contractors are commonly used in shipbuilding. The contract should stipulate the permissible extent of sub-contracting and ensure that ultimate liability remains with the builder throughout.

The usual practice is for the builder to seek the buyer's approval for the use of sub-contractors, with such approval not to be unreasonably withheld. A pre-approved "maker's list", setting out authorised sub-contractors and suppliers, can assist the process. There are a number of circumstances in which the buyer's rights may be against the sub-contractor itself. Claims in tort against a negligent sub-contractor may be possible and the buyer may be able to rely on the Contracts (Rights of Third Parties) Act 1999 to pursue claims against a sub-contractor. Builders may also agree to assign the benefits of guarantees from subcontractors to the buyer.

Assignment

The ability for the buyer to assign a contract can be very important, particularly in a rising market. Most contracts permit assignment provided the shipyard's consent is obtained.

Under English law, it is only possible to assign the benefit of a contract, but not the burden. This means that, where there is to be an assignment, the builder cannot be obliged to accept a guarantee from another third party or bank. Therefore, the original buyer may have continuing obligations and/or rights under the contract irrespective of the assignment and might be obliged to pursue claims under any builder's warranties on behalf of the ultimate buyer.

This can be avoided by signing a novation agreement. This is a tripartite document between the builder, the buyer and the ultimate buyer whereby all rights and obligations of the original buyer are transferred to the new buyer, with the agreement of all parties involved.

CONCLUSION

In summary, parties to a newbuilding contract should use clear contractual terms to avoid disputes and ensure that the contract runs smoothly. Where disputes do develop they can be costly and complex, and Members are advised to seek legal advice and assistance from the Club at an early stage.



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