

# **Shipbuilding Contracts - the Value of Defence Club Cover**





## Why the UK Defence Club for newbuilding risks?

### **Expertise:**

- Extensive experience in managing shipbuilding disputes
- Supported Members in significant, high profile cases including the RAINY SKY
- Legally qualified claims executives in London, Piraeus, Hong Kong and New Jersey.

### **Unrivalled cover:**

- \$15million limit of cover - highest of all providers of FD&D cover
- No mandatory deductibles

### **Independent:**

- Not a class of P&I
- Own Board of directors
- No requirement for membership of the UK P&I Club
- Largest provider of FD&D cover

### **Financially strong:**

- Free reserves are true FD&D reserves and not part of P&I reserves
- Reserves well in excess of regulatory requirements
- FSA regulated



## Shipbuilding Contracts – the value of UK Defence Club Cover

Shipbuilding over recent years has shown a dramatic increase in terms of ship numbers and also the yards involved. The subsequent financial crisis of 2008 has led to a rise in the number of disputes under newbuilding contracts, as shipyards which took on a significant number of contracts find themselves racing to meet delivery deadlines, or running into financial difficulties as credit lines dry up.

Although shipbuilding contracts are frequently based on one of a number of standard forms, in reality each contract is different with terms varying widely. The contract terms will be dependent on the yard, the type of ship involved, the financing arrangements, and the buyer's requirements for compliance with specifications and design, quality of workmanship and delivery timing.

The following summarises some of the areas in which disputes can arise:



## Faulty design/inherent defect/ poor workmanship

In most contracts the builder will be responsible for the design of the ship and proper workmanship in its construction. The basic presumption, (under English law at least), is that the builder will be liable in damages if there is a design or workmanship issue unless the contract specifically excludes such liability. In extreme situations a buyer may be entitled to reject delivery of the ship or cancel the contract if the defective design or construction is so fundamental that it amounts to a radical departure from the contract agreed between the parties.

The Club has been involved in a number of high profile disputes which involved the design and construction of newbuildings.

One such case involved the construction of two ro-ro ships and their trailer carrying capacity. The contract provided that the ships would have a certain number of 13 metre slots. Upon delivery a dispute arose as to whether the first ship, (and indeed the second ship which was in the process of being built), actually had the contractual number of trailer slots capable of being used in normal shipping operations. The contract provided that liquidated damages would be payable for each trailer slot which was not provided. A seemingly simple dispute had a substantial impact on the earning capacity of the ship over her operational life.

The dispute involved a detailed technical examination of the first ship's actual trailer carrying capacity and lengthy legal argument on the construction of the shipbuilding contract. This led to proceedings in the English High Court and the Court of Appeal. The legal costs in that dispute exceeded £650,000.

Another illustration of a dispute in this area involved newbuildings which were sold whilst under construction. Various representations had been made by the yard regarding enhancements which would be included on those ships. On delivery the ships were found not to have those additional features and the Member pursued a

claim in damages against the yard for breaching those representations.

In some cases the defects complained of are so fundamental that issues arise as to whether the ship should be accepted for delivery. In one such case a newbuilding LNG ship was rejected by a Member on the grounds that the ship failed to meet its contractual specifications and the defects were so fundamental that the commercial viability of the ship was materially affected and could not be compensated by an award in damages. An expedited arbitration was held which upheld the Member's decision in rejecting delivery. The case was ultimately settled however, significant legal costs were incurred in the arbitration and in settlement.

## Price and payment

Most, if not all, newbuilding contracts provide for a staged payment arrangement between buyer and builder. The buyer's payments will generally be secured by a refund guarantee occasionally given by the yard or its parent company but most usually, by a bank.

Despite the fact that a well-drafted refund guarantee from a reputable bank offers excellent security, difficulties can arise in recovering deposits or stage payments should a yard default on its obligations under the contract. It is important that any guarantee contains a 'trigger' as to when the bank or other party is obliged to meet its obligations under the guarantee. Disputes have arisen as to the wording of any such guarantee and therefore it is important that the wording of a guarantee is reviewed carefully.

Enforcement proceedings under the refund guarantee may be conditional upon the outcome of an arbitration or other legal proceedings taking place between the yard and the buyer, in which the merits of the underlying dispute have first to be resolved.

The Club was recently involved in a case where the yard at which the Member had agreed to construct 6 ships went into liquidation. This entitled the Member to cancel the contracts, and



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a demand was thereafter made under the refund guarantee for the return of pre-delivery instalments totalling \$46 million. The guarantee was not on its face conditional upon the Member first obtaining an arbitration award against the yard. However the bank sought to argue that even without specific wording to that effect, it was not obliged to make payment other than against an arbitration award. It also argued that the specific wording of the guarantee meant that no payment was due upon the yard's insolvency.

With the Club's support the Member commenced English High Court proceedings against the bank and obtained summary judgment, on the basis that the bank's defences to the Member's demand had no prospect of success. The Bank however appealed to the Court of Appeal and was successful. An appeal has now been filed by the Member to the Supreme Court which is no surprise, given the amounts at stake.

### Delivery date

Ship building contracts normally provide detailed provisions for the timing of a ship's completion and delivery to the buyer. These terms usually contain detailed liquidated damages clauses to deal with delayed delivery with varying amounts becoming payable dependant upon the length of the delay, and ultimately allow the buyer to cancel the contract if the ship is not delivered within, for example, 210 days of the contractual delivery date (though this period is often subject to amendment). The shipyard will generally try and avoid paying substantial liquidated damages and / or dispute any cancellation by the buyer if it is arguable that the ship's delayed completion was caused by some occurrence outside its control and/or by the buyer.

Substantial disputes can arise as to whether the actual events which have caused the delay are excluded from the contract (under, for example, force majeure provisions) or are attributable to the buyer (rather than the yard).

The Club has been involved in a number of disputes concerning delays to the completion of ships. Yards will often argue that delays have been

caused by the buyer's representatives making changes to the specification of the ship. Where there has been a force majeure event, for example a strike, adverse weather conditions or landslides, the extent of the resulting delay may well be exaggerated by the yard.

The Club was recently involved in a case where the construction of a ship was significantly delayed, and the parties agreed an extension to the date upon which the buyer would be entitled to cancel the contract. When this revised date was not met, the Member cancelled, however the yard then claimed that in agreeing delivery date extensions the Member had effectively abandoned its rights to cancel the contract.

The refund guarantor refused the Member's demand for the return of pre-delivery instalments, and the Member was therefore compelled to bring arbitration proceedings against the yard. This led to a 5 day arbitration hearing following which an award was given which upheld the Member's position.

### Insurance

The contract will generally specify that the builder will ensure that appropriate builder's risks insurance is in place throughout the construction process. This is generally non-controversial and safeguards the buyer against partial or total loss to the ship during her building. Normally the contractual provisions also specify how the proceeds of a builder's risk policy will be applied should an insured event occur.

The Club has been involved in a dispute where an extremely expensive ship under construction was substantially damaged by fire. The ship was already earmarked for her first year's employment. Although builder's risk insurance was in place, the damage to the ship gave rise to a number of major issues, including whether the ship would be rebuilt.

To ensure that the yard and insurers responded appropriately to the incident and in order to protect the Member's position in relation to the various parties involved the Club met significant legal and technical costs incurred by the Member.



## **The Club has been involved in a dispute involving a series of tanker new buildings.**

### **Option Agreements**

A newbuilding contract may also contain options for further new buildings. Those options have to be exercised at a certain point in time as set out in the contract.

In principle the mechanics of such options are straightforward. However, because they usually determine in advance the price at which any further ships are to be built, their exercise can give rise to disputes.

In the intervening period the market price may well have altered significantly. If the market price has gone up the builder may be reluctant, (although contractually obliged), to commence construction especially if it can obtain a higher price for other ships.

Alternatively the yard's order book may have changed and the exercise of the option may result in practical problems for the yard which is then committed to construct too many ships within a certain time frame. This can lead to scheduling disputes with each party vying to gain commercial advantage.

In terms of the Club and its cover, if an option is declared that declaration should be notified to the Association at that time to ensure that the new contract relating to the additional ship also receives the benefit of the Club's coverage.

### **Subcontracting**

It is common practice that yards use subcontractors in the construction of newbuildings. The size of the yard may well determine the extent to which any sub-contractors are used. It is important that any ship building contract sets out specifically the extent to which sub-contracting is permitted and also that responsibility for subcontractors and manufactured parts rests with the builder.

The Club has been involved in a dispute involving a series of tanker new buildings. A subcontractor was used by the yard to manufacture fuel pumps. Contractually any such subcontractor should have been approved by the ship's prospective classification society.

On delivery of the first ship, the fuel pumps were found to be defective. The yard disputed the buyer's claims and also initially refused to replace the subcontractor with a subcontractor on the approved list of the relevant classification society.

Eventually this issue was resolved to the Member's satisfaction. However, given the intransigence of the yard, with the Club's support and in order to force the issue, significant legal fees were incurred, with the matter being resolved just short of a hearing in an expedited arbitration.



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### **Assignment**

Most shipbuilding contracts make reference to whether or not the contract can be assigned by the buyer to a third party. This ability is very important particularly in a rising market.

Most contracts permit assignment provided the shipyard's consent is obtained and that consent cannot be unreasonably withheld.

Under English law it is only possible to assign the benefits of a contract not the burdens. 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. It may, for instance, be obliged to pursue claims under any builder's warranties for the benefit of the ultimate buyer.

It may be possible to agree that a novation agreement is signed, which is essentially a tripartite document between builder, buyer and ultimate buyer. With a novation agreement all rights and obligations of the original buyer are transferred to the ultimate buyer.

### **Governing law & jurisdiction**

An integral part of any shipbuilding contract will be the provisions for resolving disputes - both technical and legal. In terms of law and jurisdiction, more often than not English law

and jurisdiction will have been chosen. However, shipbuilding contracts may provide for other jurisdictions and in recent years the Club has been involved in disputes and proceedings in a variety of jurisdictions on behalf of its Members.

It should also be noted that in the construction of specialised ships, the buyer sometime contracts to provide the yard with designated machinery or equipment to be incorporated within the newbuilding. Quite apart from the disputes that can arise in the delivery and fitting of such equipment, the quality of the equipment may itself give rise to a separate dispute between the buyer and the supplier in another jurisdiction.

The Club's cover for shipbuilding contracts is generally provided without restriction to the jurisdictions which may be involved.

### **Are all FD&D covers the same?**

In short, no. Many FD&D providers place limits on the extent of FD&D cover that is available for shipbuilding disputes. In addition many insist on mandatory deductibles without limit which can mean that the Member's contribution to the costs of the case can be considerable. Shipbuilding cases are invariably very expensive and therefore it is important that any limits or other restrictions are fully explored. The UKDC's experience in managing shipbuilding disputes and its cover in this area are unrivalled.

Strength with independence.

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