

SHIPBUILDING CONTRACTS: THE VALUE OF UKDC COVER

UK Defence Club is the leading and most influential provider of legal costs cover to the maritime industry.

Shipbuilding is a significant investment which requires significant support.

Shipbuilding defence covers are materially different. Does your provider offer the following:

- \$15million of cover
- No claim sub-limits for shipbuilding risks (unlike others)
- No mandatory percentage deductibles (unlike others)
- Exceptional expertise

With UK Defence Club, this comes as standard.

Over many years the Club has developed extensive experience and expertise in handling a variety of issues arising from shipbuilding contracts. Many of those have been settled commercially however others have been litigated.

The Club is here to support its Members in obtaining the right outcome for them.

OUR EXPERIENCE

Faulty Design/Inherent Defect/Poor Workmanship

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

In one such case (*The "Star Polaris"*)¹, the ship suffered a serious engine failure just over 7 months after delivery. The builder denied all liability for the incident. The Club supported the Member in pursuing a claim for the costs of repairs and associated losses, including towage and off-hire. The English High Court, on appeal, supported the Tribunal's finding in the Member's favour that there had been a breach of the warranty provisions.

However, the court also held that the terms of the contract excluded liability for the yard beyond its obligation to remedy and repair any defect.

In some cases the relevant defects are so fundamental that issues arise as to whether the ship should be accepted for delivery. In one such case, a Member cancelled a contract for a chemical tanker after the yard tendered the ship for delivery following unsatisfactory sea trials.

The Member believed that the ship was not in a fit state for delivery due to unresolved alignment and vibration problems which had not properly been investigated and numerous defects which individually or collectively entitled the Member to reject the ship. With the support of the Club, the Member successfully pursued the shipyard in arbitration and recovered payments of around US\$20 million under the refund guarantee.

¹ Star Polaris LLX v HHIC-Phil Inc (*The "Star Polaris"*) [2016] EWHC 2941

Price & Payment

The buyer's payments under a shipbuilding contract will generally be secured by a refund guarantee, occasionally given by the yard or its parent company but most usually by a bank.

Although a well-drafted refund guarantee from a reputable bank offers excellent security, difficulties can arise in recovering deposits or staged payments should a yard default on its obligations under the contract.

The Club supported its Member in the case of *The Rainy Sky*², where the yard at which the Member had agreed to construct six ships went into liquidation. This entitled the Member to cancel the contracts, and a demand was made under the refund guarantee for the return of pre-delivery instalments totalling US\$46 million. The guarantee was not 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 support of the Club, the Member ultimately succeeded in the UK Supreme Court.

² *Rainy Sky SA and others v Kookmin Bank (The "Rainy Sky")* [2011] UKSC 50

OUR EXPERIENCE

continued

Delivery Date

Shipbuilding 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 in accordance with the length of the delay. They will ultimately allow the buyer to cancel the contract if the ship is not delivered by the contractual delivery date (although this period is often subject to amendment).

The Club has been involved in a number of disputes concerning delays to the completion of construction, with yards arguing that their obligations have been mitigated by "permissible delays" or force majeure events.

Substantial disputes can arise as to whether the actual events which have caused the delay are excluded from the contract or are attributable to the buyer rather than the yard.

Insurance

While a shipbuilding contract will generally specify that the builder will ensure that appropriate builders' risks insurance is in place throughout the construction period, disputes can arise as to how the proceeds of a builders' risk policy will be applied should a claim arise.

The Club has been involved in a dispute where an extremely expensive ship under construction was substantially damaged by fire.

Although builders' 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.

OUR EXPERIENCE

continued

Option Agreements

A shipbuilding contract may also contain options for further newbuildings which have to be exercised at a time specified 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 a yard's order book may have changed and the exercise of the option may result in practical problems for the yard if it 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.

If an option is agreed it should be notified to the Club at the date of declaration in order to ensure that any disputes relating to a potential additional ship are also covered.

Subcontracting Arrangements

It is common practice that yards use subcontractors, which may lead to disputes.

The Club has been involved in a dispute relating to a series of tanker newbuildings where a subcontractor was engaged by the yard to manufacture fuel pumps. Under the applicable contract, 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 Member's claims and initially also refused to replace the subcontractor with a subcontractor on the approved list of the relevant classification society.

With the support of the Club, the Member pursued its claims against the yard with the dispute being resolved just short of a hearing in an expedited arbitration.

OUR EXPERIENCE

continued

Assignment

Most shipbuilding contracts make reference to whether or not the buyer can assign its rights under the contract to a third party. This entitlement may be significant, particularly in a rising market.

Most contracts permit assignment provided the shipyard's consent is obtained, with that consent not to be unreasonably withheld.

Under English law it is only possible to assign the benefits of a contract, but 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 builders' warranties for the benefit of the ultimate buyer.

These difficulties may be avoided by instead entering into a novation agreement, which is essentially a tri-partite document between the builder, buyer and ultimate buyer under which the ultimate buyer replaces the original buyer in the contractual framework.

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 litigation in other jurisdictions and in recent years the Club has been involved in disputes and proceedings in a variety of locations on behalf of its Members, including China, Japan, Korea and Brazil.



WHY UK DEFENCE CLUB FOR SHIPBUILDING RISKS?

The Club has extensive experience in managing shipbuilding disputes and has supported its Members in significant, high profile cases.

The shipbuilding industry is constantly evolving and with such evolution comes new potential areas for dispute. For example, following the introduction at the beginning of 2020 of a significant reduction in permissible sulphur emissions by the IMO, a number of shipowners installed exhaust gas cleaning systems, or “scrubbers”. Given the new technology involved, the Club has been involved in several disputes involving the supply, installation and design of scrubbers.

With the increasing focus on environmental issues and emissions regulation, and the implementation of new, green technology, further areas for dispute are likely to emerge. With its experience and expertise in managing shipbuilding disputes, the Club is well placed to assist Members in responding to these new challenges.

Shipbuilding cases are often very expensive and it is therefore important that any cover limits or other restrictions are fully considered when purchasing cover. The Club offers the most extensive cover in the market with a limit of \$15 million and, unlike many FD&D providers, does not insist on mandatory deductibles.

UK Defence Club's experience in managing shipbuilding disputes and its cover in this area is unrivalled.

