Newbuilding Projects: When Good Contracts Go Bad

The warning issued by Tan Zuojun, President of China State Shipbuilding Corporation, earlier this year was stark: some 50% of Chinese shipyards are likely to go bankrupt by 2014. This was recognition of the fact that China’s shipbuilding industry is struggling on a number of fronts. A massive expansion of shipyard capacity during the boom years helped China seize the largest share of the global order-book for newbuildings. However, following the onset of the financial crisis, many of the smaller Chinese yards are being hit hard as they struggle to deal with a raft of cancellations and renegotiations of contracts taken on during the good years, Whilst at the same time facing intense competition for new orders.

Time will tell to what extent Mr Tan’s warning of shipyard bankruptcies is exaggerated. In the meantime, it serves as a useful reminder that, even where a deal has been secured on favourable commercial terms, subsequent events like a yard bankruptcy can turn a promising project into a problematic one. This briefing note examines typical instances where newbuilding projects have come unstuck – because of a change in market conditions and because of technical failings on the part of the yard. These are risks which have to be confronted wherever in the world the newbuilding project is taking place. We explain how such issues have been addressed and give some pointers as to what can be done to minimise risks in future.

Changes in Market Conditions and Builder Default

Changes in market conditions are an obvious cause of newbuilding projects turning bad and there have been many examples since the onset of the global financial crisis. During the boom years new ship orders reached historic levels and the soaring demand fuelled newbuilding prices. With the economic downturn, charter and freight rates fell and with them the value of newbuildings on order. Many projects ceased to be “in the money”. Bankers were increasingly reluctant to support them. Some buyers had to confront the uncomfortable truth that they would be unable to fund the next instalment to the shipyard when it fell due, running the risk of defaulting under their contracts and exposing themselves to potentially significant claims for damages from the aggrieved yard. There
was tremendous pressure to renegotiate or even cancel projects. Suddenly the detailed terms of shipbuilding contracts and refund guarantees were being scrutinised to establish what could be done.

Mere changes in market conditions are unlikely ever to give owners a right to terminate a shipbuilding contract. As a result, we were called upon to assist owners in renegotiations with yards and other project stakeholders. Recognising the gravity of the situation, most yards were prepared to show a degree of flexibility. Different types of deal were done such as vessel deliveries being deferred, numbers of vessels in a series being reduced or ship types changed. A number of such cases inevitably descended into formal dispute resolution procedures when contracts were repudiated or purportedly terminated on questionable grounds.

In other cases the yards were also in financial difficulties. There were numerous instances of yards stopping work, suspending payments or entering insolvency and corporate rescue programs. Builder default clauses in shipbuilding contracts may give the buyers rights to terminate in such circumstances and claim a refund of their instalments. However it was not uncommon to find that contracts concluded in the boom years contained minimal and sometimes no builder default wording. For example, the wording often did not cover court protection from creditors and other builder insolvency defaults. Buyers had been under such pressure to place orders once fundamental commercial terms (such as price and delivery date) had been agreed that insufficient attention had been paid to detailed contract terms. As a result buyers were unable to terminate for builder default when they wanted to.

Even where rights to terminate were available to buyers, there were sometimes additional complications. Not least there were problems in the drafting of many of the refund guarantees taken as security for pre-delivery instalments paid to the yard, raising the risk that claims for refunds would be unsecured. Many owners also discovered that, where their rights to terminate arose at common law (for example because the builder had committed a repudiatory breach) rather than under the express builder default provisions of the contract, their claims against the yard were likewise not covered by the refund guarantees. There were, in short, many traps for the unwary. Fortunately, one particular concern of buyers (namely the enforceability of unsigned refund guarantees issued through the swift system) has now been alleviated following a decision of the High Court last year. In a welcome judgment handed down in the case of *WS Tankship II BV v Kwangju Bank Ltd* [2011] EWHC 3103 QBD, Mr Justice Blair expressed the view that authentication by sending a message through the swift system was equivalent to authentication by signing for the purposes of the Statute of Frauds.

Parties entering a contract always run the risk that the market will move against them. However one of the lessons of the shipbuilding disputes of recent years has been to emphasise for owners the importance of well drafted builder default provisions which may be of assistance when the market crashes and the yard runs into difficulties. Allied to that is the need to ensure effective linkage between the termination mechanisms of the shipbuilding contract and the operation of the related refund guarantees. This kind of protection can be hugely important. Nowadays much more attention is rightly being paid to due diligence before contracts are concluded and to the drafting of detailed contract wording. However these good habits will have to be maintained through, hopefully, an upturn in the market.

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Failure of Yards to Perform Technically

Another common cause of disputes on newbuilding projects is a failure on the part of the yard to perform technically.

The rapid expansion in world shipyard capacity in the five or so years leading up to the global economic crisis saw many yards expanding facilities to enter the international commercial newbuilding market for the first time and new yards built from scratch. Observers at the time warned of problems ahead at some of the “brown field” yards, foreseeing that they might struggle to meet the technical challenges presented by the orders they attracted. Unfortunately this appears to have been correct at many of the smaller yards, because we have observed a steady stream of disputes where technical shortcomings have been distinguishing characteristics. The problems have been of many kinds. Parts of yard infrastructure development promised at the time of contract negotiations did not materialise or come on stream on time. Yard management did not have the necessary experience or set-up to run an efficient operation. Personnel were poorly qualified and unable to meet required quality standards. As a result of these problems the vessel build was problematic and the construction schedule significantly delayed.

Whilst shipbuilding contracts may provide procedures for resolving technical disputes during the course of the build, it tends to be towards the later stages of the project that the owner will have more effective rights at its disposal. For example, depending on the nature of the outstanding defects and deficiencies, the buyer may be entitled to reject delivery of the vessel when tendered. Furthermore, if the vessel fails to meet certain guaranteed performance characteristics (relating to matters such as speed, fuel consumption or deadweight capacity), the buyer may be able to terminate the contract entirely. Ultimately, if the yard is struggling to complete the vessel in accordance with contract requirements, the buyer may be able to terminate the contract on grounds of excessive delay in delivery.

Many of the recent disputes have ultimately been triggered by cancellations on grounds of excessive delay in delivery. Although the delays in these cases may well have been due to technical incompetence and inexperience on the part of the yard, the yard commonly disputes such cancellations by claiming that it was entitled to more time by reason of an array of different factors: possible events of force majeure, disputed modifications or alleged delay and disruption by members of the buyers’ site team. These issues, which may be of varying degrees of merit, all have to be investigated and their impact, if any, on the project measured with the assistance of factual and expert witnesses from various disciplines. Arbitrations concerning such disputes can be lengthy and costly but necessary in order to recover the instalments plus interest if a settlement is not forthcoming.

In order to address the risks that a yard will fail to perform technically in this way, it is clearly desirable to undertake detailed research into the yard and its previous track record before orders are placed. In addition, once production starts, it is essential to have a strong and effective site supervision team on the ground. At more inexperienced yards, a larger site team will be required than would otherwise be the case. The site team need to be alert to defects, but at the same time must refrain from undue interference with the progress of the yard’s works so as to avoid being blamed for project delays at a later date. As any site supervisor who has been cross-examined in an arbitration will tell you, it also helps for the site team to keep detailed written records throughout the project in order to be able to identify and demonstrate convincingly at a later date how and why things went wrong and to justify any contract cancellation.

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What Makes a Good Contract in the First Place?

Having considered ways in which good contracts turned bad, one may well ask what makes a good contract in the first place. Clearly the headline commercial terms are very important. At the same time there are basic legal protections which lawyers would advise you to include in any newbuilding contract. We have sought to highlight some of those above.

Litigators will also tell you that, if you wish to avoid a dispute, a balanced contract (by which we mean one which distributes risks clearly and equitably between the parties) is preferable to a heavily one-sided contract. The latter is much more likely to generate a dispute when the weaker party seeks to get around some unfavourable contract term. But besides having a balanced contract to begin with, one must not under-estimate the importance and impact of how that contract is implemented going forward. A newbuilding project requires co-operation and that means that there has to be an element of “give and take” on each side for the project to run smoothly. An overly aggressive site team resorting to quoting contract terms at every opportunity will simply lead to a breakdown in relationships which can jeopardise the project generally. In such cases the very best of contracts can go bad very quickly indeed.

Should you like to discuss any of the issues raised in this briefing, please get in touch with a member of our team, or your regular contact at Watson, Farley & Williams.

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