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Shipbuilding contracts: Tips and traps

Despite the recent sharp decline in oil prices and the reduction in offshore equipment spend, the offshore oil and gas sector remains a key market for the shipbuilding industry. Market analysts have identified Australasia as a 'regional market bright spot'; predicting growth of 3% per annum in offshore equipment spend between 2016 and 2020. Australia's LNG projects are said to be a key driver for Australasia's positive market outlook.

Further, the Australian government has recently announced that it proposes investing 25% of its defence capital expenditure to 2025/2026 on maritime capabilities, with a focus on local manufacturing.

Given these emerging market opportunities, it is timely to highlight some key aspects of shipbuilding contracts.

Key issues

- Shipbuilding contracts are contracts for the sale of goods.
- Unless excluded, a shipbuilding contract can be subject to implied terms under the relevant Sale of Goods legislation.
- Liquidated damages can be payable in respect of defects in the vessel, provided that the sum stipulated is a 'genuine pre-estimate' of loss.
- Liquidated damages can also be payable in respect of delay in delivery, provided the delay is not caused by the buyer; in which case the Prevention Principle will apply.
- The right to terminate a contract may be subject to express provisions of the contract, or common law. The parties may exclude the common law right to terminate the contract.

1. Shipbuilding contracts and Sale of Goods legislation

Shipbuilding contracts are categorised by both Australian and English law as contracts for the 'sale of goods': *The Ship 'Hako Endeavour' v Programmed Total Marine Services Pty Ltd* [2013] FCAFC 21; *McDougall v Aeromarine of Emsworth Ltd* [1958] 1 WLR 1126. The ultimate purpose of these contracts is to transfer legal title in the ship (the good) in return for payment of a price. Thus regard must be had to the rules underlying contracts for the sale of goods when determining disputes arising out of shipbuilding contracts.

Title passes when the parties intend it to pass; for example see s *17 Sale of Goods Act 1895* (Western Australia) (**SOGA**) . Generally, most international shipbuilding contracts provide that title to the partly constructed hull rests with the shipbuilder until delivery and acceptance of the vessel. In such a scenario, the buyer's pre-delivery credit risk in respect of the shipbuilder is generally secured by a Refund Guarantee. Continuous title provisions where title to the partly constructed hull passes to the buyer are rare. See also ss 17 to 20 SOGA for rules on transfer of title.

2. Does the vessel conform to the contract?

This is often one of the most vexed questions in the context of shipbuilding contracts, and requires consideration of the express and implied terms of the contract.

Express terms

A shipbuilding contract will expressly provide detailed specifications that the vessel must comply with. These typically include a number of 'guaranteed' standards of performance, such as speed, deadweight and fuel consumption and the like. Parties will agree that breach of the guaranteed standards entitles the buyer to liquidated damages and, in extreme cases, to reject the vessel and treat the contract as having been repudiated.

Shipbuilders warrant the vessel, her machinery and equipment usually for a period of 12 months from the date of delivery and acceptance. In the event that a defect occurs during that period due to faulty workmanship or materials, the shipbuilder is obliged to rectify the defect at its own cost, but provides no guarantee of quality and accepts no liability for the buyer's losses arising from the deficiency. All losses or expenses resulting from defects discovered after the warranty period fall to the buyer's account.

Defects in compliance with contractual specifications, international conventions, class and regulatory requirements constitute a breach of contract that "*goes to the root of the contract*", and may entitle the buyer to reject delivery of the vessel: *Photo Production Ltd v Securicor Transport Ltd* [1980] 1 Lloyd's Rep. 545 at 553. Where the defect(s) represents a lesser breach, the buyer may not have a right to reject the vessel - its remedies are usually limited to either liquidated damages or damages assessed in accordance with general principles.

Implied terms

Shipbuilders often seek to exclude statutory implied terms under s54 of SOGA or its equivalent legislation. Where they do not, regard must be had to the SOGA, or equivalent legislation. These rules only apply to contracts for sale of goods made in WA: *Ginza Pty Ltd v Vista Corp Pty Ltd* [2003] WASC 11 at [187]. Unless otherwise excluded, the SOGA implies the following terms into the contract:

- where goods are sold by description, there is an implied term that the goods correspond with that description: s13;
- where the buyer has made known that the goods are purchased for a particular purpose, the goods will be reasonably fit for that purpose: s14(2); and
- where goods are bought by description from a seller who deals in goods of that description, those goods shall be of merchantable quality: s14(3).

The SOGA provides that the following remedies are available to the buyer:

- damages for non-delivery (s50);
- specific performance (s51);
- damages for breach of warranty (s52); and
- interest and special damages (s53).

Section 54 permits parties to contract out of, or exclude, these statutory implied terms by express agreement. It is important to note that an express warranty or condition does not necessarily negative a warranty or condition implied by the SOGA unless the two are inconsistent: s14(5).

In *Neon Shipping Inc v. Foreign Economic 7 Technical Corporation Co. of China & Ors* [2016] EWHC 399 (Comm), the parties did not expressly exclude statutory implied terms. The question for determination by the court was whether fitness for purpose obligations under s14(3) of the UK SOGA could be implied into the shipbuilding contract in circumstances where the vessel was built for use in a 'standardised trade' known to both buyer and shipbuilder ie "*bulk carrier for normal worldwide service*". The buyer argued that the contract contained an implied term under s14(3) as to fitness for the particular standardised purpose. The shipbuilder argued that the implied term of fitness for purpose did not apply as while the vessel was built for use in a standardised trade, the specific purpose was not expressly identified.

The court held that the fitness for purpose term was implied into the contract, provided that term was consistent with, and put into effect, the contractual specifications. There was no need (for purposes of s14(3)) that a particular purpose be identified – "normal use" (in accordance with contractual specifications) was sufficient.

However, the contract contained a guarantee period of 12 months and specified that notice of claims were to be given within 30 days after the end of the guarantee period. The buyer failed to give notice of defect within the contractual notice period. The court therefore held that the contractual time bar applied and excluded all claims not notified within the 30 day period.

3. Liquidated damages v. penalties

A liquidated damages clause will be enforceable against a party to a shipbuilding contract where the sum stipulated is a *'genuine pre-estimate'*

of the loss that will probably arise from the breach of contract: *Paciocco v Australian and New Zealand Banking Group Ltd* [2016] HCA 28 at [16]. If the damages prescribed are *'exorbitantly disproportionate'* to the actual loss likely to be suffered, then the clause will be unenforceable as a penalty. In *Castaneda v Clydebank Engineering and Shipbuilding* (1903) 10 SLT 622, 624, the court said that liquidated damages must be "*reasonable and moderate*" and not exorbitant and unconscionable or "*in terrorem"*.

Factors that may influence whether a liquidated damages clause in a shipbuilding contract is enforceable include:

- **Commercial justifiability** - liquidated damages must be commercially justifiable, and should not be an unreasonable remedy for the breach of contract to which it relates. In *Azimutt-Banetti SpA v Darrell Marcus Healey* [2010] EWHC 2234, the liquidated damages clause withstood attack on the basis it was a penalty, despite requiring repayment of all but 20% of the purchase price if the shipbuilder lawfully terminated the contract in the event of the buyer's breach. The court said such a clause can be "*commercially justifiable", "provided that its dominant purpose is not to deter the other party from breach*." The court characterised the clause as an attempt to strike a balance between the parties in the event that the shipbuilder lawfully terminated the contract in the event of the buyer's breach.
- **Graduated levels of damages payable** – where the sum payable as liquidated damages increases by reference to the gravity of the breach, it is more likely that the court will find the sum stipulated is a "genuine pre-estimate of the loss likely to be suffered", rather than a penalty. Clauses structured in this way are widely used in shipbuilding contracts.

It is worth noting that a liquidated damages provision will not be construed as a penalty merely because the damages payable may exceed the actual loss suffered in certain situations: *Philips Hong Kong Ltd v The Attorney-General of Hong Kong* (1993) 61 B.L.R 41.

If a liquidated damages clause is found to be unenforceable as a penalty, the claimant is relegated to seeking and proving damages, assessed in accordance with general compensatory principles: *United Dominions Trust (Commercial) Ltd v Ennis* [1968] 1 Q.B. 54 at 68. The monetary compensation is to place the party in the position it would have been in had the contract been properly performed: *Wavemaster International Pty Ltd (in liq) v JR Marine Systems Pte Ltd* [2009] WASC 203.

In addition to applying to defects in the vessel, liquidated damages can also be awarded for delays in delivery of the vessel. Such liquidated damages are usually calculated on a *per diem* basis, and are usually payable by way of a reduction in the contract price or in cash upon delivery.

Prevention Principle

Liquidated damages and the right to cancel a shipbuilding contract for delay are subject to rules which protect the shipbuilder from the consequences of delay caused by the buyer: the Prevention Principle. This principle provides that the contractual time for completion will be extended if the buyer's act or omission "*renders it impossible or impracticable for the* [builder] *to do his work within the stipulated time*": *Trollope & Colls v North West Metropolitan Regional Hospital Board* [1973] 1 WLR 601. In such circumstances, the buyer is precluded from claiming liquidated damages (and is unable to require the shipbuilder to deliver the vessel by the specified date, or any other date ascertained by reference to the contract): *Multiplex Constructions v Honeywell Control Systems* [2007] EWHC 447.

If the shipbuilder is able to satisfy these requirements, time is set 'at large', and the shipbuilder's obligation to deliver the vessel by a specified date is replaced with an implied obligation to deliver the vessel 'within a reasonable time'. What is a 'reasonable time', is a question of fact determined in light of all relevant circumstances: *Shawton Engineering v DGP International* [2005] EWCA Civ 1359.

The buyer need not breach the contract for this principle to apply. The shipbuilder must however demonstrate a causal link between the buyer's act or omission and the delay: *Jerram Falkus Constructions v Fenice Investments* [2011] EWHC 1935.

In practice, the Prevention Principle is often excluded - shipbuilding contracts typically expressly provide an EOT in certain circumstances: *Adyard Abu Dhabi v SD Marine Services* [2011] EWHC 848 (Comm) at [255]. EOT clauses must be clear and unambiguous terms - any ambiguity will be construed *contra proferentum* – i.e. against the

shipbuilder as the party whose interests the clause seeks to protect.

The Prevention Principle can create traps for unsuspecting buyers. In some circumstances, the buyer may agree to grant the shipbuilder extra time to deliver the vessel, and will do so by way of formal contractual amendment. In such circumstances, it is important not to derogate from the contractual EOT clause by an amendment, as this may give rise to the application for the Prevention Principle.

4. Delays and EOT

Shipbuilding contracts will contain an express provision setting out the contractual delivery date, and when the buyer is able to cancel the contract in the event the vessel delivery is delayed i.e. by a 'drop-dead' date. However, the shipbuilder's performance of the contract may be delayed by the buyer's conduct, or a range of events that are out of either party's control. To allow for these possibilities, it is common for shipbuilding contracts to set out a contractual mechanism that shares the risk of delay between the parties by:

- providing that the date for delivery of the vessel be extended in circumstances where the buyer has impeded the shipbuilder's performance, or where the shipbuilder is impeded by events beyond its control (commonly referred to as *force majeure* events); and
- entitling the buyer to cancel the contract if the delay exceeds an agreed number of days.

Thus the contractual construction of EOT clauses and the events of delay are important questions, which can affect the buyer's ability to cancel the contract for non-performance: see for example *Zhoushan Jinhaiwan Shipyard Co Ltd v Golden Exquisite Inc* [2014] EWHC 4050 (Comm).

Non-conforming vessel

A separate, but related, consideration is whether the buyer is permitted to cancel the contract for delivery of a "non-conforming vessel", or whether the buyer must await until expiry of the 'drop-dead' date. In *McDougall v Aeromarine of Emsworth Ltd* [1958] 1 WLR 1126, the court held that a buyer is entitled to refuse delivery if it is not reasonably satisfied with performance of the craft. 'Performance' is construed widely and includes standard of workmanship and materials, compliance with specifications, and performance of the craft. If the defect in question is capable of being remedied and the shipbuilder is able to deliver the vessel within the period permitted by the contract, the buyer is not entitled to treat the contract as being repudiated by reason of such defect when the vessel was first tendered for delivery. The court found that 'deliverability' is not the converse of 'rejectability'. See also s11(2) of SOGA, which provides that whether a term is a condition (breach of which gives rise to a right to treat the contract as repudiated), or a warranty (breach of which gives rise to a claim for damages, but not to reject the goods and treat the contract as repudiated), depends in each case on the construction of the contract.

5. Performance and refund guarantees

Performance guarantees

If the buyer wants to recover its expectation losses where the shipbuilder fails to perform the contract as per its terms, a clause to that effect can be incorporated into the contract. The third-party guarantee can be called on in the event of the shipbuilder's default. What is often negotiated in the context of shipbuilding contracts is a parent guarantee, by which the parent company accepts joint obligations with the shipbuilder to build and deliver the vessel, rather than a traditional performance guarantee.

Refund guarantees

Shipbuilders are commonly called upon to provide the buyer, at the outset of the contract, a refund guarantee, which is an undertaking by a bank (or other surety) that if the shipbuilder fails to refund the pre-delivery instalments of the contract price upon the buyer's lawful cancellation of the contract, it will repay those instalments to the buyer in full.

From the buyer's perspective, it is preferable that the refund guarantee is unconditional, irrevocable and payable 'on demand'. This is in contrast to circumstances where the guarantee is payable only on a secondary basis after the shipbuilder's liability has been independently determined by a court or arbitral tribunal and the shipbuilder has failed to make payment: see *Nanjing Tianshun Shipbuilding Co Ltd v Jiangsu Skyrun International Group Co Ltd* [2011] EWHC 164.

Recovery under the refund guarantee does not necessarily preclude the buyer from claiming damages at common law: *Stocznia v Gdynia SA v Gearbulk Holdings Ltd* [2009] EWCA 75.

It should be noted that the ability to call on the Refund Guarantee is often

limited to certain events, depending on its terms. Buyer need to be aware of any such limitations. Buyers should also ensure that the Refund Guarantee does not expire before resolution of any dispute.

Injunctions

Generally, common law courts are reluctant to grant an injunction restraining a party calling on a performance bond (e.g. refund guarantee). The common exceptions to this general rule are fraud, unconscionable conduct by the party in whose favour the bond had been given, and where the party in whose favour the bond has been given has made a contractual promise not to call on the bond (normal principles relating to enforcement of negative contractual stipulations by prohibitory injunctions apply): *Lang O'Rourke Australia Construction Pty Ltd v Samsun C&T Corporation* [2016] WASC 49.

In *Duro Felguera Australia Pty Ltd v Samsung C&T Corporation* [2016] WASC 119 (appeal pending), the court said that there are generally two purposes for performance bonds, namely, (a) providing security for valid claims against a contractor and, (b) allocating risk between the parties, i.e. who shall be out of pocket pending resolution of dispute between them. Which purpose prevails is a matter of contractual construction. In that case, the Judge held that the purpose of the performance bond was to allocate risk. That commercial purpose would be defeated if an injunction were granted – the interlocutory injunction had the capacity to equate to final relief, i.e. completely defeating the commercial purpose of risk allocation before the final determination of the matter.

The purpose of the clause alters the context in which the court must exercise its discretion whether to grant an injunction "*by changing the complexion of the status quo and raising the prospect of substantial injustice if the purpose of the provision is defeated. That is, the status quo becomes what the parties had agreed to as to which of them should bare the financial risk pending final determination ...*" As such, the court held an injunction should not be granted unless the applicant establishes a *"strong case, and not merely an arguable case"* that the other party did not consider, acting bona fide, that it is or will be entitled to recover from the applicant, otherwise commercial purpose (e.g. risk allocation) would be defeated.

6. Title to the vessel & *Romalpa* clauses

Most shipbuilding contracts provide that during construction, title vests in the shipbuilder, and passes only on the buyer accepting delivery of the vessel and paying the full purchase price. The buyer risks the shipbuilder running into financial difficulty before delivery of the vessel, (with the buyer having to join the line of unsecured creditors to recover its pre-delivery payments). Securing a refund guarantee mitigates against this risk.

An alternative method of guarding against the shipbuilder's insolvency is to transfer title to the vessel as it is constructed. This is effected by what is often referred to a continuous transfer of title provision. If the contract is structured in this way, it is important that the interest be registered under the *Personal Property Securities Act 2009* (Cth).

On a practical level, the problem in seeking to confer title to the vessel upon the buyer prior to its completion is that the materials and equipment used in its construction may still belong to a third party and not to the shipbuilder. Note, under the contract, the shipbuilder only warrants that it owns the completed vessel; it is unusual for the shipbuilder to give any assurance that prior to delivery it owns the materials used in construction. It is common that the shipbuilder's suppliers contract with it on the basis that they retain title in the materials and equipment supplied to the shipbuilder until they receive payment, pursuant to *Romalpa* clauses.

7. Termination of contract

A right to terminate a shipbuilding contract can arise expressly, and at common law.

The interplay between common law and contractual rights of termination are not always straightforward, but are important to remember. In *Newland Shipping v Toba Trading* [2014] EWHC 661 (Comm) at [49]-[54], Leggatt J said:

- A contractual right to terminate arises under the contract, subject to notice requirements.
- A common law right to terminate: arises if a party commits a 'repudiatory breach', e.g. where (a) the party's breach 'goes to the root of the contract' or deprives other party of substantially whole benefit of performance; (b) a party breaches a condition; or (c) a party renounces the contract by making it clear that it is going to commit a breach listed above.
- On valid termination at common law, the parties' primary obligations of performance are released and substituted with a secondary obligation to pay compensation: *Photo Production*

Ltd v Securicor Transport Ltd [1980] AC 827 at 849

- Note that the inclusion of an express cancellation clause will not exclude the right to terminate under common law for a repudiatory breach, unless the parties' ability to elect is expressly excluded in the contract: *Stocznia Gdynia SA v Gearbulk Holdings Ltd* [2010] QB 27 at [22]–[23].
- Where the right to terminate exists under both common law and contract, a party can elect to exercise both rights at the same time, provided that doing so is not inconsistent with exercising the other: *Dalkia v Celtech* [2006] 1 Lloyds Rep 599 at [143]-[144]. What right that is sought to be evoked should be expressly stipulated

Generally, the buyer will have three express contractual rights to terminate the contract, where the vessel:

- fails to meet specified performance criteria which are the subject of an express right of termination;
- is not tendered for delivery before an express right to cancel the contract accrues – i.e. 'drop dead' date; or
- is tendered for delivery before the 'drop-dead' date, but not in a condition that contract requires.

Absent express contractual wording, parties also have the right under the common law to terminate the contract if the other party is in repudiatory or 'renunciatory' breach of contract, or has breached a condition. It is presumed that the parties do not give up these valuable rights, unless the parties expressly and clearly rebut that presumption: *Modern Engineering v Gilbert Ash* [1974] A.C. 689 at 717G.

8. Tips & traps

1. Generally, the shipbuilder retains title to vessel until final payment by buyer; in these circumstances it is important to ensure that the shipbuilder provide the buyer with a unconditional, irrevocable refund guarantee in the amount of its pre-delivery instalments and interest thereon
2. When drafting liquidated damages clauses, be mindful that the sum stipulated must be a genuine pre-estimate of loss. In this respect, in addition to ensuring the sum is commercially justifiable, it is also useful to stagger levels of damages payable by reference to seriousness of defect. Court will look beyond the form, to the substance of the clause.
3. Future pain can be avoided by clear drafting of the extension of time clause. The 'drop-dead' date may be difficult to determine.
4. If the parties intend to exclude statutory implied terms, and to have the shipbuilder's performance assessed solely against the contract's express terms, such an intention should be clearly expressed. The incorporation of express conditions will not per se necessarily exclude the incorporation of statutory implied terms.

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