Recent decisions in Shipbuilding law

There have been encouraging recent signs that the market for newbuild vessels may be improving, especially given, for example, recent reports of significant orders for LNG carriers. However, more pessimistic forecasts of 2015 orders, the fall in the price of oil and continued depression in freight and hire rates means that yards remain under pressure financially and from Buyers. Several decisions across the offshore, shipbuilding and yachtbuilding sectors in the last year highlight the continuing tendency of Buyers to rely heavily on their contractual rights (especially where an order may have become unattractive following a drop in market rates for hire and freight) and in some cases to push those rights to, or even beyond, their limits. The English courts have tended in these cases to adopt a robust line under the contracts and have often been prepared to enforce provisions that allow Buyers to terminate and claim repayment of instalments. Accordingly, shipyards must be careful to avoid straying into positions where they are at risk of any breach of the shipbuilding contract.

PART I – Termination and extensions of time

The courts have provided guidance on the rights of the Buyer to terminate, and on the ability of the yard to avoid termination, in two key decisions from 2014, most recently in Zhoushan Jinhaiwan Shipyard Co Ltd v (1) Golden Exquisite Inc. (and others) [2014] and in Bluewater Energy Services BV v (1) Mercon Steel Structures BV (and others) [2014] EWHC 2132.

Zhoushan Jinhaiwan Shipyard Co Ltd v (1) Golden Exquisite Inc (2) Golden Eye Inc (3) DNB Bank ASA: Zhoushan Jinhaiwan Shipyard Co Ltd v (1) Golden Extreme Inc (2) Golden Effort Inc.

This case concerned the cancellation of several materially identical shipbuilding contracts in which both the termination by the Buyer and response from the Builder gave rise to similar arguments. Leggatt J was required to consider the extent to which arguments arising out of various alleged defaults by the Buyer could be used to defeat contractual rights of termination exercised by the Buyer.

Facts

In each case Article VIII.3 of the contract permitted the Buyer to cancel if the total period of delay exceeded 210 days (although "permissible" delays did not count towards this period), with a "drop dead" period of 270 days including all permissible and non-permissible delay. Some delays were expressly excluded from counting towards this period, including delays "due to default in performance by the Buyer". In all of the contracts, the total delay after the contractual delivery date exceeded 270 days, and the Buyer cancelled the contract.

Prior to cancellation, the Builder had not given any notice of permissible delays, delays for which the yard was not responsible, or Buyer defaults causing delay. In each case however, after cancellation, the Builder did provide such notices, claiming that the Buyer had caused delays, and as such the yard was entitled to extensions between 90 and 100 days. The Builder complained that the delays were caused by defaults by the Buyer, in that the Buyer’s representative:

- Worked too few hours
- Imposed unreasonable requirements
- Delayed unreasonably in approving or returning drawings and procedures to the yard
The builder alleged that these defaults caused delays for which the yard could not be held responsible, and as such, the Builder argued, the Buyer could not be permitted to terminate the contracts.

**Decision**

The key section of the shipbuilding contract, highlighted by Leggatt J, was in Article IV.3. This provided that in the event the Buyer’s representative discovered a non-conformity he should give notice in writing:

“upon receipt of which the Builder shall correct such nonconformity if the Builder agrees with the Buyer. In any circumstances, the Builder shall be entitled to proceed with the construction of the Vessel even if there exist discrepancy in the opinion between the Buyer and the Builder, without prejudice to the Buyer’s right to submit the issue for determination by the Classification Society or arbitration in accordance with the provisions hereof”.

Leggatt J divided the types of delay into three categories:

- **Excluded delays**, meaning delays that automatically extended the delivery date pursuant to express terms of the contract, and so could not count toward any other delay
- **Permissible delays**, being delays beyond the control of the Builder
- **Non-permissible delays**, being delays for which the Builder was responsible

He reasoned that any delays must fit into one of these categories.

The judge found that delays due to the Buyer’s breach of Article IV did not fit within any express terms of the contract which permitted extension of the delivery date, so could not be classed as excluded delays. This in itself proved fatal to the Yard’s case, since the terminations were based on a failure to meet the 270 day aggregate period of permissible and non-permissible delay. Whether the delays were permissible or non-permissible, the Buyer remained entitled to cancel.

Leggatt J also considered the argument that allowing the Buyer to cancel would permit the Buyer to profit from its own breach. However, relying on the wording from Article IV.3 quoted above, the judge found that the yard was only required to correct non-conformities if agreed with the Buyer, and was otherwise entitled to proceed with the construction of the Vessel. The Buyer could not therefore be said to have delayed construction by the actions complained of, since “the Buyer’s supervisor had no power to delay the construction of the vessel”.

Finally, the court considered the implications of the failure of the Builder to give notice of any of the delays. The Builder had contended that the Buyer would be aware of the conduct of its own supervisor, and could always check with the yard before seeking to terminate. Leggatt J declared both arguments to be “bad”, and held that the contract could not be read as creating a form of “limbo”, whereby the Buyer could not know with certainty, after a period of delay, whether it could or could not terminate in accordance with Article VIII. The Judge also gave full force to the provisions of Article VIII.1, which stated that the Builder was not entitled to any extension of time where it had failed to give the required notices of delay in respect of permissible delay.

It is worth noting however that Leggatt J did not consider that delays due to Buyer’s breach fell within the ambit of article VIII.1, under which notice was required. For the category of “excluded delays” above, the notice requirements did not apply. Nor would any notice requirements apply to non-permissible delays (since the yard is responsible for these).

**Comment**

The court was not prepared, in this case, to look beyond the strict terms of the contract, under which the Builder was entitled to proceed notwithstanding any interference by the Buyer’s supervisor and had failed to give the notices required by the contract for any permissible delays. In the writer’s experience, the arguments raised by the Builder have been raised frequently by yards, where Buyers’ representatives fail to return drawings, delay giving instructions or impose new requirements, often without formal change orders. Such arguments however rarely succeed. Indeed, under an unamended Shipbuilders’ Association of Japan (“SAJ”) form contract, where Article IV.1 provides for drawings to be deemed automatically approved if the Buyer does not respond within 14 days, the position of the Buyer would have been even stronger.

While it is often tempting or expedient therefore for shipyards to wait for approval, or to accommodate requests without change orders, it is clear that this may later preclude shipyards from claiming extensions of the delivery date or additional costs based on those demands. For Buyers, it is worth keeping in mind the three categories of delay highlighted by Leggatt J, and that courts, or tribunals, may well be slow to accept arguments of delay raised by Yards, unless those delays fit within a clear contractual regime and the contractual requirements (specifically with regard to notice) have been met.

**Bluewater Energy Services BV v (1) Mercon Steel Structures BV (2) Mercon Holding BV (3) Mercon Group BV**

In Bluewater, the Court considered a range of arguments relevant to shipbuilding projects in the context of the design, construction and installation of a tower based soft-yoke mooring system (“SYMS”). The judgment in the TCC is a long and a very technical one, and so the writer has attempted to pick out those elements of most interest in terms of wider precedent.

The project ran into a series of delays, was not completed on time, and the Buyer, Bluewater, cancelled the contract. The contractor, Mercon, claimed (amongst other elements) that:
Bluewater were not entitled to terminate

Mercon were entitled to extensions of time due to instructions given by and/or delays caused by Bluewater

Time was at large due to acts of prevention by Bluewater

In light of Bluewater’s breaches, Mercon was entitled to claim lost profits despite a clause excluding consequential losses

**Termination**

Of particular interest in this case was Bluewater’s termination under Clause 30 of the contract, which provided that if Bluewater gave a notice of default, setting out the details of any default, Mercon were then required to take steps satisfactory to Bluewater to remedy that default, failing which Bluewater were entitled to terminate. There was a dispute as to whether actions satisfactory to Bluewater were to be judged wholly subjectively by Bluewater, or whether Bluewater’s actions were to be assessed by reference to an objective test of reasonableness.

The Court applied the principles governing the exercise of discretion set out in *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] EWCA Civ 116. In this case, the Court of Appeal had declined to impose an objective test, in which the Court became the ultimate arbiter, but left the test to the discretion of the decision maker, subject to limitations of honesty, good faith and genuineness, and a requirement to avoid arbitrariness, perversity and irrationality. Ramsey J held that in this case, the requirement to satisfy Bluewater was also a subjective test, subject only to the limits set out in Socimer.

The Court held therefore that the fact that Bluewater stated Mercon had not remedied defaults to Bluewater’s satisfaction meant that Bluewater had validly terminated the contract under Clause 30.

**Extension of time**

Mercon further claimed that the deferral of the load out date, being the date on which the SYMS was to be integrated and handed over to the ultimate employer by Bluewater entitled it to an extension of time to complete the structure or alternatively that acts of prevention by Bluewater entitled them to an extension. Mercon claimed that Bluewater had prevented them from completing the SYMS on time by failing to provide drawings on time and changing the scope of the design, delaying transport of the SYMS and delaying integration works.

The Court found that the critical path of the project ran through the completion of the structure, and only then to load out. While the load out date was delayed, the delay to completion of the structure remained an operative cause of delay to load out, because load out was dependent on completion of the structure. The delay relied on by Mercon would therefore only impact after the structure was completed. Since the structure had not been completed, that milestone lay on the critical path as the operative cause of delay, and Mercon were not entitled to an extension of time.

The Court went on to find that there were no delays for which Bluewater was responsible, and consequently no entitlement to any extension of time. Many of the acts of prevention complained of, for example, required the SYMS to be structurally complete first, and so Bluewater’s actions could not have impacted on the critical path. The decision in Bluewater confirms the line of recent decisions, as set out, for example in *Adyard v SD Marines Services* [2011] EWHC 848, that a delay must impact the critical path in order to entitle a Builder to an extension of time.

**Time at large**

Mercon’s further claim, that Bluewater’s acts of prevention meant that time was at large, was dealt with swiftly, particularly in light of the findings that Bluewater were not responsible for any acts of prevention. However, the Court also considered possible mechanisms for granting extensions of time in the contract. The Court found that there was in fact a mechanism in the contract for granting extensions of time for delays due to prevention, and as such the principle by which time becomes “at large” (as set out in *Multiplex Construction (UK) Ltd v Honeywell Control Systems Ltd* [2007] BLR 195) did not apply.

**Lost profits**

Finally, in respect of Mercon’s claim for lost profits due to Bluewater’s wrongful termination, the Court’s finding that Bluewater correctly terminated the contract meant that this argument could be disposed of on the facts. However, the Court did go on to consider the arguments involved.

Mercon contended that the clause in the contract excluding “consequential loss”, defined in the clause as “loss and/or deferral of production, loss of product, loss of use, loss of revenue, profit or anticipated profit in each case whether direct or indirect”, did not apply to losses from a termination or renunciatory breach. Otherwise Bluewater were free to repudiate the contract without any real liability to Mercon.

Mercon also pointed out that the clause was internally contradictory, since consequential loss was understood to apply to the second limb of the test in *Hadley v Baxendale*, as confirmed in *Croudace Construction Ltd v Cawoods Concrete Products Ltd* [1978] 2 Lloyd’s Rep 55 and was therefore defined as indirect loss. There could not, therefore, be any direct consequential loss.

The Court considered that the contract had set out its own definition of consequential loss, and as such the guidance provided by authorities such as *Croudace* was of no assistance. The Court was therefore required to give the clause its natural meaning, which clearly excluded claims for loss of profit for both parties.
PART II - Warranty claims

Brian Henry Austen v Pearl Motor Yachts Ltd

The market has also seen a spate of warranty claims, often presented long after the date of delivery, and after the warranty period has expired. Many yards, especially with ongoing commercial relationships with a Buyer, are also being contacted by buyers for assistance on a range of issues, whether or not those issues are strictly covered by the warranty. In these cases, the better view appears to be that the courts remain likely to uphold the clear wording of any warranty clause that restricts liability for any defect to the warranty period.

The decision in Austen v Pearl Motor Yachts Ltd [2014] EWHC 3544 concerned a defect, however, that fell well within the warranty period, and which the Builder acknowledged to be a defect. The decision, therefore, turned on the particular facts of the case. In the construction of the yacht, the propeller shaft passed under the hull, supported by a “P-bracket”. The hull laminate was moulded in order to create the recess into which the P-bracket was fixed, and should have retained a thickness of 20mm around the recess. However, in fact the hull laminate had been thinned around the recess to 7mm. While the issue was not raised in this case, the nature of the dispute does tacitly confirm the view expressed in China Shipbuilding Corporation v Nippon Yusen Kabushiki Kaisha and another [2000] 1 Lloyd’s Rep. 367, that warranty clauses will, as a matter of course, apply to defects existing on delivery of the vessel.

The Vessel grounded and the propellers struck a rock, cracking the hull precisely where the laminate was thin. The Builder argued that the force exerted by the grounding would have caused the damage even if the laminate had been 20mm.

The Claimants, after some debate, accepted that the burden of proof was on them to demonstrate that the same damage would not have occurred had the Vessel been built to the contractual specification.

The case therefore depended considerably on expert evidence as to the forces exerted by the grounding, and the claim that if the force had been sufficient to crack even the 20mm laminate, the thinner section would have been “obliterated”. On balance, the Court accepted this analysis, finding that the force was in fact considerably less than that required to crack a 20mm laminate. The Builder was therefore liable for the damage due to its failure to build the yacht to the contractual specification.

PART III - Financing

Many Buyers, particularly in the yacht market, have found that their Builder requires financial aid in order to be able to deliver the vessel. Financial arrangements with the Builder, and the refund guarantees provided by Builders are of great importance to a Buyer, and the relatively recent cases, such as Wuhan Guoyo Logistics Group Co Ltd & Others v Emporiki Bank of Greece SA (No. 2) [2012] EWCA Civ 1679; [2014] 1 Lloyd’s Rep. 273 in which the courts have upheld the nature of “on demand” bonds, will be reassuring in that regard.


In Wuhan, the Court of Appeal considered the wording of a payment guarantee issued on behalf of the Buyers under a Shipbuilding Contract. The dispute centred on whether the document was a standard guarantee, dependent on the Buyers’ liability to pay, or whether it was an “on demand” bond, and could be called on regardless of the underlying Shipbuilding contract. The distinction is important, because an “on demand” guarantee requires payment without any reference to the underlying shipbuilding contract, or the liability of the Builder. A standard performance guarantee however requires the Buyer to prove that the Builder is liable to pay under the shipbuilding contract before claiming under the guarantee.

The case therefore depended considerably on expert evidence as to the forces exerted by the grounding, and the claim that if the force had been sufficient to crack even the 20mm laminate, the thinner section would have been “obliterated”. On balance, the Court accepted this analysis, finding that the force was in fact considerably less than that required to crack a 20mm laminate. The Builder was therefore liable for the damage due to its failure to build the yacht to the contractual specification.

The Court of Appeal, overruling the decision at first instance, found that the document was an on demand bond, and that the Bank was required to pay on the Sellers’ written demand, without reference to the obligation of the Buyer under the Shipbuilding Contract. In particular, the Court of Appeal referred to Paget’s Law of Banking, which stated.

“Where an instrument (i) relates to an underlying transaction between the parties in different jurisdictions, (ii) is issued by a bank, (iii) contains an undertaking to pay ‘on demand’ (with or without the words ‘first’ and/or ‘written’) and (iv) does not contain clauses excluding or limiting the defences available to a guarantor, it will almost always be construed as a demand guarantee.”

Swallowfalls Ltd v Monaco Yachting & Technologies SAM & Anor [2014] EWCA Civ 186.

The issue of direct financing was considered in Swallowfalls.

Facts

The Defendant had sub-contracted construction to an Italian yard, but encountered serious financial difficulties in cashflow during the build. It was clear to the Buyer that to enable delivery of the yacht, it would need to provide interim financing to the Builder, which it did by way of a series of loans. In return for these loans, the Builder was to effect repayments once milestones fell due, and to transfer title in the yacht to the Buyer. The Builder failed to make any repayments, or to transfer title, and eventually the Buyer terminated the contract, which was disputed by the
Builder largely on grounds of alleged delays caused by the Buyer.

The Buyer also demanded repayment of the loan, which was contested by the Builder on the basis of alleged implied terms that:

– Swallowfalls would not prevent the Builder from repaying the loan (by delaying or failing to certify milestones for payment under the construction contract)
– Swallowfalls would co-operate in achieving the milestones and signing stage certificates.

The Builder also claimed that the loan agreement did not permit Swallowfalls simply to demand repayment. The court was therefore required to consider the wording of Clause 2.5, on which the dispute focussed.

Clause 2.5(a) of the loan agreement stated:

"The Borrower shall repay the loan … on the first to occur of:

– The date on which the Lender gives the Borrower notice that the Loan is immediately due and repayable
– The date on which the Agreement terminates…"

Judgment of the Court of Appeal

The Court of Appeal upheld the Judge at first instance in giving the words in clause 2.5(a)(i) their natural meaning, so that Swallowfalls were entitled to repayment on the date that notice was given to the Builder. The appeal by the Defendant was dismissed.

In considering the implied terms, the Court considered the second, that Swallowfalls would co-operate in achieving milestones, to be an ordinary implication in any shipbuilding contract, and that where a milestone has been reached, the Buyer must certify that milestone. Where such a term was implied into the construction contract, it must also be implied into the loan agreements, since the loan was to be repaid by the milestone payments under the construction contract.

The Court rejected the first implied term argued by the Builder, that the Buyer must not prevent the Builder from repaying the loan. However, only one implied term was required for the Builder to succeed, and Swallowfalls was therefore found to be in breach of the second implied term, with any damages flowing from that breach to be assessed at arbitration.

Comment

The cases set out above cover a range of disputes across the shipbuilding industry. However, if there is a single thread running through those cases, it is that the courts have demonstrated they are unwilling to deviate from the contractual terms agreed between the parties, and will give full effect to clear terms. None of the decisions represents a radical shift from previous authorities, but several do provide welcome clarification or confirmation of some previous partially established principles, for example, the approach to defects existing on delivery, dealt with in China Shipbuilding, but only as part of a preliminary issue.

In general, these cases highlight again the lack of tolerance in the courts for arguments that are raised late and following failures to comply with contractual mechanisms. They should serve as a warning to Buyers and Builders alike to comply carefully with contractual requirements, for example in giving notice of delays.

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