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The Fifth Edition of The Law of Shipbuilding Contracts – New Developments

William Cecil, June 2020

The fifth edition of The Law of Shipbuilding Contracts has now been published. Unlike the first four editions, which were written by Simon Curtis, the fifth edition has been co-authored by Simon, Ian Gaunt - an arbitrator and President of the London Maritime Arbitrators Association 2017 – 2020, and myself. There has been a seven-year gap between the fourth edition, published in 2012, and the new fifth edition. During that time, there have been a number of significant cases, both directly relating to the law of shipbuilding contracts, and in the context of general commercial law which impact on shipbuilding and related contracts.

This paper briefly discusses some of the new cases in the following areas (all of which are considered in more detail in the book):

- contract enforceability,
- design life,
- contractual mechanisms regulating variations to the contract,
- extensions of time outside the contractual extension of time provisions,
- the enforceability of liquidated damages provisions, and
- warranty of quality.

Contract enforceability

Contract enforceability was considered in *Teekay Tankers Ltd v STX Offshore Ltd (2017)*[1] in relation to an option agreement granting the buyer options to order three additional sets of up to four tankers.

It was agreed that the delivery dates for the option vessels would be "*mutually agreed upon at the time of* [the buyer's] *declaration of the relevant option"* and that the builder would *"make best efforts to have a delivery"* within 2016 for each of the first set of option vessels and within 2017 for each of the vessels in the second and third sets. The buyer exercised all the options it had been granted but, as a result of the builder's financial difficulties, the builder said it was unable to obtain the required refund guarantees for the vessels. The builder then argued that the option agreement was unenforceable on the grounds of uncertainty because it left the delivery dates of the option vessels still to be agreed between the parties.

The High Court accepted that the parties had intended to create a legally binding relationship between them. It was agreed by the parties that identification of the delivery dates for the vessels was an essential element of each shipbuilding contract, but the court decided that it was impossible, applying the English law principles for the implication of contractual terms, to import into the option agreement a mechanism which would generate the required delivery dates if the parties could not agree these between themselves. There was in the court's view a critical distinction to

[1] [2017] EWHC 253 (Comm)

be drawn between an undertaking to use "best efforts" to achieve a particular result (for example, completion of a newbuilding by a particular date), which was capable of being enforced, and an undertaking to use such efforts to agree upon an "essential term" of the contract (for example, the delivery date) which was not enforceable.

This decision, whilst in line with the existing authorities on the implication of contract terms, is surprising. The parties to the option agreement plainly intended that, if the options were exercised by the buyer, the vessels would be delivered either (i) within 2016 or 2017 respectively; or (ii) on the first dates thereafter achievable by the builder. That the builder was unable to meet this clear commercial expectation by reason of its own financial embarrassment but was held entitled to defeat such expectation by refusing to agree delivery dates, is arguably very harsh on the buyer.

The decision is, however, a clear warning to purchasers entering into a newbuilding option agreement not to leave key elements of the commercial arrangement (in particular the specification of the vessel, its contract price, payment terms and delivery date) to be agreed when the option is exercised.

Design life

The question of design liability can give rise to complex issues where, as is common in offshore construction projects, the contract provides that the vessel or unit should be designed to a particular standard defined in terms of years of anticipated operation within specified parameters; this is often described as her "design life". This was considered by the Supreme Court in *MT Højgaard A/S v E.ON Climate & Renewables UK Robin Rigg East Limited [2017]* [2], which concerned the construction of an offshore wind farm, where the contract provided that *"the design of the foundations shall ensure a lifetime of 20 years in every aspect without planned replacement"*. Lord Neuberger indicated that in his view this language generated a promise that the foundations had been designed to have a 20-year operational life, rather than a warranty that they would in fact last for 20 years.

Further, while a vessel must as be built to a design acceptable to the classification society and the regulatory authorities, the parties to the contract are free to allocate between themselves the risks that the design will not be so approved or that, even if approved, will not generate a newbuilding which complies in full with the requirements of the contract.

A similar issue arose in *Højgaard*, where the international standard was found to contain an error, which meant that the strength of the foundation structures had been substantially over-estimated. There was therefore a conflict between the requirement to comply with international standard and the requirement for a 20-year lifetime. The Supreme Court held that the contractor was liable for the cost of rectifying the foundations because it had assumed the risk that construction in

[2] [2017] UKSC 59

accordance with the international standard would result in the foundations having a 20-year lifetime. Lord Neuberger said that *"… courts are generally inclined to give full effect to the requirement that the item as produced complies with the prescribed criteria, on the basis that, even if the customer or employer has specified or approved the design, it is the contractor who can be expected to take the risk if he agreed to work to a design which would render the item incapable of meeting the criteria to which he has agreed"*.

Contractual mechanisms regulating variations to the contract

The SAJ Form does not require variations to the contract be documented with any degree of formality. Article V provides that the specifications "may" be modified by written agreement and that such agreement may be effected by an exchange of letters signed by the authorised representatives of the parties or by *"cables confirmed by such letters manifesting agreements of the parties"*. This generates a significant risk of disagreements arising between the buyer and the builder as to whether a variation has been agreed.

To avoid this problem, a shipbuilding contract will often set out a detailed variation procedure, including prescribed forms for the buyer to request a variation and for the builder to claim a variation in the contract price, delivery date etc. The contract may also provide that, unless the buyer has signed a variation order before the work is carried out, the builder will waive any entitlement to claim that the work is a variation to the contract.

It was for many years uncertain whether clauses of this type were fully effective i.e. whether, if the agreed procedure for variations was not followed, a party could still rely on an informal agreement to vary the contract. This question was answered by the Supreme Court in *Rock Advertising Limited v. MWB Business Exchange Centres Limited (2018)*[3]. The court, reversing the Court of Appeal's decision, decided that English law does give effect to a contractual provision requiring specific formalities to be observed for the contract to be varied. A contract which requires that variations must be in writing can therefore only be varied in writing. The court did, however, indicate that there could be circumstances where a party might be "estopped" (i.e. prevented) from arguing that it was not bound by an informally agreed variation; but this would require at least some words or conduct by that party unequivocally representing that the variation was valid notwithstanding its informality, which would need to be something more than the informal promise itself.

The consequence of the decision in *Rock* is that language in a shipbuilding contract requiring that a variation to the contractual workscope should be agreed and documented in a particular format will normally be upheld, subject to arguments of "estoppel".

[3] [2018] UKSC 24

Extensions of time outside the contractual extension of time provisions

The SAJ Form (like most international shipbuilding contracts) contains provisions permitting the builder to a postponement of the Delivery Date in certain defined circumstances, beyond extensions of time for the force majeure delays. These are typically:

i. Periods during which the buyer is in default of its obligations to pay the contract price or take delivery;
ii. Delays caused by late delivery of "buyer's supplies", or defects in them;
iii. Delays in the performance of the vessel's sea trials caused by unfavourable weather; and
iv. Delays attributable to mandatory changes in the rules or regulations in accordance with which the vessel is to be built.

The builder may also be entitled to an extension of the Delivery Date granted to it by an arbitration tribunal appointed by the parties in the event of a dispute between them.

Complex legal questions arise as to whether the above categories are "closed" i.e. whether other circumstances affecting the builder's performance of the contract, including breaches by the buyer of its other obligations[4], would entitle the builder to an extension of time under the contract or at common law. The issues raised have been of crucial importance to the outcome of many shipbuilding disputes decided by arbitration proceedings in London since the financial crisis of 2008-9 caused a prolonged shipping downturn.

In the overwhelming majority of cases considered by London arbitral tribunals and the courts, the builder's claims have centred on allegations that the buyer has failed to co-operate in relation to drawing and plan approvals or in exercising rights of supervision of the vessel's construction, which failures have caused delay to the builder. The effect of such failures was considered by the High Court in *Zhoushan Jinhaiwan Shipyard Co Ltd v Golden Exquisite Inc (2014).*[5]

In *Zhoushan,* the contract included an express obligation on the buyer to co-operate with the builder in relation to inspections of the vessel "*so as to minimize any increase in building costs and delays in the construction of the VESSEL*" and a provision entitling the builder to continue with construction if it disagreed with the buyer's notices of non-conformity with the specifications. The builder alleged that a lack of co-operation by the buyer's supervision team had given rise to delays which in turn generated an entitlement to an extension of time.

The builder argued that, in addition to (i) force majeure events; and (ii) the other causes of delay for which it was expressly entitled under the contract to an extension of time (which the judge

[4] i.e. obligations other than payment of the contract price and the timely provision of buyer's supplies.

[5] [2014] EWHC 4050 (Comm)

labelled "excluded delays")[6], there existed a further category of "buyer's breach delays" which entitled the builder to claim an extension of time. This category (it was said) included delays caused by breaches of the buyer's duty "*to minimize any increase in building costs and delays in the construction of the VESSEL*".

The builder's argument was founded on a principle of English law that, unless the contract so provides, a party cannot rely on its own wrong to advance a claim under the contract[7]. Permitting the buyer to cancel the contract for delays in delivery when the delay had in part been caused by its own supervisors' egregious conduct would offend against this principle.

Whilst accepting the validity of the principle, the judge refused to accept the existence of this further category of delay – he held that the provisions of the contract permitting the builder to claim extensions of time constituted a complete code governing the availability of such extensions. The existence of a further potential category of delay - to which the notice provisions applicable to all other claims for extension would not apply - was in his view likely to be productive of great uncertainty. In the judge's view:

> *"…the operation of the cancellation clauses* [of the contract] *depends on the parties knowing where they stand. Those provisions depend for their efficacy on the parties being able to calculate with precision and know at any given time how many days of (i) permissible delay and (ii) non-permissible delay have occurred. The parties could no doubt have made a contract which left them each to perform their own calculation and then argue about the causes of delay after a cancellation has occurred. However, they have tried to avoid such an anarchic situation. Instead, they have adopted a scheme which provides for notices to be given and agreement reached, or any dispute resolved by arbitration if necessary, whenever an event occurs which the Yard wishes to say justifies an extension of the time for delivery. It would be wholly illogical to attribute to the parties the intention that one category of delay – being one particular kind of Buyer's breach delay – uniquely falls outside this scheme."*

The judge therefore concluded that, in addition to delays for which the builder was fully responsible ("non-permissible delays"), the contract provided only for (a) force majeure delays for which the buyer was excused performance but remained at risk of cancellation where such delays exceeded an aggregate contractual threshold; and (b) "excluded delays", for which the builder was also not responsible but which would not "count" towards the cancellation threshold.

Further, because the builder was permitted by the contract to proceed with construction regardless of the complaints by the buyer's inspectors that the vessel was deficient, it was not in the judge's

[6] These were similar to the provisions listed in items (i) - (iv) above.

[7] The principal authority is *Alghussein Establishment v Eton College* [1988] 1 W.L.R 587.

view correct to say that denying the builder a right to seek an extension of time would allow the buyer to "profit from his own wrong".

The decision in *Zhoushan* turned in part on the express wording of the contract in question and the decision of the High Court might have been different in the absence of language allowing the builder to proceed with construction notwithstanding the buyer's alleged complaints. *Zhoushan* is nevertheless indicative of a judicial reluctance to allow the categories of conduct on the part of the buyer potentially generating claims for extension of time to extend beyond those expressly provided in the contract; such an outcome is, it is submitted on the basis of that decision, even more likely if the contract does not clearly require contemporary notices to be given by the builder to the buyer as a pre-condition of such claims.

The judge also dismissed the builder's argument that, if it was not entitled to an extension of time, the builder was nonetheless entitled to damages from the buyer equal to the amount of the instalments payable to the buyer on rescission, and could set off those damages against any sums payable to the buyer (less any sums the builder could recoup by selling the vessel). The judge held that the valid rescission of the contract by the buyer broke the chain of causation for the builder's claim for damages.

Note that since the fifth edition, in *Jiangsu Guoxin Corp v Precious Shipping Public Co Ltd (2020)*,[8] the High Court has again revisited the question of claims for extension of time - this time in the context of a series of newbuilding contracts. The court again found that the builder was not entitled to claim an extension of time outside the contractual regime. The judge in *Jiangsu*, however, faced with similar contractual wording to *Zhoushan*, held that there could be "buyer breach" delays, but these would be caught by the "sweep up" wording in Article VIII (delays and extensions of time for delivery), so were still within the contractual extension of time regime.[9]

The enforceability of liquidated damages provisions

It is well established that the effectiveness of a liquidated damages clause is subject to a general requirement that it should be commercially justifiable, in the sense that it should not represent an unreasonable remedy for the breach to which it relates.

Formerly, this principle was expressed by the courts in terms of a requirement that the level of liquidated damages should represent a genuine pre-estimate of the losses arising from the breach in question. Where, judged by this standard, the compensation to the victim of the breach was "extravagant or unconscionable", the clause would be legally unenforceable.

[8] [2020] EWCH 1030 (Comm)

[9] See a separate paper on this case at https://www.haynesboone.com/alerts/english-high-court-declines-to-apply-prevention-principle-to-shipbuilding-contract

More recent English decisions, however, had indicated that a broader approach should be taken, and the relevant test is whether the liquidated damages provision is "commercially justifiable".

This approach has been endorsed by the Supreme Court in two judgments delivered together in *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Ltd v Beavis (2016)*[10], which concluded that:

> *"The true test is whether the…* [liquidated damages] *provision…imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the…obligation".*

The case concerned the impact of wider considerations (namely a car park owner's reasonable and legitimate wish to manage the efficient use of its parking space and not just whether an "unauthorised parking" charge was reasonable) which are of limited relevance to the enforcement of contractual liquidated damages provisions relating to a newbuilding. In this context, the primary determinant of "legitimate interest" will normally remain whether the amount of the liquidated damages payable by the contract breaker is "extravagant or unconscionable" compared to the damages which could potentially be recoverable at common law for the breach in question.

It is, however, conceivable that circumstances might provide a commercial justification for the imposition of liquidated damages going beyond the scope of the buyer's potential recovery in damages at common law. For example, the inability of a "superyacht" to achieve her warranted speed might conceivably have a negative impact upon her reputation which would not be capable of being properly compensated by an award of common law damages, but which would justify the enforcement of an "elevated" level of liquidated damages for such breach.

Warranty of quality

Shipbuilding contracts normally set out a builder's obligations in respect of defects post-delivery. The extent to which a builder will compensate a buyer for their associated losses is often disputed, as was the case in *Star Polaris LLC v HHIC-PHIL Inc (2016)*[11]. Here a newbuilding vessel had suffered a serious engine failure six months after delivery and within the relevant twelve-month guarantee period under the contract. The builder broadly accepted responsibility for the cost of the repairs to the engine and certain ancillary expenditure, but the buyer also claimed damages for its loss of income during the period of the repairs, as well as a diminution in value of the vessel as a result of the problems that had been experienced.

In reliance on previous case law, the buyer argued that the exclusion of "*consequential or special losses*" contained in the warranty provisions of the contract only applied to losses falling within

[10] [2016] 2 All ER 519

[11] [2016] EWHC 2941 (Comm)

the so-called "second limb" of *Hadley v. Baxendale* (1867)[12], namely indirect losses which did not *"directly and naturally result in the ordinary course of events"* from the breach of contract in question. The buyer said that, by this measure, its losses of income and value were not "consequential" but "direct" in nature and were therefore not affected by the exclusionary wording.

The builder contended that the exclusion clause excluded losses which were "consequent upon" a breach of its quality obligations under the contract - if the buyer's losses were the consequence, direct or otherwise, of such a breach, these were excluded by the relevant exclusion. An experienced London arbitral tribunal agreed with the builder and dismissed the buyer's claims.

Against this background, the High Court upheld the arbitrators' award and dismissed the buyer's claim. The court decided:

i. the warranty provisions in the contract constituted a "complete code" for the builder's post-delivery obligations in relation to defects; these provisions therefore comprehensively defined the scope of such responsibility, rather than simply limited the builder's financial liabilities;

ii. the term "consequential or special loss" was not intended to introduce into the contract the principles of interpretation in *Hadley v. Baxendale;* the words were instead used, in a "cause and effect" sense, to exclude the builder's liability for all financial loss resulting from the relevant defect and its repair;

iii. the intent of the warranty provisions was, other than in respect of "documented expenses" incurred by the buyer in taking the vessel to a place of repair, to limit the builder's liability to the cost of repairing the guarantee defect and any damage caused to the vessel thereby; and

iv. that the buyer's claim for diminution in value of the vessel as a result of undergoing guarantee repairs was equally a claim for "consequential or special losses" and therefore excluded.

The second significant case dealing with warranty issues was *Neon Shipping Inc v Foreign Economic & Technical Corporation Co of China and Another (2016).*[13] In this case, the warranty clause provided that the vessel would be "*seaworthy and contractual in all respects, and free from all defects which are due to defective design, construction, calculation, material or workmanship"*. As is usual, the builder's liability was conditional on the buyer serving a defect notice within 30 days after the end of the 12-month warranty period.

[12] [1854] EWHC J70

[13] [2016] EWHC 399 (Comm)

The buyer raised defects with the vessel's cranes some three years after delivery, having not served a defect notice within the required period. The buyer argued that the warranty clause was "bifurcated"; the notice requirement only applied to defects resulting from defective design or construction - it did not apply to the builder's guarantee as to the vessel's seaworthiness and compliance with the specification.

This argument was rejected, both by a London arbitration tribunal and by the High Court on appeal, the judge holding that any purported bifurcation of the clause, creating a distinct category of post-delivery defect items for which notice was not required to be given, would be "wholly artificial" and without "commercial or other justification".

The judge also held that an implied term as to fitness for a particular purpose[14] would apply if the vessel was employed for the "normal use" of a vessel of this type in accordance with the particular requirements of the contract; these stipulations define the "particular purpose" for which the vessel is intended. This was contrary to the view expressed in previous editions of the book that section 14(3) implied terms were of limited application in a shipbuilding context because the majority of newbuildings are constructed for generalised purposes known to both the buyer and the builder rather than for a "particular purpose" which the buyer makes known to the builder.

The Court's general approach

There would appear to be a broad theme flowing through a number of the cases discussed above; this is the court's desire not to interfere with the parties' right to contract on the terms that they wish, and to give practical effect to that agreement, and the consequential allocation of risk, if the court is able to do so.

That was clearly the reasoning behind the Supreme Court's emphasis in *Makdessi* on the latitude given to liquidated damages clauses before the court will refuse to uphold them. It was also behind the Supreme Court's decision in *Rock* to give full effect to "no oral variation clauses" agreed by the parties. It was also illustrated in the court's reluctance to allow a party to claim extensions of time outside the contractually agreed extension of time scheme in *Zhoushan* (and, later, in *Jiangsu*). One limitation of that approach was, however, illustrated in *Teekay*, where the court felt that the terms of the option were not sufficiently certain to enable the court to enforce it.

Further consideration of these and other new cases, as well as updates on environmental law, leasing structures, and innominate terms, and new sections on termination at the buyer's convenience, and exclusion clauses, together with issues arising in respect of offshore construction projects can be found in the latest edition of the book.

[14] implied pursuant to section 14(3) of the Sale of Goods Act 1979