

Andreas Dracoulis for Ship Technology Global: Building on Spec

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The shipbuilding market was, across all sectors, in terrible shape during 2016. There was fierce competition for orders and for the vast majority of vessel types newbuild prices were at historic lows. The driver behind this was (and is) largely a factor of the very weak freight rates generally found in the market and also partly to do with difficult lending conditions.

While the prevailing market sentiment for 2017 tends towards the “bearish”, analysts have suggested that freight rates across many sectors are at, or near, rock bottom. There was also a positive note at the end of 2016 with scrapping rates for tankers and container ships rising, which led some commentators to conclude that a market recovery in these sectors could be expected in 2018 and beyond. When combined with continued overcapacity amongst shipyards, forecast low newbuilding demand during 2017 and the favourable pricing (and payment terms) available from many shipyards, this may tempt speculative buyers back in to the market in order to take advantage of the conditions.

However, orders made “on spec” carry a degree of risk dependent on whether the timing of the vessel’s delivery dovetails with a market resurgence. Get the timing wrong, and this is likely to lead to a disputed cancellation as the speculative buyer seeks to avoid the consequences of having re-entered the newbuilding market too early and before the market has recovered as anticipated. Even if the buyer has correctly called the market, consideration needs to be given to issues that may affect the buyer’s ability to on-sell the vessel following delivery (assuming that is the buyer’s intention).

This article explores some of the issues relevant to buyers and shipyards (who will likely know if the buyer has a genuine need for the vessel or whether it is a speculative order) when concluding shipbuilding contracts in these circumstances.

The buyer’s perspective

No matter how favourable the payments terms, there will be some proportion of the contract price payable as one or more instalments in advance of delivery. It is therefore critical to ensure that these arrangements are “back to back” with the terms of the refund guarantee securing repayment of the same in the event of cancellation. Difficulties can arise because of an expiry date that is too early or because of defective wording with the potential to discharge the obligation to refund in the event of variations to the shipbuilding contract without the consent of the refund guarantor. If there is a problem with the refund guarantee, and if the shipbuilding contract is cancelled, then the buyer may find itself an unsecured creditor of the shipyard for a claim for the return of the pre-delivery instalments.

Assuming that the buyer intends to on-sell the vessel immediately following delivery, then the buyer should ensure that its post-delivery rights, namely the post-delivery warranty provisions, are effective and readily available as part of a sale package. Particular consideration should be given to the extent of the shipyard's obligations – for example responsibility for damage caused by any defects arising during the warranty period – and the extent to which the buyer's rights in relation to the same can be assigned.

Furthermore, if there are characteristics of the vessel that are likely to be critical to the on-sale of the vessel following delivery, then these should be clearly defined so that compliance with the same can be properly assessed at the time of delivery. Depending on the nature of the characteristic, it may even be sensible to seek to include it as an addition to the standard list of performance related guarantees for speed, deadweight, fuel consumption, etc.

The shipyard's perspective

The shipyard must take care when agreeing provisions relating to the acceptance of the vessel by the buyer and the shipyard's obligation to repair defects before delivery. To the extent possible the shipyard would be well advised to including wording preventing the buyer from rejecting the vessel for "minor" defects.

The shipyard should also try to avoid agreeing to absolute, or unqualified, obligations. For example sea trial provisions often require the vessel to be "completed" prior to sea trials but this can generate arguments about the validity of the trials. Similarly the shipyard should ensure that the requirements in the specification are actually achievable and particularly so in the context of sea trial procedures where there may be serious consequences if a specified test cannot be undertaken.

The shipyard should pay close attention to the refund guarantee the terms of which should provide for a delay in repayment in the event of a dispute. If it does not and the buyer cancels the shipbuilding contract and calls on the guarantee, then the shipyard will not be able to prevent the guarantor paying out. Then even if it is found that the buyer wrongly cancelled, the shipyard will rank as an unsecured creditor of the buyer (which is likely to be a single purpose company of limited means) in a claim for its losses.

Furthermore in circumstances where the buyer is paying only a minimal proportion of the overall contract price in advance of delivery, the shipyard should consider whether there is scope to obtain security from the buyer for the delivery instalment. In the current market this may not be possible to negotiate, but before the shipyard commits itself to limited upfront financial commitment from a speculative buyer it should factor in the risk of the buyer walking away and the shipyard being left with an asset of limited market value (which was seen in offshore construction, particularly for jack-up rigs, following the oil price bust in 2014 arising out of the global crude oil glut).

Finally, and once construction starts, the shipyard should ensure that it follows the contractual procedures (including those for drawing approval, variations and notices such as for force majeure and inspections) and maintains a full record of construction progress. Evidence of good contract administration and the availability of construction records are likely to be a vital resource for a shipyard in the event of a dispute.