

# Shipbuilding Contracts in a Seller's Market

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**PRACTICES** International, Shipping, Ship Construction and Conversion, Construction, Shipping Dispute Resolution

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Most shipbuilding contracts derive from a few standard forms (mainly, the Shipbuilders' Association of Japan form) with modifications that have been made over many years, spanning several ups and downs in the shipping and shipbuilding market. The risks for buyers and shipyards, however, can change significantly depending on the state of the shipping and shipbuilding market. Despite the recent dip in newbuilding orders because of a number of uncertainties, the fundamentals may remain the same. If that is the case, the shipbuilding market is likely to be a seller's market for some time to come. How can a buyer better protect its position?

## The Shipbuilding Market

2024 was an exceptional year for newbuilding orders. In terms of gross tonnage ordered and newbuilding prices, 2024 saw levels that were among the highest on record. Activity was particularly strong in the container market with a large portion of orders for alternative fuel vessels, particularly LNG DF, while bulk and tanker orders have remained focused on conventional fuels. The boom has been driven by a combination of factors, including demand for fleet replacement of a middle-aged fleet (the tanker fleet is now the oldest it has been since the late 1990s) and the recycling of profits from the last few years into replacement, renewal and growth strategies. This has contributed to a high level of newbuilding (and retrofit) demand across most vessel sectors. Demand has weakened in the last few months on the back of weaker trading, as prices have become difficult to justify compared to current earnings. Geopolitical uncertainty is also deterring investment. With a lack of clarity over tariffs, Ukraine and the Red Sea, it makes long term predictions almost impossible. The proposed action of the United States Trade Representative proposing the imposition of substantial port fees on vessels entering U.S. ports that were built in China, operated by Chinese companies, or even operated by non-Chinese companies that have *other* vessels either built or on order in China is also likely to result in a "wait-and-see" approach in the market until the outcome of such proposed action is known (the timeframe for which is unclear). However, even if 2025 sees a dip in contracting, the replacement requirement and the increasing penalisation of consumption and pollution should ensure continued investment in more fuel-efficient newbuildings, which should keep demand robust and pricing resilient.

In response to the post-COVID surge in demand, there has been a significant increase in shipbuilding capacity, with the first new facilities for many years being added as well as increased capacity through improved productivity and the revival of some mothballed facilities. Capacity has only really grown in China, however, with Korea and Japan restricted by limited labour availability and significantly lower profitability. With yards so busy, some are under commercial or technical pressure as they struggle to manage big orderbooks, particularly in relation to providing refund guarantees and meeting contractual delivery dates; although this is only really the case in China, and mainly at less established yards.

## What Steps Can a Buyer Take to Protect Itself in a Seller's Market?

In a strong shipbuilding market, a buyer will want to ensure that it can take delivery of the vessel and start trading as soon as possible. The shipyard, on the other hand, may find it has potential buyers willing to pay a higher price for a vessel (or for the drydock slot for that vessel) than an existing buyer has agreed to pay, or may find that it has been caught out by inflationary pressures on its building costs, making the project less profitable or even loss making.

These market forces will impact how buyers and shipyards negotiate and operate their shipbuilding contracts.

What, then, are the key things a buyer should do to mitigate risk in this type of market?

## 1. Risk That Contracts Are Not Legally Enforceable

*Avoid or limit conditions precedent to contract effectiveness*

While it is common to see a requirement that certain specified events occur before a contract becomes effective (such as board approval), a buyer should avoid conditions precedent to contract effectiveness where possible, particularly those not within the buyer's control. If that is not possible, the buyer should limit conditions precedent, both in terms of number and also the period of time for their fulfilment. It is preferable for the provision of refund guarantees to be made a condition precedent to payment by the buyer of any pre-delivery instalment rather than a condition precedent to contract effectiveness, bearing in mind that it can take time for refund guarantees to be issued.

*Ensure all requirements for contract formation are present*

The following must all be present to amount to a legally enforceable contract: offer, acceptance, consideration (unless the agreement is entered into as a deed), intention to create legal relations and the agreement must be sufficiently certain. Courts and tribunals are unlikely to enforce agreements which are incomplete or too uncertain.

This can be an issue for option agreements under which a buyer has the option to purchase additional vessels in the future, often at the same or a similar price. These can be particularly popular with buyers in a rising market. However, a buyer sometimes believes it has a binding option agreement with a seller when the terms agreed are too vague to be enforceable or the 'contract' they have, legally, is nothing more than an 'agreement to agree' which is unlikely to be enforceable under English law.

## 2. Risk of Excessive Delay in Delivery

In a seller's market, the buyer will want to take delivery of the vessel as soon as possible and will be extremely reluctant to cancel the shipbuilding contract. In these circumstances, the usual contract structure of payment of liquidated damages (LDs) by the shipyard to the buyer for delay in delivery, followed by a buyer's right to terminate the contract once delay LDs reach a certain level will be unlikely to provide adequate compensation for losses suffered by the innocent buyer because of the shipyard's breach of contract. Usually, the buyer will only be entitled to a refund of pre-delivery instalments plus interest. The buyer's lost earnings and the cost and delay resulting from cancelling the contract and starting from scratch with a new yard for a potentially higher price will far exceed the sums recovered from the shipyard. The buyer may instead find itself with no choice commercially but to elect to accept a much later delivery date with no additional LDs or other compensation. A buyer can mitigate this risk by ensuring that:

In a strong shipbuilding market where there is high demand for their services (and their subcontractors and suppliers), shipyards will look to maximise output and profits. This may result in shipyards taking on more work; in some cases, possibly more than they can manage. If that becomes the case, the shipyards may seek to cut corners to maintain schedules and deliver vessels.

It is also worth bearing in mind that a booming shipbuilding market may result in the project being loss-making for the shipyard as the shipbuilding contract price will be fixed at the outset, based on the shipyard's internal estimate of the costs of building and delivering the vessel. These costs will be incurred over the lifetime of the construction project. If the strong market leads to inflation in the shipyard's subcontractor, supplier or labour costs, which has not been considered in the shipyard's original estimate, this may reduce or even eliminate the shipyard's profits.

It is therefore important for a buyer to ensure that:

- The level of LDs is adequate to incentivise progress and provides a meaningful level of compensation to the buyer in the event of delay, and is not subject to a cap.
- Pre-delivery instalments are paid on the basis of progress (measured objectively – e.g. stage certificates certified by Class) rather than simply by specified dates.
- Permissible delay provisions (e.g. *force majeure* provisions) do not include the shipyard's subcontractors'/suppliers' delays (or anything else that falls within the subcontractors' or suppliers' control).
- The parties agree to a sensible construction schedule and the buyer's personnel utilise the tools contained in the contract that allow them to monitor and encourage progress.
- It does not readily give up common law rights and should carefully assess any limitations on the shipyard's liability. An exclusion of a buyer's common law rights may, for example, result in the buyer being unable to terminate the shipbuilding contract for repudiatory breach (at the same time as terminating under the contract terms) and recover its losses arising from that breach as common law damages in addition to recovering the pre-delivery instalments plus interest.

### 3. Risk of Quality Issues

In a strong shipbuilding market where there is high demand for their services (and their subcontractors and suppliers), shipyards will look to maximise output and profits. This may result in shipyards taking on more work; in some cases, possibly more than they can manage. If that becomes the case, the shipyards may seek to cut corners to maintain schedules and deliver vessels.

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It is therefore important for a buyer to ensure that:

- The shipbuilding contract contains sufficient rights for the buyer's representatives to inspect the works and attend tests and trials from an early stage of the project. Such rights are all the more important in respect of specialised vessels and those incorporating new technologies.

Early problems, particularly with the design, can lead to significant defects and delays at a later stage if they are not addressed quickly.

- The shipyard takes full responsibility for the design of the vessel (as opposed to the shipbuilding contract providing for split design responsibility between the parties, which can be a breeding ground for disputes).
- It has control over (i) the extent to which the shipyard may subcontract, (ii) the shipyard's choice of subcontractors for key subcontracts (and suppliers of key pieces of equipment), and (iii) subcontracting terms.
- It has as extensive rights as possible in respect of post-delivery defects. A shipyard's liability is typically limited to defects notified to the shipyard within a specified period after delivery. It is also typically limited to the cost of repairing the defect itself, with no liability for other significant costs that arise, including the costs of the vessel being out of service and the cost of taking the vessel back to the shipyard (or another yard) for repairs. The buyer should ensure that the shipbuilding contract entitles the buyer to arrange for repairs itself and claim as much as possible of the repair costs from the shipyard. The buyer should also try and obtain extended warranty periods for elements of the work which, if defective, may not exhibit the defect within the standard warranty period.

#### 4. Risks Arising from Variations

For the reasons explained above, the shipyard may be subject to inflationary pressures which may eat into or eliminate its anticipated profit on the project in a strong shipbuilding market. If that is the case, the shipyard may try to recover time and costs by claiming variations under the shipbuilding contract. Protections for a buyer in variation clauses may include:

- A requirement for the shipyard to issue a variation order request within a specified time after the events claimed to give rise to that request, failing which the shipyard is barred from claiming a variation.
- A requirement for variation orders to be agreed before the shipyard proceeds with alleged variation works, failing which the shipyard is barred from claiming a variation.
- Notwithstanding the above, if there is a dispute about whether there has been a variation, or the consequences (in terms of time and costs, etc.) of that variation, the buyer is entitled to instruct the shipyard to perform the disputed work and there is then a robust mechanism for determining the reasonable price for any variation. This is to avoid the shipyard being able to hold the buyer to ransom by delaying the work or refusing to carry out a requested variation.

In summary, if the strong shipbuilding market continues despite the current dip in demand, then buyers would be well advised to adopt strategies to try to combat the specific additional risks that may result from this. However, it is important to recognise that within the normal framework of the usual shipbuilding contract, the contract can only go so far in protecting the buyer's position. It is important that the buyer does not let its desire to obtain a profitable vessel as quickly as possible displace due diligence. The buyer in this market must exercise extra care in selecting the shipyard in terms of its reputation, experience, technical capabilities and financial standing. Even a strong contract will not fully protect the buyer against a poorly performing shipyard.

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