SOME COMMON ISSUES IN SHIPBUILDING CONTRACT ARBITRATIONS

与造船合同仲裁相关的共性问题

Ian Gaunt,
MA, FCIArb, DiplCArb

Introduction

It is reasonably estimated that 90% of international shipbuilding contracts are governed by English law and perhaps 80% are subject to English arbitration, many on Terms of the London Maritime Arbitrators Association (LMAA). The collapse of freight markets in late 2008 and 2009 (with a corresponding sharp decline in ship values) led to a crisis in the shipping industry which affected almost all sectors of the shipbuilding industry too. The problems have continued. The situation led to many arbitrations with owners trying to get out of shipbuilding contracts or renegotiate terms, in particular to delay deliveries or reduce prices, or to cancel contracts on grounds of shipyard delay. The following is an overview of some of the issues which have come to the attention of LMAA arbitrators in dealing with recent shipbuilding cases, particularly the large number involving Chinese and Korean shipyards, many of which are now in serious financial difficulty.

Frustration and the economic crisis

In the early stages after the crisis hit in 2008 and early 2009, some buyers hoped to get out of shipbuilding contract obligations by invoking the principle of frustration. It is quite clear from English court decisions that the crisis in this case, although unusually severe, could not be relied on to claim that performance has been discharged by frustration.

Commercially, contracts may have become considerably less attractive to perform and new ships may have to be laid up but this did not, and will not in future, persuade London arbitrators or the English courts to excuse a buyer from performance.

Buyer's performance and shipyard risk

As a general point, shipbuilding contracts for standard ships do not usually require many steps in performance from the buyer. Normally the buyer's obligations are confined to paying the pre-delivery instalments and taking delivery and paying the balance of the contract price due on delivery. The buyer is expected to provide buyer's supplies but in most cases these are a relatively minor part of the overall ship construction and do not affect the critical path (关键路径). The buyer has the right (but not an obligation) to provide an inspection team and is expected to approve construction drawings. If however the buyer does not approve the drawings within a stipulated time, the shipyard is entitled to proceed with construction according to its version of the drawings (provided that, where relevant, they also have classification society approval). This means that if the buyer pays the pre-delivery instalments (amounting to perhaps 40% of the price) the shipyard may not know until shortly before delivery that the buyer intends to try to reject the ship on doubtful or speculative technical grounds. By this time the shipyard has a big investment risk unless it has a guarantee for the payment of the final instalment of the price or can complete and sell the ship for a price which will make it whole.

The predelivery instalments made by the buyer in such a case may be retained by the

shipyard until the ship is sold but the shipyard will then normally be required to account for any surplus (buyer's paid instalments + net sale proceeds to third party buyer less original contract price). Two issues arise:

(1) if it is impractical to complete the ship for sale (for example if no more than the keel has been laid - which requires no more than 50 tons of steel to be placed on the blocks), can the buyer compel the shipyard to render some form of account for the pre-delivery instalments paid. This may depend on the wording of the buyer default clause and whether this situation has been expressly provided for. If it has not, it is unlikely that an arbitration tribunal will order an account and the pre-delivery instalment will in effect be treated as a deposit and forfeited.

(2) If the ship is completed and sold and ,as is ususally expressly stipulated, an account is required, the shipyard will be required to provide detailed evidence to support its costs and expenditures. In a number of London arbitration cases the shipyard has not been able to provide evidence to back up its claim for, for example, costs of insurance, maintenance of refund guarantees, lay-up costs etc. and its claim has accordingly been reduced so that the buyer has been effectively able to reclaim a portion of the pre-delivery payments to which it might not otherwise have been entitled.

Buyer defaults and permissible delays

In a number of arbitration cases where a buyer had cancelled a shipbuilding contract for delay by the shipyard, the shipyard argued that the delay had been caused by breaches by the buyer of specific obligations under the shipbuilding contract (for example to return

approved drawings within a given period or to inspect the ship in a timely way). This argument (often based on rather scanty evidence and seldom successful) frequently resulted in long drawn out cases (and resulting legal expenses). Detailed evidence about the conduct of individual inspections etc had to be heard in oral hearings. This sort of argument is now perhaps less likely to be advanced following the 2014 English High Court decision in *Jinshan Zhouhaiwan Shipyard Co., Ltd v Golden Exquisite Inc*. In this case the judge held, as a matter of construction of the shipbuilding contract, that such buyer defaults were in effect part of the "permissible delay" regime. Thus, if the shipyard has not given the relevant notices required under most shipbuilding contracts as a condition for a claim for delay (as is often the case), the shipyard's claim to take account of these delays will fail. It will also fail unless the shipyard can prove that the delay in delivery of the ship was caused by the buyer's breach (see further below)

The "prevention principle": 妨碍原则

In civil construction contracts, outside the field of shipbuilding, the so-called "prevention principle" has been successfully invoked to enable a builder to defeat arguments by a buyer that the builder has not completed a project on time, that is where the buyer has allegedly itself held up the construction and caused or contributed to the delay by failing to fulfil some or all of its own obligations under the contract. Where the argument is successful, time for completion may become at large and the buyer will not be able to rely on provisions entitling it to terminate the contract for failure to complete the ship by a given "drop dead" date. This principle has been adopted in argument in a number of

recent shipbuilding cases. The argument is effectively a variant of the argument referred to above under the heading "buyer defaults".

Whilst it may have some relevance, as was recognised in *Adyard Abu Dhabi v SD Marine Services* in 2011, the application of the "prevention principle" to most shipbuilding cases is likely to be limited, unless for example the buyer is required to provide a significant element of the design or "buyer's supplies" on a large scale (for example in contracts for offshore vessels and structures where the buyer frequently undertakes to supply the "topside" equipment or so called "owner furnished equipment" or "OFE"). Even then the principle can not be invoked successfully if the contract itself includes express provisions dealing with the consequences of the relevant action or inaction as is usually the case in the form of force majeure or permissible delay clauses extended to actions or inaction of the buyer as well as third party events and natural causes..

Permissible delays and causation

A large number of cases involving cancellation for delay have involved consideration of whether an alleged default by a buyer actually caused a delay in the delivery date of the ship. This could equally apply in cases where the contract is not cancelled for delay but where there has been a delay and there is an argument as to whether liquidated damages for delay are payable. Shipyards all too often take it as assumed that a tribunal will accept that the mere occurrence of an event listed in the "permissible delay" or "force majeure" clause will entitle them to a claimed delay and postponement of the contractual delivery

date. This is not so. As the party trying to rely on what is in effect an exemption, they must be in a position to *prove* on a balance of probabilities that the delay claimed was caused by the relevant event of permissible delay or force majeure event.

Shipyards should be aware that in cases where they seek to reply on permissible delays, they will now almost always be met by evidence from experts in critical path analysis (关键路径分析) engaged by buyers to challenge whether an admitted event actually caused a critical delay. In many cases in which shipyards have asserted claims for permissible delay the shipyard's claim has been destroyed by opponents' experts on the basis of lack of proof of causation of the delay. The shipyard will almost always be challenged to produce in evidence planning records which prove the linkage between critical events in the production schedule and evidence that the delay was caused by the relevant event. Ideally these should be not only produced retrospectively for the purposes of the arbitration but also built into the planning process. Whilst it is clearly possible to build ships without taking account of critical path analysis, an awareness of the need to be able to justify permissible delays by reference to this technique is essential in the building process (and may indeed help the shipyard itself in administering the construction process).

"Estoppel" and "affirmation" arguments

Many recent arbitration cases have involved arguments based on a principle of evidence known as "estoppel" which can be sub-divided into estoppel by representation

(陈述性禁止反言), promissory estoppel (允诺性禁止反言) or estoppel by convention (共识性禁止反言). The shipyard's argument in such cases is that the buyer has in some way conducted itself so as to lead the shipyard to change its position so that it would be unfair for the buyer to claim later that it had not done so and to insist strictly on the rights set out in the contract text. An example might be where the buyer had allegedly agreed to a postponement of the delivery date whilst a particular engineering or supply problem was resolved. It should be borne in mind that this type of argument will often lengthen the proceedings because the arguments involve detailed examination of the dealings between the parties over a significant part of the construction period and depend heavily on oral evidence by witnesses at expensive hearings.

In a similar line of argument a shipyard has had more success in a claim that the buyer had "affirmed" a shipbuilding contract when it had not exercised its right of cancellation which had undoubtedly arisen because of delay. but had allegedly encouraged the shipyard to believe that the right would not be exercised: *Primera Maritime (Hellas) Limited v Jiangsu Eastern Heavy Industry Co., Ltd (2015).* (This was also, interestingly a case in which the parties had expressly agreed to exclude the right to appeal to the English High Court on the basis that the tribunal had made a mistake of law. The appeal was brought on the grounds that the tribunal had committed a serious procedural irregularity in not addressing one of the issues raised by the buyer in the arbitration. This was quickly dismissed by the court as being a disguised attempt to appeal on a legal point when the right to do so hade been excluded).

Involving an assignee financier in renegotiations with the buyer

Many buyers assign their rights under a shipbuilding contract to their financiers. Shipyards dealing with a buyer where a project has got into difficulty (for example because of cost overruns or delay) need to be very careful to consider the position of the assignee since an agreement with the buyer may not be binding on the assignee once notice of the assignment has been given unless the assignee has expressly agreed to it. Whether the shipyard needs to involve the assignee in negotiations depends on a careful study of the wording of the notice of assignment given to the shipyard. Assignee banks often reserve the right to step into the position of the buyer after giving notice of a default, but do not always want to do so do that the buyer will continue to ”front” the claim.

Where the benefit of the shipbuilding contract has been assigned to a bank, careful thought also needs to be given as to whether it is necessary to join the bank assignee as a party in arbitration proceedings as well as the buyer/assignor.

Shipyard insolvency and stays of arbitration proceedings

Bankruptcy and insolvency reorganisation proceedings to which a shipyard has been subjected may in turn affect pending arbitration proceedings in other jurisdictions. If an arbitration has its “seat” in London the UK Cross Border Insolvency Regulations may be applicable so that, on an application by the bankruptcy or reorganisation administrator of the insolvent company, the English court may stay English arbitration proceedings

pending the outcome of the foreign insolvency proceedings. LMAA arbitrators have been involved in a number of such cases mostly concerning Korean insolvency proceedings affecting shipyards and shipowners, most recently the Korean shipping company Hanjin. It is in fact surprising that no bankruptcy administrator in China has apparently tried to stay claims in a London arbitration against any bankrupt Chinese shipyard. It needs to be understood in this context that it is not enough for a party to an arbitration to simply claim to the arbitrators that both China and the UK have adopted the UNCITRAL Model Law on Cross Border Insolvency and therefore the arbitrators ought to stay the arbitration proceedings. It is necessary to make a formal application to the English Court for the Chinese bankruptcy proceedings to be recognised and the arbitration stayed. This can however be done comparatively easily and quickly.

Immediate partial awards in respect of pre-delivery payments

In cases where it has become apparent that a buyer will not wish to proceed to perform a shipbuilding contract but the contract provides for pre-delivery payments to be made on specific dates rather than by reference to particular stages of construction (e.g. steel cutting, keel laying, launching etc), a shipyard may try to apply for an immediate partial award in respect of the unpaid instalments as debts due, even though the shipyard has done little to progress the construction. English caselaw suggests that an immediate partial award may be appropriate in such circumstances (unless there has been a total failure of consideration on the part of the shipyard because it has not itself done anything to perform the contract).

Refund and performance guarantees

Many buyers have attempted to find grounds for terminating shipbuilding contracts (in most cases delay by the shipyard) and to claim on refund guarantees to obtain repayment of pre-delivery instalments of the contract price. Sometimes buyers have been surprised to find that refund guarantees will not pay out when and how they had anticipated. This is particularly the case when the contract has few provisions for termination until the final cancellation date is reached or unless it can be proved that the ship cannot physically be completed by that date. For example the insolvency of the shipyard may not automatically be a ground for the buyer to terminate unless this is provided in the contract. An issue of this kind has led to an important 2011 decision of the English Supreme Court: *Rainy Sky Inc and others v Kookmin Bank*.

It is extremely important for the shipyard, the issuer of a refund guarantee and the buyer to make sure that the provisions of the refund guarantee fit perfectly with the provisions of the shipbuilding contract and that they understand the conditions on which the guarantee can be called on. There have been many cases in this area which are the result of poor drafting.

It is also apparent that different jurisdiction provisions in shipbuilding contracts on the one hand, which are invariably subject to arbitration, and refund and performance guarantees on the other, which are frequently subject to the jurisdiction of the English High Court, cause difficulty and delay in resolving issues concerning the guarantees.

Often a shipyard will give notice of arbitration under the shipbuilding contract simply to block a call on a guarantee and then take no further action until the buyer makes a claim. The LMAA Terms 2017 now provide that a claimant should "normally" serve claim submissions within 28 days after service of a notice of arbitration. This may enable arbitrators to expedite the resolution of the claims by requiring the service of claim submissions by orders. These may enable the claim to be dismissed if the order is issued in peremptory form and claim submissions are not served by the relevant party in breach of the order. In practice however, it may be necessary for the buyer to serve claim submissions (even though it was the shipyard which gave notice of arbitration) so that the buyer can obtain an arbitration award and unlock the refund guarantee by presenting the award to the refund guarantor.

Finally, on this subject I would draw attention to the distinction in English law made between secondary or "see to it" guarantees which may require the claimant to show that there has been a breach of an underlying obligation under the contract guaranteed on the one hand, and performance bonds callable on demand on the other. Most refund guarantees issued for obligations of a shipyard to repay pre-delivery payment if the shipbuilding contract is cancelled will be performance bonds of the second kind (although the obligation to make payment is usually postponed until the issue of an award in favour of the buyer if arbitration proceedings challenging the buyer's right to cancel the contract are started by the shipyard): see *Spliethoffs Bevrachningskantoor BV v Bank of China Limited (2015).* Similarly, guarantees given by a buyer's bank to the shipyard to secure pre-delivery instalments will also normally be performance bonds rather than "see

to it" or secondary guarantees: see *Wuhan Guoyu Logistics Group Co., Ltd v Emporiki Bank (2012)* .

Deliverability

A critical issue which has arisen in a number of cases has been the question of when a ship is in a deliverable condition under a shipbuilding contract. A detailed specification is always an important part of the shipbuilding contract documentation. However, a ship may in some cases be validly tendered for delivery and the buyer obliged to take delivery where not every detail of the specification has been 100% complied with. This is particularly the case if the classification society under whose survey the ship has been built is prepared to issue the statutory safety and other certificates for the ship and the ship has passed through sea trials (even with non-class remarks). This is not however to say that a ship for which classification society certificates are available will necessarily be deliverable. It is all a question of degree.

English law distinguishes between contractual *conditions, warranties, and innominate terms.* "Conditions" are terms of the contract which if not complied with give rise to a right to reject and terminate the contract (in other words they automatically result in the breach of condition being regarded as repudiatory). "Warranties" are contractual terms the breach of which gives rise to a claim for damages but does not give rise to a right of rejection or termination. "Innominate terms" (which include may provisions of the specification for a ship) are contractual obligations the breach of which may or may not give rise to a right to reject and terminate and therefore be treated as repudiatory,

depending on the significance of the term in the context of the contract and the consequences of the breach. The test laid down in 1962 in *Hong Kong Fir Shipping Co., Ltd v Kawasaki Kisen Kaisha* (and elaborated in several important decisions since) is whether the breach would deprive the "innocent" party of substantially all, or a substantial part of, the commercial benefit which it has contracted to receive. In the context of a shipbuilding project this would depend on whether the ship could or could not be reasonably used for its intended commercial purpose, including any particular purpose if that purpose had been drawn to the attention of the shipbuilder. In some cases compliance with classification society rules such as to enable class certificates to be issued will rule out the conclusion that the tender for delivery of the ship which is not 100% compliant with the specification involves a repudiatory breach but, if a standard cargo ship also complies with the "conditions" as to carrying capacity, speed and fuel consumption specified in the contract (and which carry rights of termination if not complied with by more than a specified margin), the buyer may find it difficult to argue successfully that a breach of another requirement of the specification is "repudiatory", even if it may give rise to a claim for damages.

Backdating of shipbuilding contracts

There have been a number of arbitrations In London in recent years where it has been apparent that a shipbuilding contract has been deliberately backdated to try to avoid the need to comply with construction regulations which have been introduced by reference to the date of the contract (rather than the date of for example keel laying). A prime example is the PSPC Regulations introduced rather hurriedly by IACS as part of the

Common Structural Rules for bulk carriers. In these cases it has been argued, usually successfully, that the shipbuilding contract as a whole is void for illegality. This is likely to be the result on the basis of English case law even if it is not established that some person (e.g. class) has actually been deceived. The point to make is that this is a dangerous practice and to be avoided at all costs, however keen the buyer or shipyard may be to take advantage of a short window in the construction schedule.

Parallel proceedings in local courts

The objective of arbitration is to provide a means of resolving commercial disputes without intervention of the courts. In those 150 or so countries which are parties to the 1958 United Nations Convention of the Recognition and Enforcement of Foreign Arbitratral Awards (the New York Convention) the courts will normally decline jurisdiction where the dispute is the subject of an arbitration agreement between the parties. It has however come to be a quite frequent practice, not least in cases involving shipbuilding contracts and related refund guarantees, for a party to try to frustrate the likely consequences of an international arbitration award by launching court proceedings in its own country. In China this has often taken the form of an action in a local maritime court alleging fraud and seeking to restrain a bank refund guarantor from making payment under its on-demand refund guarantee on the publication of an arbitration award adverse to the shipyard. Whilst the proceedings in the local court have frequently been dismissed eventually, they have invariable caused delay and expense, not all of which may be recovered by the successful party.

The remedies available to the party seeking to rely on a London arbitration agreement when parallel proceedings are brought in another country are, generally, (1) to seek an anti-suit injunction from the court of the "seat" of the arbitration (usually the English Court) or from the arbitration tribunal itself and (2) to claim damages for breach of the arbitration agreement and, possibly, (3) to seek a from the English court a declaration of non-liability in the foreign court proceedings or, if a third party such as a bank or insurer is involved, (4) claim In the English court for the tort of conspiracy to induce a breach of the arbitration agreement. The anti-suit injunction is addressed to the parties in such a case, not to the foreign court. The extent to which the party to which the injunction is addressed takes account of the injunction may well depend on whether it has officers or assets within the jurisdiction of the English court. Beyond this, a claim for damages for breach of the arbitration agreement before the English arbitration tribunal or English court may of course lead to an award or judgement which may be enforceable in another country in which the defendant does business or has assets.

Guarantee claims and "consequential" losses

The normal arrangement under a shipbuilding contract is for the shipyard to offer guarantee of defects which become apparent in the ship within a period of 12 months from delivery. This guarantee will usually be expressed to cover the repair or replacement of defective parts or equipment but will expressly exclude liability for "consequential" loss. The Newbuildcon form (clause 37(b)(ii)) makes it clear that this excludes "loss of time, loss of profit or earnings or demurrage directly or indirectly incurred by the buyer". This exclusion of consequential losses may not however exclude certain other losses

directly resulting from defects falling within the guarantee. One example would be the costs of additional oil needed to be consumed because of a defect in the exhaust gas boiler. Another example might be contamination of cargo due to defective application of tank coatings. The recent case of *Star Polaris LLC v HHIC Phil Inc (The "Star Polaris") (2016)*, where the buyer claimed unsuccessfully for diminution in the value of a recently delivered newbuilding resulting from a main engine failure, suggests however that an exclusion of "consequential loss" may in future be construed quite widely and the shipyard's responsibility correspondingly narrowed, particularly where the warranty clause states that it is or is construed as a compete code for allocating responsibility for post delivery claims.

Other procedural issues of concern

Many delegates will have some experience of London arbitration proceedings but I would make the point that there are two particular issues of concern to those who do not come from a common law legal tradition:

1. the scope of disclosure of documents
2. the cross examination of witnesses.

These procedures may be unusual in China. However, as Mr Zhu Zhihong, General Counsel of Cosco Shipyard Group pointed out in a recent lecture in Dalian, it is essential that in English arbitrations (and equally in Singapore and Hong Kong which follow common law procedures) sufficient attention is paid to the preparation and back up of witness statements and the process of disclosure. Neglecting to do so can lead to losing an otherwise meritorious case.

Conclusion

The foregoing draws attention to a number of particular issues which have been raised in English arbitration cases and appellate decisions in the period since the shipping crisis began in 2009. This talk may give some indications as to how London arbitration tribunals may be expected to approach typical arguments in shipbuilding disputes in the future and as to how parties should approach preparation for such cases. The hope is that parties will thereby be saved at least some delay worry and expense and achieve a certain and just result which London arbitrators certainly aim to do.

IAN GAUNT
MARITIME ARBITRATOR

T: +44 (0)20 235 6878
M: +44 (0)7788720144

61 CADOGAN SQUARE
LONDON SW1X 0HZ

EMAIL: ian.gaunt@virgin.net