Introduction

Just like any other contract, a contract for the building and purchase of a new ship requires the usual elements of offer, acceptance, consideration and parties’ intentions to create a legal relationship. However, it should be noted that a shipbuilding contract is a type of contract that requires close cooperation between the parties, namely the builder and the buyer, to ensure that the objectives of the contract are met.

The building of a new ship is a cost-intensive project and requires commitment, dedication and financial resources on the part of both the builder and buyer. It is for this reason that the entry into a shipbuilding contract is often preceded by a prior course of dealing between the builder and the buyer over a period of time where the parties open up a bridge of communication and develop trust and faith between them.

The purpose of this article is to give some general pointers on shipbuilding contracts and some points of compromise that a builder and a buyer may want to consider.

Contract Documents

The contract documents for a shipbuilding project would often comprise the following:

- a Letter of Intent;
- a shipbuilding contract; and
- Specifications (including the Plans).

Letter Of Intent

A Letter of Intent is usually regarded by commercial parties as being no more than a non-binding statement of intention to work together towards the execution of a formal shipbuilding contract. However, there are instances where the Letter of Intent is viewed as having already created legally binding obligations between the builder and the buyer. As an example, upon the construction of the Letter of Intent, it is found that the terms are relatively certain and the parties had clearly intended to enter into a binding relationship. If the builder and the buyer do not wish to be legally bound until the execution of the shipbuilding contract, then the Letter of Intent should be drafted to be non-binding and state that it is subject to the negotiation and execution of a shipbuilding contract.

Shipbuilding Contract

Although there is no formal legal requirement for a shipbuilding contract to be in writing, owing to the extensive rights and obligations of the parties during the project, the builder and the buyer will usually enter into a formal written contract that is based on one of the common shipbuilding forms. The forms may have taken into account the common contractual problems that have plagued builders and buyers in the past. However, as these forms usually emanate from shipbuilders’ associations, certain provisions are slanted in favour of the builder. The buyer should
thus take care to ensure that its own interests are not unduly compromised by the forms.

One common form is the Shipowners’ Association of Japan Form (‘SAJ Form’). Owing to the brevity of this article, reference shall only be made to the SAJ Form as it is the most commonly used form especially for ships built in the Far East.

**Specifications**
The Specifications basically set out the description of the ship being built.

**The Legal Nature Of The Shipbuilding Contract**
Although there may be elements of construction present in a shipbuilding contract, its ultimate aim is the sale and purchase of a completed ship. Hence, such a contract can be described as an agreement to sell future goods by description. That being the case, the conditions inherent in sale of goods law, for example, the conditions of correspondence to description, satisfactory quality and fitness of purpose, would apply. It is little surprise then that builders may have to take pains to exclude the applicability of such conditions to the shipbuilding contract.

**Suggested Points Of Compromise**
In order for the parties to enjoy a close relationship in a shipbuilding venture, both the builder and the buyer would do well to compromise on certain aspects of the shipbuilding contract based on the SAJ Form, some of which are highlighted in the following paragraphs.

**Liquidated Damages**
The buyer may be anxious to overstate the liquidated damages in the SAJ Form. The latter provides for compensation to be payable by the builder where the ship fails certain thresholds. These thresholds are usually in relation to the ship’s speed, fuel consumption, deadweight and where applicable, container capacity.

For instance, it may be provided that the buyer has a right to rescind the contract or reduce the contract price at a stipulated rate when the speed of the vessel falls below certain thresholds. The right to rescind given to the buyer is seen as an alternative to receiving liquidated damages.

As with any other contract, the courts may hold as void a purported liquidated damages clause on the ground that the amount provided for is not a genuine pre-estimate of the buyer’s loss, and amounts to a penalty instead.

The buyer may thus want to reconsider ‘over-stressing’ the liquidated damages provision, in an effort to get the builder to compromise further on some contractual provisions that are traditionally slanted in favour of the builder. In addition, the buyer may want to incentivise the builder by agreeing to increases in the contract price where the performance of the ship exceeds a certain threshold above the guaranteed benchmarks. This is especially so where the ship can be delivered more than 30 days earlier than the contracted delivery date and the buyer has immediate and lucrative employment for the ship.

**Subcontracting**
The SAJ Form provides that the builder has an unfettered right to subcontract any portion of the construction work of the vessel to a third party. This is not desirable for the buyer. It is thus suggested that the buyer restricts the builder’s rights to subcontract by requiring that:

- the builder seeks the buyer’s prior written consent, such consent not to be unreasonably refused or delayed; and
- the builder remains ultimately responsible for the subcontracted works, even though this may be implied.

The above qualifiers can be justified since the builder may require any delay or defective performance on the part of the subcontractor to be a ‘permissible delay’ thus extending the contracted delivery date under the force majeure provisions. In addition, the buyer should also ensure that the builder’s limited warranty against defects in the ship (usually for a period of 12 months from the date of delivery) also includes the works done by the subcontractors.
Force Majeure Provisions - Delay in Delivery Date

If the builder invokes a force majeure provision in the shipbuilding contract to delay the delivery date, this would constitute a 'permissible delay'. Other permissible delays include a request for modifications or alterations to the ship requested by the buyer, or a delay in payment by the buyer.

The force majeure provisions are generally couched in wide terms in order to protect the builder from circumstances 'beyond its control'. One such circumstance is the performance of its subcontractors. The buyer should ensure that the builder is only able to rely on a fault on the part of a subcontractor as constituting force majeure if the builder can show it exercised due diligence when choosing the subcontractor in an effort to ensure that a margin for delay was catered for in the contracted delivery date.

The buyer should ensure that the builder strictly complies with any contractual notice of force majeure. Note that in the SAJ Form, the builder has to give a written notice to the buyer within seven days from the date of commencement of the delay claimed by the builder as a force majeure event. There are, however, no express wordings in the SAJ Form prohibiting the builder from relying on force majeure if the builder fails to give the notice in accordance with the terms provided. Although it may be implied that in such a case, the builder has lost its right to rely on force majeure, the buyer should ensure that this is expressly stated.

Default

Although there are provisions for the buyer’s default in the SAJ Form, they are not comprehensive. For example, the position of insolvency or cross default in other agreements between the builder and the buyer are apparently not taken into account. They should be included - especially where the builder and the buyer have entered into more than one shipbuilding contract.

The deficiencies with respect to the builder’s default are even more glaring - there are basically no contractual provisions dealing with this. It is suggested that provisions be included dealing with the builder’s default, in similar terms as the buyer’s default, where applicable.

Buyer’s Representatives And Refund Guarantee

Other important matters to be considered are the buyer’s representative (‘Representative’) and the Refund Guarantee.

As the shipbuilding contract is a close collaborative effort between the builder and the buyer, the Representative should be up to his job. He has to be present at the builder’s yard to maintain a close liaison with the Classification Society and the builder and to give certain approvals on behalf of the buyer, for example, on the plans and drawings of the ship. The Representative’s role also becomes critical during the sea trials of the ship. The SAJ Form may preclude a buyer from rejecting the ship once the Representative has accepted the ship after the sea trials.

In most shipbuilding contracts, the buyer would insist on a Refund Guarantee from a first class bank to secure a refund of the pre-delivery instalments paid by the buyer to the builder in the event that the buyer becomes entitled to a refund pursuant to the buyer’s rescission of the shipbuilding contract. It is important that the buyer carefully reviews the terms of the Refund Guarantee. In particular, as the buyer may wish to sell the uncompleted ship to a third party in the course of its construction, the Refund Guarantee should be assignable to the benefit of another party at the buyer’s request.

Conclusion

As can be seen, a close, intimate relationship between the builder and the buyer is desirable during the pre-contract stages and during the period of construction. This can make the difference between an aborted deal and the successful delivery of a new-born ship.

Anil Sachdev is a Partner with the Admiralty & Shipping Practice Group of Rajah & Tann. For advice on matters relating to shipping corporate issues, Anil can be contacted at anil.sachdev@sg.rajahtann.com.

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