

Shipbuilding 2019

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Shipbuilding

2019

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Lexology Getting The Deal Through is delighted to publish the eighth edition of *Shipbuilding*, which is available in print and online at www.lexology.com/gtdt.

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes a new chapter on Turkey.

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Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editor, Arnold J van Steenderen of Van Steenderen MainportLawyers BV, for his continued assistance with this volume.



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PARTICIPATION AND OWNERSHIP

Restrictions on foreign participation and investment

- 1 | Is the shipbuilding industry in your country open to foreign participation and investment? If it is open, please specify any restrictions on foreign participation.

The commercial shipbuilding industry in the US is open to foreign participation and investment. For example, in 2008, the Manitowoc Marine Group, which includes Bay Shipbuilding Company of Sturgeon Bay, Wisconsin – a builder of barges, dredges, platform supply vessels, articulated tug barge units and ferries – was purchased by Fincantieri Marine Group, an Italian company, and US-based BAE Systems, owned by British multinational BAE Systems.

Government ownership of shipbuilding facilities

- 2 | Does government retain ownership or control of any shipbuilding facilities and, if so, why? Are there any plans for the government divesting itself of that participation or control?

The US government does not retain ownership of commercial shipbuilders. However, commercial shipbuilders that also build vessels for the US military are subject to security controls of varying degrees related to required security clearances for personnel involved in the design of the vessel, and the design, installation and content of certain components and, in some instances, the entire vessel, depending on the sophistication and national security elements of such components or the entire vessel.

KEY CONTRACTUAL CONSIDERATIONS

Statutory formalities

- 3 | Are there any statutory formalities in your jurisdiction that must be complied with in entering into a shipbuilding contract?

There are no statutory formalities or requirements (beyond standard contractual requirements) that must be complied with by parties when entering into shipbuilding contracts for commercial vessels.

Choice of law

- 4 | May the parties to a shipbuilding contract select the law to apply to the contract, and is this choice of law upheld by the courts?

Parties to a shipbuilding contract may select the law to govern their shipbuilding contract as long as the choice of law has some reasonable relation to the contract and the work to be performed thereunder. The

law can be that of the place where the shipyard is located or where the contract is negotiated or where one or both of the parties reside – and such choice of law will be upheld by the courts. Even foreign choice-of-law clauses will be enforced if there are sufficient contacts present. For instance, in *Hartford Fire Insurance Co v Orient Overseas Containers Lines (UK) Ltd*, 230 F3d 549, 556 (2d Cir. 2000) it was held that '[a]bsent fraud or violation of public policy, a court is to apply the law selected in the contract as long as the state selected has sufficient contacts with the transaction'. Additionally, New York law permits parties to select New York law to govern their contractual relationships where the transaction amount is at least US\$250,000 and to avail themselves of New York courts where the transaction amount is at least US\$1 million despite lacking other contacts with the state. See *IRB-Brasil Resseguros SA, v Inepar Investments SA*, 20 NY3d 310, 958 NYS 2d 689 (2012) and McKinney's General Obligations Law sections 5-1401, 5-1402.

Nature of shipbuilding contracts

- 5 | Is a shipbuilding contract regarded as a contract for the sale of goods, as a contract for the supply of workmanship and materials, or as a contract sui generis?

Under US law, a contract for construction of a vessel is a contract for the sale of tangible personal property and is not a maritime contract. Thus, such contracts are subject to articles 2 and 9 of the Uniform Commercial Code (UCC) in the relevant state as well as other applicable state laws. See *Primera Maritime (Hellas) Ltd v Jiangsu Eastern Heavy Industry*, 2009 WL 249249 (SDNY 2009) (citing *CTI-Container Leasing Corp v Oceanic Operations Corp*, 682 F2d 377, 380 n.4 (2d Cir 1982)). It is 'well established that a contract to build a ship is not maritime'.

Hull number

- 6 | Is the hull number stated in the contract essential to the vessel's description or is it a mere label?

The hull number of a vessel is always stated in the contract; it is unique to the vessel's description and for the identification of components and equipment in the shipbuilders' and subcontractors' yards or premises including any equipment and materials furnished by the owner. The hull number also serves other functions, including shipyard accounting for materials and equipment (especially where the shipyard is building a series of vessels and the contract provides that title to work and material passes to the buyer as payments are made – see question 13) and critical path tracking for the shipyard and the classification society. A hull identification number (HIN) (which is not the vessel's hull number) is required by the US Coast Guard to be located on the transom of all vessels constructed in the United States. An HIN is a serial number for vessels. The Code of Federal Regulations (at 33 CFR section 181.23) provides that the last two digits of the HIN denote the year in which a vessel was constructed (33 CFR section 181.25) and that the

manufacturer or builder is required to affix the HIN to the vessel in two locations (33 CFR section 181.23). Vessel identification by HIN or other clearly descriptive data is also a prerequisite to official documentation under 46 CFR section 67.205.

Deviation from description

- 7 | Do 'approximate' dimensions and description of the vessel allow the builder to deviate from the figure stated? If so, what latitude does the builder have?

The vessel's dimensions are generally specified or described in the shipbuilding contract or may be specified in the vessel's specifications, which are typically incorporated by reference in the shipbuilding contract. Generally, the vessel's length and depth are described as 'abt' (about), which affords the shipyard extremely limited deviation within the tolerances of the construction standards of the shipyard and the classification society. However, the vessel's breadth, length between perpendiculars and draft should always be stated precisely so as to allow no deviation from these critical measurements, which are also critical to the vessel's ability to load and trade to certain ports and for some vessels' ability to transit the Panama Canal. The dimensions, if not strictly complied with, may also affect the vessel's deadweight capacity and the liquidated damages clause of the contract.

Guaranteed standards of performance

- 8 | May parties incorporate guaranteed standards of performance whose breach entitles the buyer to liquidated damages or rescission? Are there any trade standards in your jurisdiction for coating, noise, vibration, etc?

Shipbuilding contracts generally contain provisions for the payment of liquidated damages for the failure to meet certain technical requirements of the contract, namely, delays in delivery that are not excused by events of *force majeure* or buyer's fault, insufficient speed, deadweight capacity shortage and excess fuel consumption. The shipyard is provided limited leeway for each of these elements before liquidated damages are payable (as a deduction from the payment of the contract price due on delivery). The buyer is also generally afforded the right to rescind the contract if any of these elements exceed negotiated amounts. Liquidated damage clauses must be reasonable and geared to an estimate of the losses likely to be sustained from the relevant breach. If the liquidated damages specified are deemed to be penal in nature or unconscionable, they are not likely to be enforceable. See *In re Trans World Airlines*, 145 F3d 124 (3d Cir 1998) (liquidated damages provision unenforceable as against public policy, in that damages provided for had no bearing on lessor's probable loss in event of breach); also *Resources Funding Corp v Congregare*, 1994 WL 24825 (SDNY 1994) (citing *Truck Rent-A-Center v Puritan Farms 2d*, 41 N.Y.2d 420, 424-25 1977): 'It is plain that a provision which requires, in the event of a contractual breach, the payment of a sum of money grossly disproportionate to the amount of actual damages provides for a penalty is unenforceable.'). At this time, with the exception of specifically negotiated terms, there are no disclosed trade standards for coatings, noise and vibrations.

Quality standards

- 9 | Do statutory provisions or previous cases in your jurisdiction give greater definition to contractual quality standards?

Quality standards are achieved in great part by contractual requirements to comply with classification and other regulatory requirements and by the buyer confirming that the shipbuilder and its subcontractors have satisfied the relevant requirements of the International Organization for Standardization. Most shipbuilding contracts reference

quality standards, albeit in various formats. Some refer to 'good quality and standards of workmanship and scope of subcontractors to be no less than those which have been incorporated by the builder in vessels of the same class as the vessel' or 'the builder will utilise and incorporate in the vessel the best quality and standards prevailing in the shipyard as of the date of the contract' or 'such standards will be no less than those which have been reviewed and agreed to for the construction of an earlier vessel for the same buyer'. Shipyards are generally loath to refer to quality standards as the 'highest' because such a description is likely to lead to disputes.

Classification society

- 10 | Where the builder contracts with the classification society to ensure that construction of the vessel leads to the buyer's desired class notation, does the society owe a duty of care to the buyer, or can the buyer successfully sue the classification society, if certain defects in the vessel escape the attention of the class surveyors?

Classification societies provide a comprehensive framework of rules (the Rules) detailing the structure and mechanical details of the vessel, the methods to be utilised in the construction of the vessel and assessing the compliance of the vessel with both the Rules and relevant statutory regulations. In addition, working together with the builder and the buyer's on-site supervision team, the classification society surveyors supervise the construction of the vessel and witness tests of materials for the hull and certain items of machinery as required by the Rules. Throughout construction, the classification society's surveyors will maintain an ongoing dialogue with the buyer and the builder to ensure the Rules are understood and adhered to and to assist in resolving differences that may arise. When a vessel is constructed under the supervision of the classification society the classification notation will be preceded by a Maltese cross. In the US, most vessels are classed by the American Bureau of Shipping (ABS), which also performs many supervisory regulatory functions on behalf of the US Coast Guard to ensure compliance with applicable US regulations.

Classification societies are employed by the builder, who also pays their fees. Accordingly, contractual obligations of the classification society are the builder's responsibility rather than the buyer's and, except in limited circumstances under which courts have opened the door to classification society liability (*In re Eternity Shipping Ltd*, 444 F Supp 2d 347 (DMd 2006)), US courts have not imposed tort liability on classification societies in favour of the buyer in conjunction with losses attributable to defects on vessels they have classified. See generally *Sundance Cruises Corp v American Bureau of Shipping*, 799 F Supp 363, 383 (SDNY 1992) aff'd, 7 F 3d 1077 (2d Cir. 1993) ('[I]n *Shipping Corp of India v ABS* (SDNY 1990) 744 F Supp. 447, Judge Motley applied East River to relieve the defendant now before us from tort liability for its professional services in issuing classification certificates.'). and *Reino de Espana v American Bureau of Shipping*, 729 F Supp 2d 635, 643-44 (SDNY 2010) ('[T]he court stated, citing a long line of federal maritime cases, that the ultimate responsibility for the vessel's seaworthiness rests on the shoulders of the shipowner, and the shipowner cannot delegate this duty to a classification society or to any other entity.').

Flag-state authorities

- 11 | Have the flag-state authorities of your jurisdiction outsourced compliance with flag-state legislation to the classification societies? If so, to what extent?

As stated in question 10, the US Coast Guard has outsourced a good part of monitoring compliance with applicable US regulations to the ABS.

Registration in the name of the builder or the buyer

- 12 | Does your jurisdiction allow for registration of the vessel under construction in the local ships register in the name of the builder or the buyer? If this possibility exists, what are the legal consequences of this registration?

US federal law does not currently allow for registration of vessels under construction. In 2009, the Maritime Law Association proposed legislation that would permit a vessel under construction to be documented in the name of the party that actually has title to the vessel construction project under the terms of the construction contract, but this proposed legislation has not yet been enacted. If this proposed legislation becomes law, it would permit the party that has documented the vessel under construction to subject the vessel to a preferred mortgage that would enjoy the same priority benefits and the benefit of admiralty foreclosure procedure that are now enjoyed by the mortgagee of a completed vessel.

Title to the vessel

- 13 | May the parties contract that title will pass from the builder to the buyer during construction? Will title pass gradually, upon the progress of the vessel's construction, or at a certain stage? What is the earliest stage a buyer can obtain title to the vessel?

The parties to a shipbuilding contract may agree as to when title passes from the builder to the buyer. Generally, property in and title to the vessel and all risk and loss remain with the builder until the contract price has been paid in full and the vessel is actually delivered to and accepted by the buyer as evidenced by a protocol of delivery and acceptance signed by both parties. However, some contracts provide that title to all completed work, materials and equipment pass to the buyer as instalments of the contract price are paid to the builder.

Passing of risk

- 14 | Will risk pass to the buyer with title, or will the risk remain with the builder until delivery and acceptance?

See question 13.

Subcontracting

- 15 | May a shipbuilder subcontract part or all of the contract and, if so, will this have a bearing on the builder's liability towards the buyer? Is there a custom to include a maker's list of major suppliers and subcontractors in the contract?

Shipbuilding contracts generally permit the shipyard, subject to negotiated limits such as dollar amounts, distance from the shipyard, the magnitude of work and whether the builder will have to obtain the buyer's consent to each subcontractor, to subcontract certain portions of the work without derogating from the builder's obligations or the buyer's rights under the contract. These clauses are generally the subject of intense negotiations, as the more geographically widespread the subcontractors are, the more difficult it is for the buyer's site supervision team to monitor the quality of any work performed by such subcontractors.

Extraterritorial construction

- 16 | Must the builder inform the buyer of any intention to have certain main items constructed in another country than that where the builder is located, or is it immaterial where and by whom certain performance of the contract is made?

For a US-flagged vessel to be qualified to engage in US coastwise trade (46 USC 55102(b), originally section 27 of the Merchant Marine Act, 1920, as amended (Jones Act trade)) and qualify for a coastwise endorsement on its certificate of documentation it must be, inter alia: built in the United States and owned by entities whose chief executive officer, president and chairman of the board of directors (and anyone that can act in their absence or disability) must be US citizens, and whose equity is at least 75 per cent held (of record and beneficially) by US citizens. A vessel is deemed to be built in the US only if all major components of the hull and superstructure are fabricated in the US and the vessel is entirely assembled in the US (46 CFR 67.97). The US Coast Guard has consistently held that items not integral to the hull or superstructure, such as propulsion machinery, consoles, wiring harnesses and other outfitting that has no bearing on a US build determination, may be foreign-built without compromising the vessel's coastwise eligibility. The US Coast Guard has also held that foreign components amounting to less than 1.5 per cent of a vessel's steel weight are not considered 'major'. Within these confines the shipbuilding contract and the vessel's specifications should permit foreign-sourced materials and equipment to be incorporated in the vessel without adversely affecting the vessel's qualification for a coastwise endorsement on its certificate of documentation. Virtually all shipbuilding contracts will provide for an agreed maker's list of major supplies of listed components. A list of approved subcontractors for specific components of the vessel may also be attached to the shipbuilding contract.

PRICING, PAYMENT AND FINANCING

Fixed-price and labour-and-cost-plus contracts

- 17 | Does the law in your country have different provisions for 'fixed-price' contracts and 'labour-and-cost-plus' contracts?

US laws do not restrict parties to commercial shipbuilding contracts from negotiating fixed price or cost-plus priced contracts, although the latter are virtually non-existent. However, in commercial shipbuilding contracts it is not uncommon to see escalation or economic price adjustment clauses based on increases in costs of materials, steel or labour, calculated by reference to published indices such as the CRU Plate Index (steel) or indices published by the Bureau of Labor Statistics may be incorporated into the contract to provide objective standards for periodic price escalation.

Price increases

- 18 | Does the builder have any statutory remedies available to charge the buyer for price increases of labour and materials despite the contract having a fixed price?

Fixed-price contracts are just that; once agreed, the parties are contractually obligated even if prices for labour, steel or any vessel components increase substantially.

Retracting consent to a price increase

19 | Can a buyer retract consent to an increase in price by arguing that consent was induced by economic duress?

If a buyer has consented to a price increase and later attempts to assert that its consent was induced by economic duress, the buyer will have to prove by a preponderance of the evidence that such was the case – a very difficult burden. See *In re Toscana*, 799 F Supp 2d 230 (EDNY 2011) where it was determined that a claim of duress sufficient to vitiate a contract under New York law requires a showing of a threat, that was unlawfully made, and caused involuntary acceptance of contract terms, because the circumstances permitted no other alternative. Moreover, in *Vanguard Packaging Inc v Midland Bank*, 871 F Supp 348, 352 (WD Mo 1994) it was held that:

[I]n sum, to establish its claim of economic duress, Plaintiff must prove to this Court, by a preponderance of the evidence, that Defendant created a situation of economic exigency for Plaintiff by performing a wrongful act which, in light of all relevant circumstances, overcame Plaintiff's free will and forced it to do something it would not have otherwise done.

Exclusions of buyers' rights

20 | May the builder and the buyer agree to exclude the buyer's right to set off, suspend payment or deduct certain amounts?

Shipbuilding contracts generally provide that each instalment is to be paid in full when due when certain events have occurred or stated milestones have been satisfied without any deduction whatsoever; however, some contracts do provide that amounts of progress payments in dispute may be deposited by the buyer in an escrow account, at the same time as the buyer pays the undisputed amount of the progress payments. In contracts that contain such provisions an escrow account will be opened at the time the contract is entered into. Any amounts escrowed are then paid out at the time the dispute is resolved.

Refund guarantees

21 | If the contract price is payable by the buyer in pre-delivery instalments, are there any rules in regard to the form and wording of refund guarantees? Is permission from any authority required for the builder to have the refund guarantees issued?

Refund guarantees are uncommon in the case of US shipbuilding contracts. Parent company guarantees, both for the builder and the buyer are common. Generally, as a condition of any payment by the buyer to the builder, the builder grants the buyer a continuing first priority security interest in the whole of the vessel and to all of the builder's right, title and interest to the whole of the vessel and all parts thereof, to all inventory, work in progress and all documentation relating to the vessel and in conjunction therewith the builder will execute and deliver UCC Form 1 financing statements in favour of the buyer, the filing of which perfects the buyer's first priority security interest in the vessel and all parts thereof.

Advance payment and parent company guarantees

22 | What formalities govern the issuance of advance payment guarantees and parent company guarantees?

The shipbuilding contract will specify when and what conditions have to be satisfied before the buyer is obligated to make each progress payment. See question 21 with respect to parent company guarantees. Statutory company formalities governing authorisation for the issuance of such

guarantees are dictated by the type of structure of the entity issuing such guarantee and the jurisdiction of its incorporation or organisation.

Financing of construction with a mortgage

23 | Can the builder or buyer create and register a mortgage over the vessel under construction to secure construction financing?

See question 12.

Financing alternatives available to US shipowners

Through two US Merchant Marine Act programmes US shipowners may avail themselves of two alternatives to traditional financial institutions financings – the Capital Construction Fund programme and Title XI Federal Ship Financing Program as described below.

Capital Construction Fund programme

The Capital Construction Fund (CCF) programme is designed to encourage owners of US-flagged vessels built in the US and at least 75 per cent owned by US citizens to accumulate large amounts of capital to acquire additional US-built and flagged vessels by providing tax incentives to do so. The shipowner who wishes to take advantage of this programme applies to the Maritime Administration (Marad) for enrolment, and after its application has been approved enters into a CCF agreement with Marad. These agreements provide that the shipowners may deposit into a CCF amounts up to its taxable income earned by 'eligible agreement vessels', which are listed on the CCF agreement plus the amount of depreciation allowed as a deduction on such vessels. The CCF agreement will also require the CCF holder to make minimum deposits to the CCF unless a waiver is obtained from Marad. Vessel owners are entitled to an income tax deduction for the amount deposited into the CCF attributable to income from eligible agreement vessels. Earnings on funds in the CCF are tax deferred in a similar manner to funds in an individual retirement account.

The holder of a CCF may make a tax-free 'qualified withdrawal' for the acquisition or reconstruction of US-flagged vessels in a US shipyard and to pay indebtedness in connection with such acquisition. US-flagged vessels acquired with qualified withdrawals are 'qualified agreement vessels', which are subject to several restrictions – they must be documented under the laws of the US and must be operated in the US foreign, Great Lakes or non-contiguous domestic trade (trade between the contiguous 48 states and Alaska or the insular territories), or short sea transportation trade (carriage by vessel of cargo that is contained in intermodal cargo containers and loaded by crane on the vessel or loaded on the vessel by means of wheeled technology and that is loaded at a port in the United States and unloaded either at another port in the United States or at a port in Canada located in the Great Lakes St Lawrence Seaway System or vice versa) (as per America's Marine Highway Program). These new qualified agreement vessels include platforms and rigs attached to the sea bed of the outer continental shelf beyond the three-mile limit. All qualified agreement vessels must operate in such trades for 20 years from the date of acquisition. Second-hand qualified agreement vessels must operate in such trades for 10 years from the date of acquisition. That portion of the costs of building a vessel funded by CCF is not eligible to be depreciated for income tax purposes (ie, the tax basis of such vessel is reduced accordingly).

Title XI Federal Ship Financing Program

The primary purpose of the Program is to promote the growth and modernisation of the US Merchant Marine and US shipyards. The Title XI Program enables owners of eligible vessels and eligible shipyards to obtain long-term financing with attractive terms relative to commercial financing alternatives.

Vessels eligible for Title XI financing include, inter alia, US-flagged bulk carriers, tankers, towboats, barges, offshore oil rigs and support vessels.

The amount of the obligations (debt) guaranteed by the US government in a Title XI financing is based on the 'actual cost' of the vessels, which generally includes those items that normally are capitalised as vessel costs under usual accounting practices, such as cost of construction or reconstruction, including design, inspection, outfitting, equipping, shipyard supervision, interest during construction and the Title XI guarantee fee.

The Title XI Program provides for a guarantee of up to 87.5 per cent of the actual cost of most eligible vessels and up to 75 per cent of the actual costs of certain other vessels. The shipowner must provide from its own sources a minimum of 12.5 per cent of the equity for the project. The maximum guarantee term provided is the lesser of 25 years or the remaining economic life of the vessel and the interest rate of the obligations guaranteed is determined by the private sector, generally the benchmark rate being the interest rate carried by the US Treasury obligations comparable to the average life of the proposed debt issue. As part of the application process the shipowner must demonstrate to Marad the economic viability of the project. In 2014, Marad published a notice of a proposed policy to further promote the modernisation of the US Merchant Marine and US shipyards through the construction or reconstruction (to include repowering) of vessels. Marad proposed the consideration of various environmentally friendly initiatives such as alternative fuel system designs, fuel cells, hybrid propulsion systems, air emissions reductions technologies or ballast water treatment technologies that may improve the environmental sustainability of vessel operations to the extent that such initiatives lead to future cost savings as 'other relevant criteria' in its evaluation of the economic soundness of applications made under the Title XI loan guarantee programme. Marad has implemented this policy, albeit for a very limited number of projects.

Marad charges a number of fees to shipowners that avail themselves of the Title XI Program. The applicant must pay a non-refundable fee of US\$5,000 when the application is filed. Prior to the issuance of the commitment letter, the applicant must also pay an investigation fee of 0.5 per cent of the obligations to be insured up to and including US\$10 million plus 0.125 per cent on all obligations to be issued in excess of US\$10 million. Marad may also impose additional fees to offset the cost of external advisers used in the review process. Finally, there is a guarantee fee, which is generally based on the ratio of net worth to long-term debt of the shipowner or shipyard and is generally between 0.25 per cent to 0.5 per cent per annum from the period prior to delivery or during construction and between 0.5 per cent to 1 per cent per annum from the period after delivery. No guarantee fees paid will be refunded.

The above descriptions of the CCF and Title XI Program touch upon certain highlights only.

DEFAULT, LIABILITY AND REMEDIES

Liability for defective design (after delivery)

24 | Do courts consider defective design to fall within the scope of poor workmanship for which the shipbuilder is liable under the warranty clause of the contract?

Builders' warranty clauses are very specific as to what is and what is not covered and as to the time frame of the warranty. The warranty generally covers all defects and damage due to defective workmanship and materials furnished by the builder or its subcontractors or other fault in construction or installation or builder's specifications or drawings and almost universally excludes consequential losses. Attempts to expand the builders' warranty to include any damage caused as a direct and immediate consequence of the defect are extremely difficult to achieve.

Since US courts strictly construe warranties (guarantees), the specific terms of the warranty must be negotiated very carefully. This was held to be the case both in *New York Marine & General Insurance Co v Gulf Marine Towing*, 1993 WL 408374, 2 (ED La 1993) ('[E]xpress warranties are strictly construed in admiralty law'); and *Lexington Insurance Co v Cooke's Seafood*, 835 F 2d 1364, 1366 (11th Cir 1988).

Remedies for defectiveness (after delivery)

25 | Are there any remedies available to third parties against the shipbuilder for defectiveness?

Absent a specific provision expressly conferring on third parties (expressly identified either as a member of a class or by particular description) certain contractual rights, such third parties will be precluded from enforcing any rights under a shipbuilding contract. See, for instance *In re Gulf Oil/Cities Service Tender Offer Litigation*, 725 F Supp 712, 733 (SDNY 1989): 'Although a third party need not be specifically mentioned in the contract before third-party beneficiary status is found, New York law requires that the parties' intent to benefit a third party must be shown on the face of the agreement [. . .]. Absent such intent, the third party is merely an incidental beneficiary with no right to enforce the contract'.

Liquidated damages clauses

26 | If the contract contains a liquidated damages clause or a penalty provision for late delivery or not meeting guaranteed performance criteria, must the agreed level of compensation represent a genuine link with the damage suffered? Can courts mitigate liquidated damages or penalties agreed in the contract, and for what reasons?

The liquidated damages provisions in shipbuilding contracts generally specify that the buyer shall not be entitled to claim any damages, whether direct or consequential, in addition to those specified arising out of the failure of the builder to comply with specified requirements of the contract. See question 8.

Preclusion from claiming higher actual damages

27 | If the building contract contains a liquidated damages provision, for example, for late delivery, is the buyer then precluded from claiming proven higher damages?

See questions 8 and 26.

Force majeure

28 | Are the parties free to design the force majeure clause of the contract?

The parties are free to negotiate and craft the *force majeure* clause of the contract, which can vary in its specificity as to events, efforts by the builder to ameliorate or overcome the effects of such events, notice provisions as to the start and finish dates of relevant events and the effect of such events on the delivery of the vessel.

Umbrella insurance

29 | Is certain 'umbrella' insurance available in the market covering the builder and all subcontractors of a particular project for the builder's risks?

Shipbuilding contracts universally require the builder to provide insurance to cover the vessel and such parts as shall be constructed and all materials, engines, machinery, outfit and equipment to be installed in or on the vessel, as well as all of the owner's supplied equipment within

the premises of the shipyard against all risks of loss and damage pre-keel laying and builder's risk insurance for a total loss of not less than 100 per cent of the contract price. The builder's risk policies generally include American Institute of Marine Underwriters (Institute) builder's risk clauses, increased value, Institute strike clauses, Institute war clauses and coverage against hurricanes, windstorms and earthquakes. When the vessel is under way for sea trials or en route to or at the place of delivery, the contract should also require the builder to insure the vessel for protection and indemnity risks and for hull and machinery risks in the same amounts referred to above. Other types of insurance required to be maintained by the builder are workers' compensation insurance at statutory amounts with Longshoreman and Harbor Workers' Compensation Act coverage endorsement, employer's liability insurance and contractor's equipment and auto liability and comprehensive public liability insurance for negotiated and agreed amounts.

Disagreement on modifications

- 30 Will courts or arbitration tribunals in your jurisdiction be prepared to set terms if the parties are unable to reach agreement on alteration to key terms of the contract or a modification to the specification?

Some shipbuilding contracts provide that technical disputes that relate solely to the vessel's classification may be mediated by the chief surveyor of the classification society. Other contracts provide for arbitration according to the Rules of the Society of Maritime Arbitrators or other recognised arbitration bodies. Some contracts provide for arbitration of disputes up to an agreed amount and litigation thereafter or litigation alone. The dispute resolution clause in these contracts is generally driven by the builder based upon its prior experiences with disputes.

Acceptance of the vessel

- 31 Does the buyer's signature of a protocol of delivery and acceptance, stating that the buyer's acceptance of the vessel shall be final and binding so far as conformity of the vessel to the contract and specifications is concerned, preclude a subsequent claim for breach of performance warranties or for defects latent at the time of delivery?

A protocol of delivery and acceptance, which states that the vessel is delivered in compliance with the terms and conditions of the contract limits the buyer's post-delivery rights against the builder to those set forth in the builder's warranty clause and precludes the buyer from other remedies against the builder. See Stephenson Harwood, *Shipping Finance*, pp. 281–82 (3rd edition, Euromoney Institutional Investor PLC 2006) ('For example, the protocol may be worded in such a way that the buyer acknowledges that the vessel is delivered 'in accordance with' the vessel's construction contract and specifications. If the vessel does not 'accord' with the MOA the buyer would normally have a right to claim damages from the seller. By executing a protocol of delivery and acceptance such rights may be lost'). The protocol of delivery and acceptance when executed by the builder and the buyer evidences the exact time that all rights, title and risk to the vessel pass from the builder to the buyer.

Liens and encumbrances

- 32 Can suppliers or subcontractors of the shipbuilder exercise a lien over the vessel or work or equipment ready to be incorporated in the vessel for any unpaid invoices? Is there an implied term or statutory provision that at the time of delivery the vessel shall be free from all liens, charges and encumbrances?

At the time of delivery, the builder is required to certify to the buyer that the vessel is delivered to the buyer free and clear of any liens, claims or other encumbrances upon the buyer's title thereto and in particular that the vessel is absolutely free from all liabilities of the builder to its subcontractors, employees, crew and of all liabilities arising from the operation of the vessel in trial runs or otherwise, prior to delivery and acceptance. If, notwithstanding the builder's certification, a supplier or subcontractor has not in fact been paid and subsequently asserts a lien against the vessel after it has been delivered to the buyer, the buyer will have to take appropriate measures to have the lien released and claim against the builder for the amount of the lien and its expenses to have the same released.

Reservation of title in materials and equipment

- 33 Does a reservation of title by a subcontractor or supplier of materials and equipment survive affixing to or incorporation in the vessel under construction?

As indicated in question 5, a US shipbuilding contract is subject to the UCC. Applying the principles of article 9 of the UCC, a perfected reservation of title by a subcontractor or supplier of materials and equipment (goods under the UCC) would survive incorporation into the vessel provided the goods remain an accession. An 'accession' is a good that is physically united with other goods to become one good in such a manner that the identity of the original is not lost. Goods only become accessions if the identity of the original good is preserved in spite of the union (UCC section 9-102(a)(1)). Goods that have lost their individual identity are 'commingled goods' governed by UCC section 9-336 and are not deemed accessions. 'A security interest may be created in an accession and continues in collateral that becomes an accession' (UCC section 9-335(a)). 'If a security interest is perfected when the collateral becomes an accession, the security interest remains perfected in the collateral' (UCC section 9-335(b)). Under the ordinary rules, whether the security interest is in the accession only or whether it attaches to the whole depends on whether the good as a whole is within the description of the collateral covered by the security agreement and the UCC Form 1 financing statement. In certain circumstances, where the incorporation of the good into the vessel constitutes 'commingled goods', a perfected reservation of title in the good when it was an accession, prior to becoming commingled, could create a security interest that attaches to the product or mass that results when goods become commingled. Therefore, the outcome in each individual scenario is dependent upon the facts of each case as well as the description in both the security agreement and on the UCC Form 1 financing statement.

Third-party creditors' security

- 34 Assuming title to the vessel under construction vests with the builder, can third-party creditors of the builder obtain a security attachment or enforcement lien over the vessel or equipment to be incorporated in the vessel to secure their claim against the builder?

A security interest can be created in favour of third-party creditors of either the buyer or the builder over both a vessel under construction and related equipment (see question 33 for a discussion of a security

interest over equipment and materials to be incorporated into the vessel). While a security interest in favour of builder's lenders over inventory may extend to a vessel under construction, the enforceability of the security interest may vary depending on state law and the specific facts of each case. For example, in *In re Tacoma Boatbuilding Co*, 158 BR 19 (SDNY 1993), on the bankruptcy of the builder, the enforcement of a security interest in inventory of the builder over two vessels subject to construction contracts with the same buyer was found to depend on the stage of completion of the vessel at the time the bankruptcy filing. The security interest in the builder's inventory applied to a vessel while still under construction to defeat a later filed UCC financing statement in favour of the assignee guarantor of the buyer. However, the court held that as construction of the other vessel was completed prior to the bankruptcy filing, it became a good 'identified' to the contract within the meaning of UCC 501(1)(b) and title to the vessel had passed to the buyer's guarantor free and clear of the security interest of the builder's lender. The court further found that the buyer qualified as a 'buyer in the ordinary course of business' under UCC 1-201(9) taking 'without knowledge that the sale is in violation of the ownership rights or security interest of a third party'. Any right of retention on the part of the builder for non-payment will be resolved pursuant to the terms of the construction contract and financing documentation.

Subcontractor's and manufacturer's warranties

35 Can a subcontractor's or manufacturer's warranty be assigned to the buyer? Does legislation entitle the buyer to make a direct claim under the subcontractor's or manufacturer's warranty?

When the builder enters into a subcontract or purchases equipment for the vessel, the builder's counterparty knows that the work or equipment, as the case may be, will become part of the vessel and the builder generally obtains a warranty from its counterparty, which may exceed the term of the builder's warranty to the buyer under the shipbuilding contract. In such cases, the builder will be required by the terms of the shipbuilding contract to assign to the buyer all rights and privileges of the builder in such extended warranty; accordingly, the buyer will be able to make a direct claim under such extended warranty after the builder's warranty period has expired. Prior thereto, during the warranty period specified in the contract, the buyer will pursue its warranty rights under the shipbuilding contract against the builder.

Default of the builder

36 Where a builder defaults in the performance of the contract, is there a legal requirement to put the builder in default by sending an official notice before the buyer's remedies begin to accrue? What remedies will be open to the buyer?

Where a builder defaults in the performance of the shipbuilding contract, the buyer is relegated to those remedies specified in the contract, which usually includes a requirement for sending an official notice of default to the builder, apart from any provision in the contract that may be adjudged as against public policy; this is unlikely especially if both builder and buyer are represented by counsel in the negotiations.

Remedies for protracted non-performance

37 Are there any remedies available to the shipowner in the event of protracted failure to construct or continue construction by the shipbuilder apart from the contractual provisions?

There are no statutory remedies available to the shipowner in the event of protracted failure to construct or continue construction other than

those set forth in the contract. Prudent shipowners will insist on a builder's default clause that covers a material failure of the builder to prosecute the contract work with such diligence and in such manner as will enable the builder to complete such work substantially in accordance with the vessel's contract delivery date, except to the extent that such failure is owing to causes excused by events of *force majeure* or by the buyer's actions. Without such a clause the shipowner will not be able to call a default and rescind the contract until the delay in delivery is permitted under the late delivery rescission clause.

Builder's insolvency

38 Would a buyer's contractual right to terminate for the builder's insolvency be enforceable in your jurisdiction?

Such termination provisions are commonly known as ipso factor clauses. If the insolvency results in the filing of a bankruptcy petition, either by or against the builder, the answer is no. Once a bankruptcy case has been filed, section 365(e)(1) of the US Bankruptcy Code prohibits modification or termination of an executory contract based solely on the insolvency or financial condition of the debtor. Absent a bankruptcy filing, the buyer may be able to enforce termination rights under the building contract depending on the application of the relevant state contract law. Further, although a bankruptcy filing will generally defeat an insolvency-based termination provision, where an executory contract bars assignment without the other party's consent, the non-debtor contracting party may be able to seek relief from the automatic stay in bankruptcy to terminate the contract. Depending on the terms of the construction contract, this remedy may be available to the buyer in the event of a builder bankruptcy filing. These facts raise complex questions of law and legal advice should be obtained.

Judicial proceedings or arbitration

39 What institution will most commonly be agreed on by the parties to decide disputes?

See question 30. A frequently designated arbitral institution in US shipbuilding contracts is the Society of Maritime Arbitrators in New York, which has many seasoned arbitrators knowledgeable in maritime matters. Otherwise, contracts will provide that disputes are to be arbitrated in accordance with other recognised arbitration associations or litigated in state or federal courts in accordance with the parties' agreed contract clause.

Buyer's right to complete construction

40 Would a buyer's contractual right to take possession of the vessel under construction and continue construction survive the bankruptcy or moratorium of creditors of the builder?

There is not a clear answer to this question. Certain variables must be taken into consideration. A buyer to protect itself in order to survive the bankruptcy or moratorium of creditors of the builder should:

- obtain and perfect an appropriate security interest of all of the builder's obligations to the buyer under the shipbuilding contract under article 9 of the UCC of the state in which the shipyard is incorporated or organised. This should cover, at a minimum, the goods to be purchased and all materials, component parts and accessories acquired by the builder that are to be incorporated into the vessel and other items related to the construction of the vessel (ie, plans, specifications, relevant contracts with third parties, specialised tooling);
- obtain lien searches against the shipyard to identify any conflicting security interests;

- establish the priority of the buyer's security interest by securing subordination agreements and consents to the buyer's priority from the holder of any conflicting security interests – these may be difficult to obtain; and
- apply to require the shipyard or its estate to maintain adequate insurance during the shipbuilding process with the buyer to be named a loan payee under a lender's loss payable endorsement recognising the buyer's interest as a secured creditor under its security interest.

A buyer will need to take all of these steps to obtain the best protection possible.

ADR/mediation

- 41 | In your jurisdiction, do parties tend to incorporate an ADR clause in shipbuilding contracts?

At present ADR clauses are rarely incorporated in shipbuilding contracts for ocean-going commercial vessels.

Default of the buyer

- 42 | Where the buyer defaults in the performance of the contract, what remedies will be available to the builder? What are the consequences of the builder's cancellation of the contract?

In the event of a buyer default, remedies available to the builder, including but not limited to retention of the vessel and cancellation of the contract, and the consequences of enforcement of such remedies will be governed by the terms of the construction contract as may be limited under the UCC and the US Bankruptcy Code.

CONTRACT FORMS AND ASSIGNMENT

Standard contract forms

- 43 | Are any standard forms predominantly used in your jurisdiction as a starting point for drafting a shipbuilding contract?

In the US, standard forms such as those of the Shipbuilders' Association of Japan, the Association of European Shipbuilders and Shiprepairers and Baltic and International Maritime Council's Newbuildcon, as well as the more recent BIMCO Newbuildcon, are rarely used. Each shipyard has developed its own unique form as a starting point and the parties negotiate from there.

Assignment of the contract

- 44 | What are the statutory requirements for assigning the contract to a third party?

There are no statutory requirements for assignment or novation of shipbuilding contracts. Virtually all shipbuilding contracts prohibit assignment or novation of the contract to a third party that is not affiliated with the buyer without the prior written consent of the builder. Assignment clauses are negotiated by the parties and may provide that, post assignment: the assignor is relieved from all rights and obligations under the contract from the effective date of the assignment; or the assignor and assignee remain jointly and severally liable for all rights and obligations under the contract.

The assignment agreement is between the buyer, the builder and the assignee, and may provide that the assignment takes effect upon execution of the assignment agreement or may only become effective upon delivery of the vessel. Again, this is dependent upon the specific negotiated terms of the assignment.



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UPDATE AND TRENDS

Hot topics

- 45 | Are there any emerging trends or hot topics in shipbuilding law in your jurisdiction?

The specifications for shipbuilding contracts now have to address the incorporation of scrubbers, whether of the closed or open loop type, or the requirement to consume fuels with sulphur content of 0.5 per cent or less, or run on alternative fuels such as LNG from 1 January 2020 in order to comply with relevant IMO regulations.

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