

# **Shipbuilding Contracts:**

## **The Allocation of Risk between Purchaser and Builder**

By Brad Caldwell (Published in *Western Mariner* - June 2012)

As a result of the signing of the National Shipbuilding Procurement Strategy on 14 February 2012 and the anticipated spillover effect to other shipyards, maritime lawyers in British Columbia are starting to dust off their shipbuilding contract precedents and reacquaint themselves with their shipyard clients.

This article reviews some of the terms commonly found in shipbuilding contracts. Although the word “ship” is used primarily in this article, most of the commentary is equally applicable to contracts to build yachts and fishing vessels.

### **Title and Security**

Contractual terms regarding title and security can vary depending upon whether or not the ship is being built for export. In contracts for the construction of ships to be used within British Columbia, there are normally provisions that provide for title to pass to the purchaser as construction proceeds and the ship is paid for. Since there is presumption in favour of builders retaining title, provisions providing for title to pass as construction proceeds must be drafted clearly and not contradict other provisions within the agreement. In order to register title after the sale has completed, it is necessary for the shipbuilder to provide the purchaser with a builder’s certificate naming the purchaser as the first owner of the ship. It is also common to receive an invoice or series of invoices for the ship and all its related equipment.

Provisions providing for transfer of title as construction proceeds can cause problems if a ship is being built for export outside the province and/or country. Often through careful planning, sales tax can be avoided by structuring the sale so as to qualify for export exemptions provided by applicable sales tax laws. By transferring title prior to delivery and prior to the vessel leaving the province there is a serious risk of losing one or more of these tax exemptions. Accordingly, this risk is often avoided by providing the purchaser an alternative (and less secure) source of security by way of a builder’s mortgage. This is done by leaving title in the name of the shipbuilder and having it record the vessel under construction with the Ship’s Registry. The builder then grants the purchaser a builder’s mortgage to be registered against the recorded vessel.

### **Method of Payment**

Contractual terms regarding the method and time of payment can vary widely depending upon the cost of the ship being built and the negotiating strength of the parties. Often, payment is made by a number of progress payments that occur when certain milestones have been passed. These milestones could include: the laying of the keel; completion of the hull; installation of engines, tanks and generators; installation of the superstructure; completion of interior finishing; completion of sea trials; and expiry of a trouble-free period since delivery. It is important when negotiating such a schedule to try to have it accurately reflect the work

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performed to date. Since it almost always costs more to have a second yard finish a job started by another, a purchaser with negotiation leverage will normally try to hold back a reserve to cover at least part of the extra cost of having a different yard finish the job should this become necessary. In order to avoid disputes, it is also useful to give some person, such as a marine surveyor or naval architect, authority to make a binding determination of whether or not a milestone has been achieved.

An approach sometimes used as an alternative to defined milestones, particularly in government contracts, is for regular payments to be made based upon the percentage to which the vessel has been completed at the date of the payment. As in the case of the milestone method, in order to avoid disputes it is also useful to give some designated person the authority to make a binding determination as to the percentage the vessel has been completed.

### **Plans and Specifications**

Most shipbuilding contracts have specifications and drawings attached as schedules. The purchaser should review these schedules with great care, as they contain most of the details of the ship to be built. If the purchaser does not have expertise in ship construction, he should retain a naval architect or marine surveyor to assist him in reviewing the specifications and drawings. Since not all the details of construction can be included in the drawings and specifications, it is also common to have a general provision requiring the builder to build the ship “in accordance with good ship building practice”. In addition, there are often provisions requiring the ship to be built so as to conform to any applicable standards for the ship in question such as those of Transport Canada Marine Safety or the requirements of any classification societies designated by Transport Canada as “Recognized Organizations.”

### **Warranties and Limitation of Liability**

Most shipbuilders give a warranty against faulty workmanship and material for a specified period of time. However, negotiations over warranties can be quite difficult as ship builders are generally reluctant to expose themselves to unlimited liability for their product. Common issues of contention are:

- In the case of a ship that is designed by a shipbuilder, whether or not that builder will warrant his design with respect to matters such as speed, fuel consumption, length, hold capacity, or tonnage;
- The question of who should bear the cost of travel if the ship breaks down at a distant location;
- Liability for consequential damages for loss of use (usually excluded); and
- Liability for equipment manufactured by others.

### **Completion Dates**

Given the difficulty of obtaining materials and other supplies on a timely basis as well as the general reluctance of shipyards to turn away any work, completion dates can be a problem. If it is important for a purchaser to have a ship completed by a certain date, it is best to include a liquidated damages clause in the contract specifying the per diem penalty for late delivery. In exchange for a clause of this nature, shipyards will sometimes require a bonus for early delivery. At the very least, a shipyard will require a “force majeure” clause spelling out the circumstances outside its control that will excuse it for failing to meet the completion date.

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Although shipyards are generally very reluctant to allow a purchaser to terminate a contract for late delivery, they will sometimes agree to a provision allowing for the purchaser to take possession of the vessel (after reasonable notice of its intention to do so) and have it completed by another shipyard. Such provisions will also usually reserve the right of the purchaser to make a claim against the original ship builder for the extra costs associated with having the ship completed by another yard.

### **Insurance**

It is important to make sure the ship is adequately insured for the benefit of both the shipyard and the purchaser. Normally shipyards carry a Commercial General Liability policy, a Builder's Risk policy and a Ship Repairer's Liability policy. Since the scope of these policies can vary quite widely from insurer to insurer, it is best to review any proposed policies and provisions regarding insurance coverage with an experienced marine insurance broker prior to entering into any contract.

### **Contracts with Government**

There are both advantages and disadvantages to contracts with government. The main advantage is the security of knowing that the government has the financial ability to pay the contract price for the ship. A possible disadvantage of working with governments can be the imposition of fairly extensive reporting, quality control, and pollution control requirements. However it has been reported that governments are usually prepared to pay for these extensive requirements. For example, with respect to quality control requirements in Federal Public Works contracts, an ISO 9001 Quality Management System registration results in a 5 per cent reduction for the purpose of bid evaluation.

Since governments usually self-finance, the absence of security being granted to lenders usually makes the documentation less complex. However, in this situation the need for a properly drafted clause transferring title as construction proceeds and progress payments are made is of particular importance.

### **Conclusion**

As is the case with many commercial agreements, the negotiating of a shipbuilding contract is an attempt to avoid future disputes by trying to anticipate as many problems as possible in advance and decide ahead of time how those problems will be resolved or avoided. To a large extent, many of the contractual provisions involve allocation of risk between the purchaser and the builder. The extent to which a builder is prepared to accept risk will depend on a number of factors, including the availability of other work and the profit which he anticipates making on the contract. Similarly, a purchaser may be prepared to accept more risk if the purchase price is lower than that offered by competing yards. Hopefully this article will help purchasers and shipyards to avoid disputes by helping them to evaluate the risk they are assuming when they are entering into a shipbuilding contract and negotiate for provisions commensurate with the amount of risk they are prepared to accept and the amount of security they are prepared to pay for.

*Brad Caldwell is a Vancouver based lawyer whose practice is primarily devoted maritime and insurance matters. An earlier unabridged version of this article that also includes a discussion of provisions regarding extras and taxes is located at*

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