

## “Shipbuilding transactions in jeopardy: fighting or renegotiating?”

*A decision to be taken with wisdom*

**By Francesco S. Lauro**

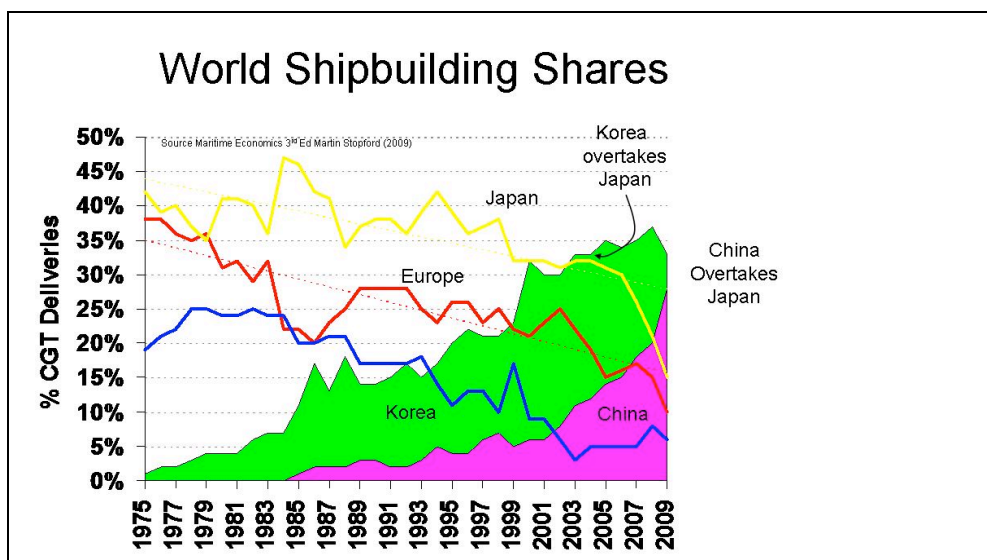
[francescolauro@studiolegalelauro.it](mailto:francescolauro@studiolegalelauro.it)

+390815800199



*If you do not think to the future  
you will be in troubles when it will approach<sup>1</sup>*

From 2003 to the summer of 2008 the world's shipping markets have recorded the greatest and most prolonged bonanza after the second World War. Owners, in nearly all segments of the market, signed an unprecedentedly huge book of orders. Chinese shipyards got the bulk of this new business due to the ability of China shipbuilding industry to make competitive prices and to its constantly increasing quality production which made it to overcome the Japanese one in 2009 and probably the Korean one in the years thereafter.



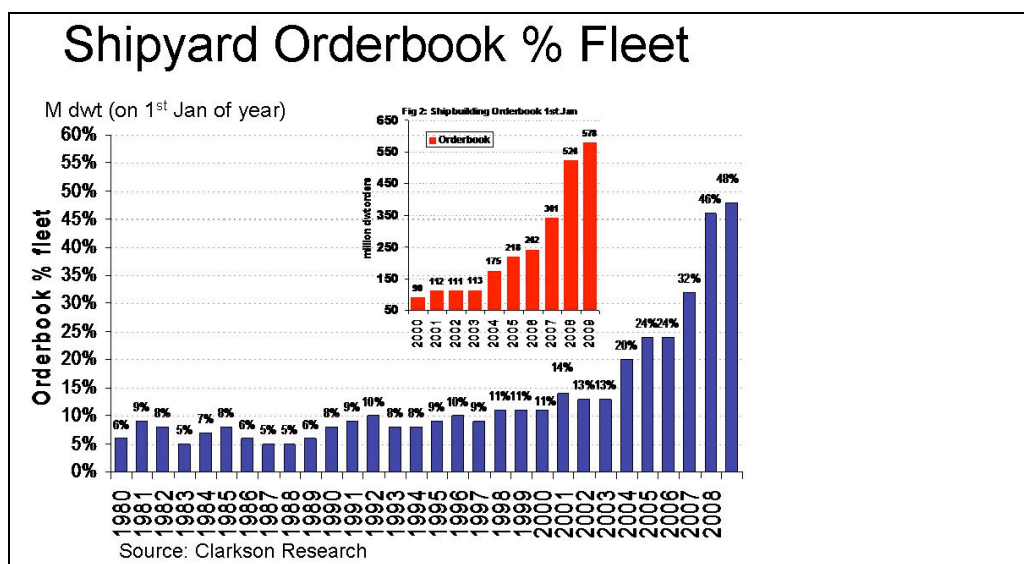
2

<sup>1</sup> Confucius. *Dialogues*

<sup>2</sup> Clarkson Research

The bigger a boom is, the worse will be the bust thereafter. In fact, since September 2008, in parallel to the word economic crisis, we have been watching a generalized collapse of shipping freight and sale and purchase markets. An environment biased by an “irrational exuberance”, which produced a crazy but widespread belief in a never ending boom, led owners to sign a record number of new building orders mainly in Far East and particularly in China. In the sudden time of few weeks, at the end of the summer of 2008, this scenario was dramatically reversed, leading to a most somber, still lasting, economic climate with several of the projects, started during the booming years appearing now at risk if not in fact financially unviable.

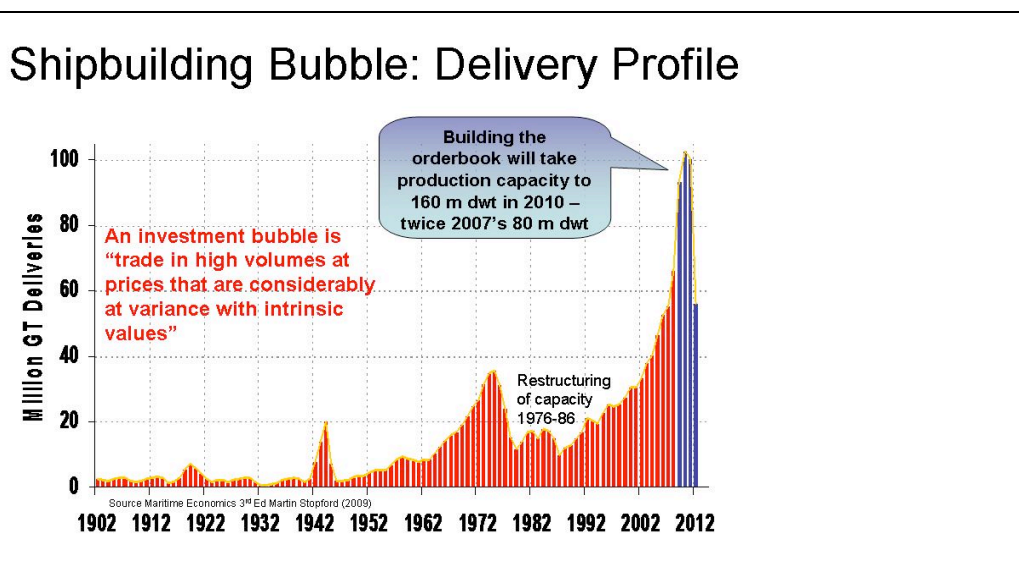
Reduction of the demand of sea transportation, due to the recession in America, Europe and Japan plus the slowing down of China, India and other emerging economies, is coupled, as we have just seen, with an unprecedented new-building output, causing a dramatic increase of the world merchant fleet in all markets segments.



3

The doubling of world’s shipbuilding capacity from 2007 to 2010 and a record number of deliveries scheduled up to 2012/2013 will add a huge tonnage extra capacity to an already existing dramatic unbalance between supply and demand.

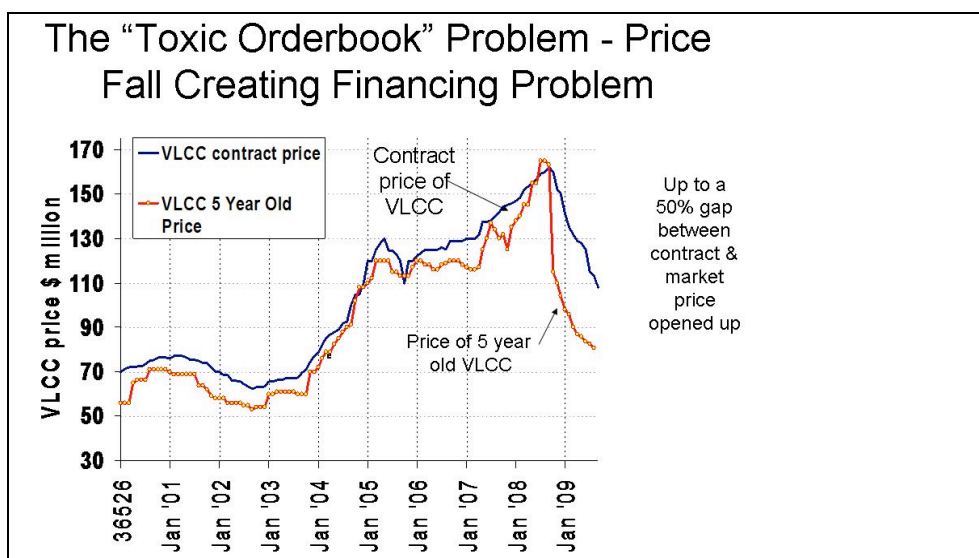
<sup>3</sup> Clarkson Research



4

This shipbuilding bubble is going to depress the shipping markets (particularly the dry-bulk and container ones) for several years unless many orders are swiftly cancelled or postponed.

With new-buildings' market values at lows which sometime hardly cover 50% of the shipbuilding contract prices (and an even lower percentage of the resale prices) and chartering freight plummeted sometime lower than 10/20% of the pre-crisis rates, even cautious owners who covered their risks with long term charterers, freight contracts or disposed of the vessels by entering into resale contracts may result heavily exposed.



5

<sup>4</sup> Clarkson Research

<sup>5</sup> Clarkson Research

Long shipbuilding related transaction chains, which flowered in the bonanza years, may now collapse like card towers due to the failure of any of the subjects composing them.

The longer a chain is, the higher the risk for all parties involved. Take, as an example, the following shipbuilding, resale and chartering transaction chain:

#### THE SHIPBUILDING RELATED TRANSACTION CHAIN

Freight multi-voyage contract charterers

|

One or more long term time-charterers

|

Bare-boat charterers

|

One or more resale purchase owners

|

Original owners signatories of shipbuilding contract

|

Shipyard

|

Shipyard suppliers/subcontractors

The failure of any subject representing a link of the above transaction chain, may generate a domino effect which would cause the collapse of the subjects located underneath<sup>6</sup>.

In fact, it does not matter whether owners (a) pre-arranged adequate lines of credit at the time the vessels were ordered, (b) entered into long term time-charters, (c) disposed of the ships they ordered by means of resale contracts. In view of the diminished lending capacity and extra-cautious approach adopted by the banks hit by the financial crisis and often directly burned by the increasing defaults of owners, it is now extremely difficult for owners to find the necessary finance for their shipbuilding orders and even the owners who prearranged finance lines may not be able to satisfy drawdown criteria required by their banks<sup>7</sup>. This applies to the owners purchasing the vessels directly from shipyards, as well as to resale purchasing owners, who might have had the

---

<sup>6</sup> Bjørnstad, Finn. *Shipping Contracts in distress*. Bulkform Annual Summit (27 April 2009)

<sup>7</sup> Bjørnstad, Finn; Berg, Fredrik; Leonard, Guy. *Renegotiation of Shipbuilding Contracts: Strategic Consideration* (International Law Office 8 July 2009)

backing of a resale contract or long term time charter with subjects whose financial reliability and soundness became, in the light of the present market conditions and its future prospects, questionable if it could not to be considered already impaired.

From their own prospective banks, who are exposed towards owners for having financed their previous acquisitions, or have already paid price installments on vessels to be delivered, may have to face a hard decision: should they continue lending (and perhaps accepting to restructure owners' existing debt) with the risk of increasing their exposure, and the prospect of only partial mortgage protection of their exposure, or should they stick to the covenants and look for any opportunity walk out, as quickly as they possibly can, from existing credit arrangements even if this would cause the bankruptcy of their debtors and the loss of the moneys they already lent? <sup>8</sup>

A similar dilemma would confront shipyards. Given the typical Chinese payment schedule of 5 installments each of them representing 20% of the contract price, let us consider the case of owners, who just paid a price advance of 20% at the contract signing and are unable to pay the remaining price amount and may be found in fundamental breach of contract. If, due to their financial conditions, the owners have not much to lose, unless the purchasers provided a sound performance guarantee, shipyards may be exposed to a very substantial loss. With market values as a fraction of contract prices, equipment purchase and subcontracting agreement prices fixed at the highest historical market levels, a likely further drop in the new-building prices once the market will be flooded by hundreds, or thousands, new-buildings on sale, many shipyards will go bust and refund guarantees will be called in full by owners who would not have much interest, due to the market conditions, in taking delivery of uncompleted vessels. This scenario will put hard questions to the shipyards and refund guarantee banks too.

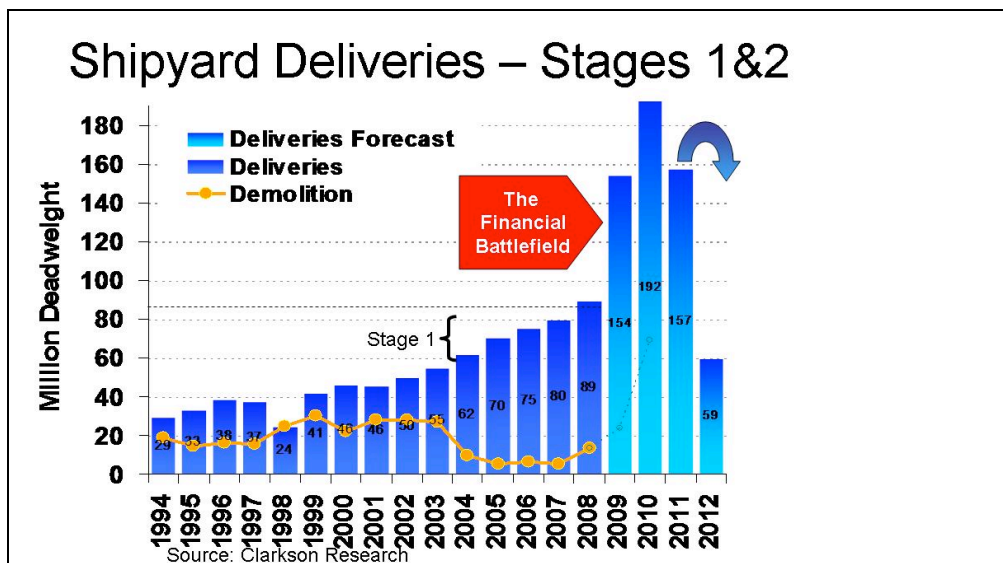
It is not necessary to analyze each subject's position in detail to conclude that all links of the chain, from the top, down to the shipyard subcontractors and suppliers, are at risk. The failure of a chain link may cause the whole transaction to collapse as a house of cards, hitting a plurality of subjects with serious consequences for the banks involved.

From a macroeconomic prospective the only way to prevent the above from happening would consist in the cancellation of the largest possible number of vessel orders and of the spreading of the vessels' construction and deliveries on number of years after 2013. This course of action

---

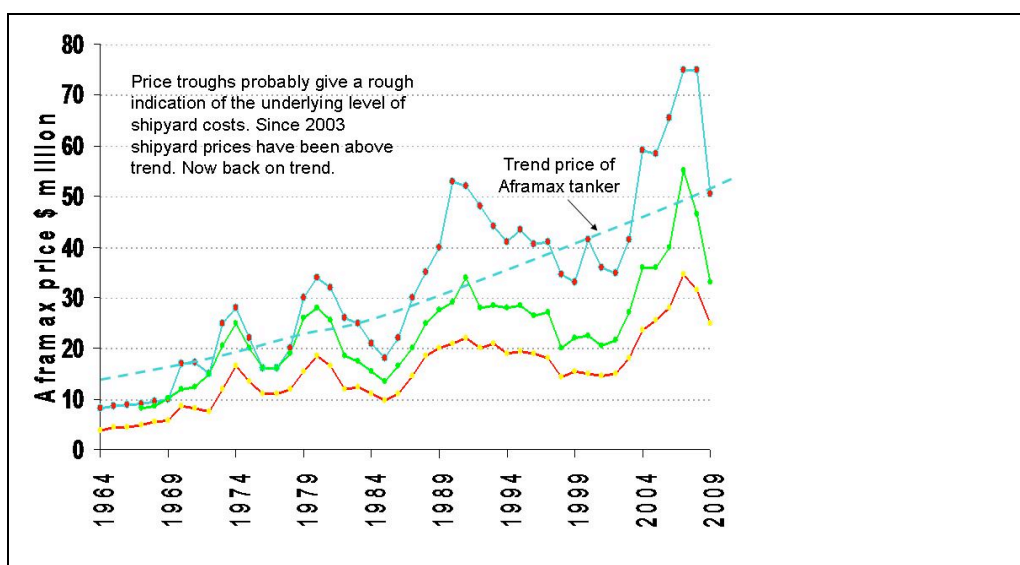
<sup>8</sup> Lux, Jonathan. *The Credit Crunch: Impact on Shipping Contracts* (WHO'S WHO LEGAL JUNE 2009/SHIPPING 8 MARITIME). According to the Author it has been estimated that the maritime sector will need in the region of US \$ 350 billion over the next three or four years. This figure appears to have substantially increased at US \$ 490 billion. Stopford, Martin (Verbal communication, October 2009)

should be coupled with the introduction of new international regulations fixing tight limits to the life of each type of vessels<sup>9</sup>.



10

The foreseeable increase of the cargo offer, due to the international economic and trade recovery, enhanced by the inevitable increasing need of supplies of the emerging economies, will do the rest.



11

The best way to face such situations would be a multilateral and coordinated action directed in a first instance by the Asian, EU and other important shipbuilding and ship owning states, supported

<sup>9</sup> Grimaldi, Emanuele. Last at 13th Euro-Med Convention (23 October 2009)

<sup>10</sup> Clarkson Research

<sup>11</sup> Clarkson Research

by international and maritime and shipbuilding organs and associations of ship manufacturers and ship owners and backed by the bank system.

If such a coordinated action does not materialize I believe that having to address each case singularly may prove to be extremely difficult and we may not be able to prevent a turmoil of the market which will cause severe damages. All the subjects involved will have to face difficult decisions which may have dramatic consequences on the market and on their own business. Substantially they should decide in each case whether taking legal steps (generally by arbitration often coupled with arrest and enforcement proceedings) against the party who is in breach of contract or adopt a more flexible approach which contemplates renegotiation. In the event of litigation, risky decision will have to be taken anyway concerning the execution of shipbuilding activities which, when for instance an owners' repudiatory breach occurs and/or the litigation starts, are in progress.

As Carl von Clausewitz pointed out, war is subject to its "essential unpredictability"; so is litigation. Furthermore in war (and litigation) you may have to take essential decisions which could prejudice the financial survival of several subjects, including the decision making one, from a not very easy position, being surrounded by a blinding (as the Prussian strategist would say) "fog of war"<sup>12</sup>. And being confused by fog is not precisely what you need in evaluating difficult decisions which require the analysis of complex information and scenarios.

As an alternative to litigation, renegotiation may open to the parties all necessary exchanges of information and a degree of cooperation essential to produce, on a smaller scale, positive actions similar to those I referred to, in the previous page, which would minimize risks and losses for all parties concerned. If many renegotiations, one by one go through this would have also a beneficial effect on the market as a whole.

In order to decide whether or not we should accept or promote renegotiation of the existing contract a full screening of the position should be carried out case by case. Through an accurate SWOT analysis each party should be evaluating its points of Strength, Weakness, Opportunities, Risks.

If the financial security offered by your counterparties and/or their guarantors is high, and you have a good case, you may want to stick to the existing contract and reject requests which may only be

---

<sup>12</sup> Von Clausewitz, Carl. *Vom Kriege* (Berlin 1832)

a bluff. However also in this type of situation there might be various factors which could induce you to leave the door (at least partly) open for renegotiation. Keeping a good relationship with an important customer has its value, even though this might not be quantifiable in monetary terms. It has an added value for a shipyard in a situation in which, even though it might be full of orders<sup>13</sup> for the next two or three years, it very likely, will have to face a further catastrophic period of several years with no or very few new orders. Why not adopting a more flexible approach which would spread on a longer period deliveries and negotiate a reasonable compensation for such flexibility?

If your counterparties have not enough to lose, or may have no, or little, assets on which to enforce a favorable award or judgment, renegotiation of the contract should be taken then into serious consideration. Renegotiation, in the language of the practitioners, mainly means: obtaining a discount on the price, postponing the delivery of few months or maximum a year, buying the cancellation of some orders or their transformation in options. These are very basic ways of renegotiating which may just reflect the contractual power of the parties. However there are more complicated situations which require a lot more of creativity and technical skills. When a shipbuilding transaction becomes unviable, or just very risky, a holistic approach may be required.

The transactional chain architecture should be examined very carefully, the position of any link of it to be evaluated both singularly and with regard to the whole structure. My recommendation is that no effort is saved to put around a table all parties connected, including resale purchaser and sellers, charterers, subcontractors and suppliers, and all chain subjects' finance providers (bankers, bond holders, etc.). This will assure that a full picture of the consequences of a bust on each subject is considered and it will show that, if the whole situation is addressed as a whole by a coordinated action of all protagonists or at least some of them, it may offer a lot of alternatives or further creative solutions when compared with the step which could be taken if each transaction if it is tackled singularly.

Due to the variety of interests and positions, a very good way of handling the negotiation process, particularly if it is a multilateral negotiation, would be mediation. The task of the mediator would be finding, and convincingly submitting to the parties, a fair and balanced solution which takes into account the contractual power of the involved subjects, which often may require coming out with innovative proposals. The mediator approach should be, a bit like that of a liquidator, as a sort of a

---

<sup>13</sup> During a long crisis in the eighties, the Italian Ship-owner Peppino D'Amato had a 95.000 MT deadweight bulk-carrier vessel (M/V Peppino D'Amato) chartered for 10 years to one of the world's energy Majors at a very good hire. He wisely accepted to substitute the T/C vessel with a larger one (135.000 MT DW) maintaining the same hire by so doing building up an exceptional relationship with this so important Charterer (verbal communication made to the writer in the '80s and reconfirmed in October 2009).



*real politick* one: the merits of the case are not the only consideration and sometime even not the main one, if the actual prospects of obtaining satisfaction, namely a fair compensation of the damages caused by the party in breach, are very thin due to the actual financial security offered by this subject. Each party should give an adequate contribution, proportional to the advantages (or its loss minimization) which would arise from a successful renegotiation.

I am optimistic that many shipbuilding transactions in which Chinese shipyards, or other Chinese parties are involved, could be rendered healthier by means of renegotiations bringing to harmonious solutions, so avoiding risky, and often catastrophic, litigations. The Chinese culture historically differs from the Western one since it is not so much based on pure rationalism. There is less emphasis on relationship based on conflicting dualistic concepts as right/wrong, innocence/fault, etc. Each party should maintain its promises, and contractual terms and conditions are promises and undertakings, but, aside the rules of contract, there are those emanating from the customs, the common sense, the human conscience, the harmony of nature. The damage to the innocent party should be as much as possible mitigated but litigation should be possibly avoided. The party who is unable to perform should carry the main burden but a sensible and harmonious solution to face the problems should be looked for by both the parties, through negotiations, with a degree of flexibility in respect to the original promises (contained in the contract). In other words Chinese culture from the ancient times to the present ones considers “harmony as the most precious thing” in order “to build a harmonious society”.



*Harmony is the most precious thing*<sup>14</sup>



*To build a harmonious society*<sup>15</sup>

---

<sup>14</sup> Confucius. *Dialogues*

<sup>15</sup> Hu, Jintao. *Speech to Cadres at the Party School of the CPC Central Committee* (19 February 2005)