

The Continuing Importance Of Commercial Sense In Poorly Drafted Contractual Clauses

An Owner's – Buyers' (Shipping Company's) Experience In A Shipbuilding Dispute.

- The project involved five newbuilding vessels under five separate contracts.
- April 2014: the last shipbuilding contract concluded between Owner's Special Purpose Vehicle as Buyers and a ship builder (Yard) in China with an excellent record for quality; Owner also provided parent company guarantee
- September 2014: addendum to last Shipbuilding Contract adding a third party as "Seller's Agent" and jointly liable under the shipbuilding contract.
- Yard had done a rapid expansion, depleted credit capacity with their Bank and could not have their Bank issue further Refund Guarantees. Seller's Agent was a financially strong third party with reserve credit capacity to counter secure the refund guarantee Bank.
- Two RGs issued iro last Hull and two pre-delivery installments paid partly financed by debt secured by assignment of the contract and RGs by Buyers in favour of Buyers' Bank.

Some More Background History of Project (Slide 2)

- Normally, the Buyers are entitled to terminate the contract due to pre determined excessive delays, or failure, beyond tolerable limits, to reach the guaranteed particulars.
- Buyers may wish to include critical milestones in the construction progress, in the form of completion, by a pre-agreed maximum number of days from a specified milestone date, of specific sections of the vessel, and thus retain the right to terminate early on when it becomes obvious that it shall not be possible for the builder to deliver the vessel without incurring substantial delays.
- In this case, it was becoming increasingly obvious, beyond reasonable doubt, that it would be impossible for the Yard to deliver without huge delay or at all; however, Buyers had not managed to include clauses providing for critical milestones in the construction progress, hence Buyers had to wait for termination rights to mature.

ARTICLE X CANCELLATION, REJECTION AND RESCISSION BY THE BUYER

- Buyers had managed to negotiate and include in the shipbuilding contract a Builder's default clause.
- The default clause entitled Buyers to rescind the contract in the event of insolvency, bankruptcy or similar dramatic events affecting the Builder or affecting the validity of the Refund Guarantee or the Builder's Bank.
- In instances of rescission, the Buyer is entitled to refund of pre-delivery payments with interest, but no liquidated damages. Liquidated damages are only payable in cases of excessive delays. It is not unreasonable to negotiate a provision for liquidated damages in cases of rescission, as well.

Boilerplate default clause with bespoke elements

5. The Buyer may in addition and also at his own option also rescind/cancel the Contract and demand that the Seller shall repay all installments actually paid by the Buyer with five (5%) interest:

- a) If an order or an effective resolution is passed for the winding up of the SELLER (except for the purpose of reorganization, merger or amalgamation), or,
- b) The Court declares Bankruptcy Proceedings against the SELLER under Chinese Law; or,
- c) After the Court has accepted Petition for reorganization proceedings, such proceedings against the SELLER are cancelled by the Court due to the default of the SELLER or are withdrawn by the SELLER in breach of the reorganization plan.
- d) If the issuer of the Letter of Refund Guarantee becomes insolvent unless the SELLER procures the issue of a replacement Letter of Refund Guarantee acceptable to the BUYER, not to be unreasonably withheld, within sixty (60) business days from being requested to do so by the BUYER.

More background facts to dispute

August 2016: the local Chinese Court accepts bankruptcy application initiated by a creditor of the Yard and appoints an administrator A couple of days later: letter from Yard headed “Bankruptcy Re-organisation Process”

- In the meantime Buyers scrutinize RGs to ensure valid per SAFE regulations, binding even if Yard was in difficulty when RGs issued and cover circumstances of insolvency of the shipbuilder (Rainy Sky). Also, consultation with regard to powers of administrator and with regard to enforceability of London arbitration award if in conflict or in competition with insolvency proceedings in China.
- A few days later: notices of cancellation for Hulls 1-5 and letters of demand to refund guarantor Bank. Seller’s agent disputes cancellation of Hull 5 and commences arbitration proceedings on its own (Yard joined later).
- 29 September 2016: full repayment of principal and interest received from RG Bank for Hulls 1-4
- With the exception of the last contract, all paid pre delivery installments in respect of the previous four contracts were refunded to Owners by the RG Bank. The Seller’s Agent stopped the refund iro the last contract by instituting arbitration proceedings. However, the conduct of the Yard iro hulls 1-4 appeared to exercise no controlling influence over the outcome of the dispute iro hull 5.

Procedural steps in the arbitration

- Each party appointed its arbitrator who jointly selected a third (the Chairman) following service of the parties' submissions.
- If it was determined that the cancellation was invalid then Buyers would be in wrongful renunciation and, at a minimum, risk losing instalments paid amounting to US\$9,500,000.
- Claim submissions were served. Seller sought a declaration that they be permitted to keep the instalments paid to date amounting to US\$9,500,000.
- Defence and Counterclaim submissions served timely. Buyers claimed repayment of the instalments paid, plus interest at a rate of 5% per annum: circa US\$10,100,000.
- Further responsive pleadings exchanged. Exchange of linguistic reports on Chinese terminology. The parties served "skeleton arguments" setting out their respective arguments. One day hearing.
- A call would be made under the refund guarantee following an award in Buyers' favour and expiry of the relevant period for appeal (28 days).

“the Court declares Bankruptcy Proceedings against the SELLER under Chinese Law”; What does this mean?

- It appears to be describing circumstances where an organized Tribunal makes known in public the setting in motion according to Chinese law of a sequence of formalized events which may end up in the liquidation of the Seller.
- In the view of a civil law lawyer, this critical sentence is full of uncertainties. Does the Court have to be a Chinese Court or can it be foreign? Does it have to be competent according to Chinese civil procedure? Does “Chinese law” refer to Chinese substantive law of insolvent Enterprises or merely to the procedural law?
- Does the verb “declares” refer to a decision of a declaratory nature?
- Does the phrase Bankruptcy and/or Bankruptcy Proceedings refer to an irreversible phase of terminal liquidation or does it refer to any stage of insolvency proceedings?

What about:

(b) an Event of Insolvency occurred affecting the SELLER; would that have been clearer?

- So, instead of “the Court declares Bankruptcy Proceedings against the SELLER under Chinese Law”, could there have been a clearer clause for Buyers?
- Literal and purposive interpretations of sub clause (b) can both lead us to treacherous paths, Buyers have wondered whether possible to do a better job at drafting the crucial sub clause:
- The clause refers to the declaration of “*proceedings*”, not the declaration of “*bankruptcy*”. Is this clear and unambiguous enough? – Couldn’t a reasonable person conclude that the term “*proceedings*” should be ignored in favour of a nuanced technical reading of the term “*declares*”?
- However the technical words declares and bankruptcy have stirred serious issues; this broader clause would have avoided these words and emphasize commencement of process: **(b) any Insolvency Proceedings commence against the SELLER**; this indicates there was indeed a problem of poor drafting.

Literal (or grammatical) interpretation

- To “declare Bankruptcy Proceedings” is in any event a mediocre expression as opposed to “declare bankruptcy” or “declare the debtor bankrupt”.
- The literal or grammatical interpretation may lead to a conflicts of laws analysis: so, under English private international law we would presumably have to be referred to Chinese Law of Enterprises Bankruptcy;
- whether sub-clause (b) here has been fulfilled entitling Buyers to cancel.
- Can reorganization be distinctively recognized as a pre (or out of) Bankruptcy phase of insolvency proceedings?
- in any event quite separate from the liquidation stage?

Two competing but equally possible constructions

- **Construction No.1**

The first construction is that the court “declares Bankruptcy Proceedings” against a debtor when it accepts a petition for bankruptcy under Art 11 EBL. The ‘declaration’ means no more than an announcement, which is constituted by some Civil Order of a Chinese District Court, whereby the court for instance entertains the application filed by a creditor of the Yard for bankruptcy liquidation of the Seller.

- **Construction No.2**

The second construction is that the court “*declares Bankruptcy Proceedings*” against a debtor when it makes a declaration of bankruptcy under Art 107 EBL.

Purposive (Teleological) interpretation slide 1

The Buyer may cancel the Contract: (a) If an order or an effective resolution is passed for the winding up of the SELLER (except for the purpose of reorganization, merger or amalgamation); or, (b) The Court declares Bankruptcy Proceedings against the SELLER under Chinese Law; or, (c) after the Court has accepted Petition for reorganization proceedings, such proceedings against the SELLER are cancelled by the Court due to the default of the SELLER or are withdrawn by the SELLER in breach of the reorganization plan.

- Contracts should be interpreted with the aid of good faith and business ethics rather than by ritually sticking to words in a formalistic manner (general principles of civil law)
- In English law, the clauses should (per *West Bromwich principles*), be given “*the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.*”

Purposive (Teleological) interpretation slide 2

- look at all three sub-clauses together;
- the three sub clauses may be describing situations in descending order of definitiveness or revocability, otherwise the clause will at worst not make sense or at best will show a quite uneven rationale.
- Sub clause (a) speaks of a decision to dissolve the Seller and notably makes an express exception for reorganization or similar goals.
- It is therefore almost inevitable that sub clause (b), although not clear, could not be speaking of a stage of Proceedings where reorganization would still be open.
- Subsequently sub clause (c) speaks of self inflicted breach of the reorganization plan.

Contra Preferentem Rule

- “Whoever holds the pen creates the ambiguity and must live with the consequences.”
- The second form of the contra preferentem principle is that any contractual ambiguity is construed against the party who seeks to rely upon the clause in question.
- However, the current view of the courts is to apply the contra proferentem rule as a last resort.
- In other words, the contra preferentem rule would only operate against the Buyers if the scales were so finely balanced between the parties that the rule is the only way of resolving the dispute.

Matters of common ground

- xuāngào, in the context of legal proceedings, has a specialized, technical meaning. It means a declaration that is determinative of substantive legal rights. Hence its use in the context of Article 107 (declaration of bankruptcy). The most accurate English translation in the context of legal proceedings is where the Chinese Court makes a “declaration”;
- gōnggào, in the context of legal proceedings, means a declaration which is not determinative of substantive legal rights. The most accurate English translation in the context of legal proceedings is where the Chinese Court makes a “(public) announcement”, without any determination of substantive legal rights;
- this distinction accords with that made in EBL Art 107 itself between xuāngào and gōnggào (both words being used in that Article with the respective meanings identified);
- no dispute between the parties as to the mechanism by which insolvency proceedings unfold under the EBL; no dispute between the parties that the Seller has not been declared bankrupt under EBL Art 107.
- everything turns on what Art X.5(b) means. If the Buyers’ construction is right, the termination was lawful. If the Seller’s construction is right, the termination was unlawful.

Seller's (Builder's) main argument

- The key issue is the correct interpretation of Article X(5)(b) of the Contract.
- This provides for a right of termination in favour of the BUYER where “the Court declares Bankruptcy Proceedings against the SELLER under Chinese Law.”
- The SELLER believed this only permits cancellation when the SELLER has actually been declared bankrupt as opposed to commencement of insolvency. Process may result in pay off or third party guarantee, reorganization or compromise and conciliation. Otherwise, Buyer could terminate even where on commencement of proceedings the vessel was ready. And that delay pending bankruptcy proceedings could be addressed as excessive delay for purposes of cancellation.
- The word “Proceedings” must be ignored, or at least subdued, or, absorbed by the word Bankruptcy, and the use of the word “declares”, a term of art, was intended by the parties to refer to a specific Chinese word, “Xuangao”, also a term of art, which is used within the Chinese Enterprise Bankruptcy Law (“EBL”) only in the context of a final declaration of bankruptcy under Article 107.

Meaning of the words per Seller

- a) Art X.5(b) refers to Chinese Law, the only relevant part of which is the Enterprise Bankruptcy Law (“EBL”);
- b) Bankruptcy proceedings are commenced when an insolvency case is accepted under Section 2 EBL (see Art 11).
- c) Accepting an insolvency case is not the same as declaring a debtor to be bankrupt/insolvent. This is plain from Arts 12, 70 and 95.
- d) A debtor or creditor can only file a reorganization application after the court has accepted the bankruptcy proceedings, but before the debtor has been declared bankrupt . Therefore the right to cancel under Article X.5(c) of the Contract could not arise until after the right to cancel under Article X.5(b) had arisen, so Buyers’ construction was making Article X.5(c) obsolete or redundant.
- e) A debtor may be the subject of bankruptcy proceedings without ever being declared bankrupt. That will be the case where the Court accepts a bankruptcy application under Art 11, then accepts a reorganization plan under Art 88, and then the reorganization plan is implemented and the supervising period expires (Arts 90-91).

Meaning of the words per Seller (2nd slide)

- The term '*declaration*' is never used in the EBL in conjunction with the beginning of bankruptcy proceedings.
- The term '*declaration*' is only used in the EBL in one of the following two contexts:
 - a) The court declaring a debtor to be bankrupt: Arts 12, 70, 78, 79, 88, 93, 95, 99, 103, 104, 107-108.
 - b) Creditors declaring claims: Arts 14(3), 44-57, 59, 62, 92, 100.

Meaning of the words per Seller (3rd slide)

- The EBL uses one Chinese expression (xuāngào) to mean “a declaration with substantive effect”, and another (gōnggào) to mean “a public announcement”. In particular, xuāngào is only ever used in the EBL in the context of a declaration of bankruptcy;
- when accurately translated into English, xuāngào is “declares” and gōnggào is “publicly announce” (or their nominal equivalents);
- therefore “declares” in Art X.5(b) must refer to a declaration of bankruptcy under the EBL (Art 107 being the relevant article);
- although this construction requires the reader of Art X.5(b) to ignore the word “Proceedings” in “Bankruptcy Proceedings”, that is the only construction which gives effect to the true meaning of “declares”;
- no declaration under EBL Art 107 (and hence no declaration of Bankruptcy Proceedings) had been made by the time Buyers cancelled in this case;

Purposive interpretation per Seller

- a) The most natural reading of Article X.5(b) seemed that it refers to the bankruptcy procedure to which Art. 108 EBL refers, i.e. the procedure consequent upon a declaration of bankruptcy.
- b) It seemed less natural for Article X.5(b) to refer to the acceptance of an insolvency case to which Arts. 9-21 EBL (in particular) refer, especially given the reference in X.5(c) to the acceptance of a petition for reorganization proceedings.
- c) Articles X.5(a) - (c) all target the liquidation of the Seller, because that is the result of the events identified in all three. Article X.5(b) is unlikely to refer to the acceptance of a bankruptcy petition, because that does not in itself mean (and does not necessarily lead to) the liquidation of the Seller.
- d) If Art X.5(b) referred to the acceptance of the bankruptcy petition, Art X.5(c) would be redundant, because there can only be reorganization proceedings after the court has accepted a bankruptcy petition. True, the contract may provide for a second bite at the cherry (Buyer can sit out the Article X.5(b) right after it accrues, and then cancel later under Article X.5(c)). That seemed, commercially, a possible but less obvious scheme.

**“the Court declares Bankruptcy Proceedings against the SELLER
under Chinese Law”
per BUYERS (general assessment of case)**

- The Buyers’ case is that, for the purposes of Art X.5(b), a declaration of Bankruptcy Proceedings against the Seller under Chinese law was made by (at the latest) the time of the Chinese Court’s “Public Announcement”.
- It was Buyers’ view that the meaning of the Clause is clear and unambiguous and to be interpreted not by reference to principles of Private International Law but directly in accordance with English Law, which will give prominence to the intention of the parties identifiable by the natural and ordinary meaning of the words used, the overall purpose, the other clauses, the facts at the time of entering the contract, common sense but ignoring subjective intentions of the parties.
- Buyers considered it unlikely that the Tribunal would wish to delve into the details of Chinese Law or the correct translation into English of the EBL.

Buyers' primary arguments

- X(5)(b) is to be interpreted under English Law without reference to Chinese Law. The word “declares” was not intended as a term of art and should be given its ordinary English meaning: i.e. “announces” or “makes known formally”. A detailed semantic analysis must give way to reasonableness and business common sense, a unitary rather than sequential process, involving, context, and consequences of rival interpretations.
- Buyers' construction is less forced than the Seller's. It asks the Tribunal to read “declares” in the sense of “announces”, which is a natural enough step, a natural enough compression;
- The parties would not have included the word “Proceedings” if they had intended the right only to arise when Yard was finally adjudicated bankrupt. Also, the factual matrix and commercial intention of the contract is that the Buyers, because of the volatility and high risk of the shipping business, wish to avoid additional uncertainty and delay of Yard's prolonged insolvency process.
- Upon final adjudication of bankruptcy, the contracts seem doomed in any event.
- Perceived inequity could still be there if vessel ready, yet contract cancelled upon terminal declaration of bankruptcy.

Buyers' arguments (more detail)

Buyers' secondary position, should the Tribunal consider Chinese Law relevant, was that:

- The word “declares” does not translate in Chinese only as “Xuangao”; the EBL uses at least three other Chinese verbs which also translate “declare” back in English;
- The Yard's case requires too much reasoning backwards from Chinese words to the English word “declares”. It is easier to conclude that “declares” in Art X.5(b) does not mean *xuāngào*, than to insist that it does and manipulate the rest of the sentence accordingly.
- There was no evidence to suggest that the parties agreed that the word “declares” should bear the special meaning referred to above.
- If the parties had intended to incorporate in the contract reference to a specific article of the Chinese EBL, they could and would have said so.
- The above arguments are reinforced by the observation that X(5)(b) originates from a “boilerplate” clause where one can find Korean Law in lieu of Chinese Law, depending on Yard's base.
- Presumption against surplusage. On Yard's construction of Art X.5(b), it is unclear what the practical difference is between that Article and Art X.5(a). The Tribunal was likely to lean somewhat away from interpreting two provisions to mean (in practice) the same thing.

Commercial sense

- Once the Court has accepted a creditor's application, and an administrator has been appointed, the whole commercial picture relating to a shipbuilding contract changes.
- It makes eminent commercial sense for a shipbuilding contract to entitle a Buyer to terminate in those circumstances.
- Both the BIMCO Newbuildcon and CMAC standard forms would permit termination well before the final death knell
- It is far more important for a buyer to have a right to terminate at the start of the bankruptcy process than to have a right when the final death knell sounds (here by way of a declaration of bankruptcy).
- That the Buyer can do nothing until the final death-knell sounds when the debtor is finally declared bankrupt – is uncommercial in the extreme and lacks business common-sense.

Relevant cases

- *Prenn v Simmons* [1971] 1 WLR 1381
- *Reardon Smith Line Ltd v Hansen Tangen* (“The Diana Prosperity”) [1976] 1WLR 989
- *Investors Compensation Scheme v West Bromwich Building Society* [1988] 1WLR 896
- *Co-operative Wholesale Society Ltd v Westminster Bank plc* [1995] 1 EGLR 97
- *Tam Wing Chuen v Bank of Credit and Commerce Hong Kong Ltd* [1996] 2 B.C.L.C. 69
- *Beaufort Development (NI) Ltd v Gilbert Ash (NI) Ltd* [1999] 1 AC 266
- *McCann v Switzerland Insurance Australia Ltd* [2000] HCA 65, per Kirby J.
- *Dairy Containers Ltd v Tasman Orient Line CV* [2004] UKPC 22
- *Shamil Bank of Bahrain v Beximco Pharmaceuticals Ltd* [2004] EWCA Civ 19; [2004] 1 WLR 1784] at [51].
- *Chartbrook v Persimmon Homes* [2009] AC 1101
- *Co-operators Life Insurance Co v Gibbens* 2009 SCC 59 (Supreme Court of Canada).
- *Rainy Sky SA v Kookmin Bank* [2011] UKSC 50
- *Marley v Rawlings* [2014] UKSC 2
- *Arnold v Britton and Others* [2015] UKSC 36
- *In Morris v Blackpool Borough Council*[2014] EWCA Civ 1384; [2015] L & TR 6.
- *Ronelp Marine Ltd v STX Offshore and Shipbuilding Co* [2016] EWHC 2228 (Ch): para [7] of that judgment.
- *Wood v Capita Insurance Services Ltd* [2017] UKSC 14
- Cf Levinson, “The Interpretation of Contracts” (6th ed., 2015)