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Soundings

In this issue: Refund Guarantees – to pay or not to pay?

Refund Guarantees – to pay or not to pay?

Most shipbuilding contracts require a prospective owner of a ship to pay the purchase price in instalments, usually linked to key stages in the construction of the ship. Where a shipyard is in a foreign jurisdiction, a key question for the owner will be his ability to recover these instalments if the ship is ultimately not delivered, for example by reason of excessive delay or the shipyard going out of business. This risk is nearly always addressed through refund guarantees, whereby the guarantor, usually an internationally recognised bank, will agree to refund any advanced instalments if the yard defaults on its obligations to the owner.

Against this general proposition, the recent decision by the Court of Appeal in England in *Rainy Sky v Kookmin Bank* ([2010] EWCA 582) has caused a degree of uncomfortableness, as the court concluded that a bank's obligations under the refund guarantee in question were not triggered by the insolvency of the shipyard.

The owner, which was a Member of the Club, entered into shipbuilding contracts with Jinse Shipbuilding Co. of Korea for the construction of six ships. Refund guarantees were provided to secure the pre-delivery instalments. The yard however entered into a debt work-out procedure. Consequently the Member claimed under the refund guarantees for the return of the advance instalments totalling \$45 million. The guarantees in question were "on demand" guarantees and did not allow the bank, Kookmin Bank, to withhold payment in the event that the yard disputed the Member's claim.

The Issue

The refund guarantees in question provided as follows:

- "(2) Pursuant to the terms of the Contract, you are entitled, upon your rejection of the Vessel in accordance with the terms of the Contract, your termination, cancellation or rescission of the Contract or upon a Total Loss of the Vessel, to repayment of the pre-delivery instalments of the Contract Price paid by you prior to such termination..."
- (3) In consideration of your agreement to make the pre-delivery instalments under the Contract ... we hereby, as primary obligor, irrevocably and unconditionally undertake to pay to you ... on your first written demand, all such sums due to you under the Contract ..."

The key issue raised by the case was whether the words "all such sums due to you under the Contract" in paragraph (3) of the refund guarantees referred back to the words "the pre-delivery instalments" at the beginning of that paragraph or to the specific repayments or payments referred to in paragraph (2).

Essentially the Bank argued that the terms of paragraph 3 and the phrase "*all such sums due to you*" referred to amounts set out in paragraph 2 and therefore only to repayments due upon rejection or total loss of the ship, or termination, cancellation or rescission of the contract and payments due for buyer's supplies. As Article 12.3 of the contract did not refer to the yard's

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insolvency the Bank argued that this did not give rise to a liability under the refund guarantee.

The Member had been successful in the English Commercial Court where the judge had agreed with the Member that the words used in paragraph (3) were clear and unqualified. The Court had also agreed that the wording as suggested by the bank would lead to an uncommercial result of a refund guarantee not responding to the most obvious circumstance which it was designed to protect from.

Court of Appeal judgment

The English Court of Appeal (by a majority) however disagreed with the High Court and overturned the lower court's ruling. The Court of Appeal comprised Sir Simon Tuckey (a Commercial division judge), Lord Justice Patten (a Chancery division judge) and Lord Justice Thorpe (a Family division judge). The Member's position was upheld by Sir Simon Tuckey, however Lord Justice Patten and Lord Justice Thorpe found for the bank.

In his judgment, Sir Simon Tuckey accepted that the bank's construction of the guarantee was possible. However, in his view what was decisive was whether it was surprising and uncommercial. On this point he agreed with the first instance decision. He considered it important that regard should be had to the specialism of the Commercial Court, and concluded:

“As an experienced commercial judge the judge's conclusion... should be given considerable weight by this Court. I agree with his conclusion. On the Bank's construction the bonds covered each of the situations

in which the Buyers were entitled to a return or refund of the advance payments which they had made under the contracts apart from the insolvency of the Builder. No credible commercial reason has been advanced as to why the parties (or the Buyers' financiers) should have agreed to this. On the contrary, it makes no commercial sense. As the judge said, insolvency of the Builder was the situation for which the security of an advance payment bond was most likely to be needed. ...It defies commercial common sense to think that this, among all other such obligations, was the only one which the parties intended should not be secured. Had the parties intended this surprising result I would have expected the contracts and the bonds to have spelt this out clearly but they do not do so.”

Lord Justice Patten however disagreed. As to the construction of the guarantee, he concluded:

“Although the Buyer's construction is, as lawyers say, arguable, it is not in my view the meaning which the document would convey to a reasonable person reading it with knowledge of the terms of the shipbuilding contract...”

He then considered the question of what he described as “the alleged uncommerciality” of the bank's construction, and whilst recognising the weight that had been given to this aspect by both the Commercial Court and by Sir Simon Tuckey, he went on to say:

“Although the judge is right to say that cover for such event was, objectively speaking, desirable, that is not

sufficient in itself to justify a departure from what would otherwise be the natural and obvious construction of the bond. There may be any number of reasons why the Builder was unable or unwilling to provide bank cover in [the event of its insolvency and why the Buyer was prepared to take the risk. This is not a case in which the construction contended for would produce an absurd or irrational result... and merely to say that no credible commercial reason has been advanced for the limited scope of the bond does, in my view, put us in real danger of substituting our own judgment of the commerciality of the transaction for that of those who were actually party to it.”

Accordingly, Lord Justice Patten allowed the bank's appeal.

Lord Justice Thorpe did not give a full judgment, restricting himself to the following comments:

“I find myself in the invidious position of expressing a decisive opinion in a field that is completely foreign. With considerable trepidation I support the judgment of Patten L.J. I found that Mr Philips submissions had turned me from my preliminary position that Simon J was right for the reasons he gave. I would allow the appeal for the reasons stated by Patten L.J.”

Appeal to the Supreme Court

The Member has recently been granted leave to appeal to the Supreme Court and the Managers will report on the outcome of the appeal in due course. In the meantime this case reinforces the need to check the wording and scope of refund guarantees very carefully.

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