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soundings

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A refund guarantee is a crucial aspect of any newbuilding contract. It is the security which underpins the pre-delivery instalments that the buyer has to make. If something goes wrong it is that security which aims at placing the buyer in the same position as he was when he entered in to the contract.

With the downturn in the markets the efficacy of the refund guarantees has now begun to be tested both by buyers and shipyards. When contracts are cancelled consideration will be given to whether the refund guarantee is an “on-demand” guarantee or one that responds when certain conditions are met. Unsurprisingly shipyards and insurers standing behind such guarantees are actively considering ways in which their exposure to such guarantees can be minimised.

The Association has recently been involved in a case to determine whether or not a refund guarantee was an on-demand guarantee. In the case of RAINY SKY ([2009] EWHC 2624 (Comm)) the Association supported the buyer Member in its claim against Kookmin bank. In addition to whether the refund guarantee in question was

an on-demand guarantee there was a further issue as to whether that guarantee responded to the insolvency of the yard. Following the yard’s bankruptcy, the Member sought to recover approximately \$ 55 million paid to the yard by way of pre-delivery instalments.

The bank argued that the refund guarantee did not cover the pre-delivery instalments and, further, argued that the guarantees were not “on demand” guarantees which required the bank to make immediate payment on receipt of a genuine (ie non-fraudulent) claim. The Member argued that if the pre-delivery instalments were not covered by the refund guarantee this would be “odd and highly uncommercial”. In his judgment, Mr Justice Simon agreed that the Member’s arguments were “plainly right” on this issue. He went on to find that the guarantee was an on-demand guarantee and ordered immediate payment by the bank to the Member.

The bank is pursuing an appeal to the Court of Appeal and the Managers will report further on this in due course.

In light of this case Members should be considering how their refund guarantees are drafted in future so that the enforceability of such guarantees is as straightforward as possible.

What other things should be considered?

1. Jurisdiction

If the refund guarantee has been issued by a Korean or Chinese bank then it is preferable for the jurisdiction clause to provide for disputes to be resolved by arbitration, rather than before the English High Court. This is because arbitration awards are enforceable in China and Korea under the New York Convention whereas the enforcement of High Court judgments is less straightforward.

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In the event that the guarantee provides for High Court jurisdiction, it is important to ensure that it also includes an address for service of process to save the cost and time (which can be considerable) of obtaining leave to serve out of the jurisdiction and affecting service.

2. To what does the guarantee respond?

Quite often the guarantee as drafted will only respond to a contractual cancellation under the shipbuilding contract. That raises the difficult issue as to whether the refund guarantee will respond if there has been a termination of the contract by the buyer following a repudiatory breach by the yard. By way of example if, in advance of the “drop-dead date”, the yard makes it absolutely plain that it cannot or will not build the ship in time, and the buyer chooses to terminate the shipbuilding contract, a dispute may arise over whether the guarantee will respond. It is therefore prudent to ensure that the guarantee specifically responds to “termination” as well as to contractual rights of cancellation/rescission.

Care should also be taken to ensure that the guarantee responds in other situations in which the buyer is not entitled to cancel or terminate but is entitled to demand a refund under the guarantee. It is not uncommon for a shipbuilding contract to provide that in the event of an insolvency situation (take for example an administration under the Korean rehabilitation statute) the buyer is entitled to demand a refund of the instalments, but it does not give rise to a right to cancel the shipbuilding contract. Instead, the yard has the option to build the ship (albeit without instalments) and tender it for delivery.

3. Expiry of the refund guarantee

In some instances, the refund guarantee provides that it will expire on rescission of the shipbuilding contract by the yard in the event of the buyer’s default. However, provision needs to be made for the possibility of the validity of that rescission being challenged by the buyer. Accordingly, provision should be made to ensure that the refund guarantee will continue to remain in place in case the yard’s rescission is the subject of proceedings and is held to be wrongful (giving rise to a right of refund to the buyer).

Following on from this, it is important to ensure that the guarantee remains in place until the conclusion of proceedings, so the possibility of appeals needs to be taken into account. It is therefore recommended that the guarantee is worded in such a way so that it will only expire a certain number of days after an unappealable award or, in the event of an appeal, a certain number of days after an unappealable judgment.

4. Interest

The interest provisions in the refund guarantee should match those in the shipbuilding contract. Sometimes the interest rates will differ depending upon the basis upon which the contract has been cancelled by the buyer. For example, in some contracts where the contract has been cancelled in the light of a number of days of permissible delay the builder will seek to pay no, or a reduced level of, interest.

5. Non-waiver clause

It is essential for there to be a non-waiver clause which states that the guarantee will be unaffected by any variation of the shipbuilding contract

or any extension of time granted to the yard. This ensures that if the shipbuilding contract is varied, even without the consent of the refund guarantor, the refund guarantee will remain effective.

6. Swift Guarantees

An issue has arisen over recent months as to whether a Swift guarantee meets the requirements of the UK Statute of Frauds which requires that a guarantee is signed by the guarantor. It is often the case that refund guarantees sent by Swift are simply authenticated by the remitting bank without there being a signature or even the name of the authorised signatory appearing. This is an extremely technical area (and there are competing opinions from leading counsel) but as a minimum the Swift message should contain the name of an authorised signatory at the refund guarantor bank.

7. Costs

Refund guarantees have not historically made provision for the recovery of costs. Therefore if costs are incurred against the shipyard in any arbitration proceedings these are only recoverable from the yard and not the refund guarantor. Clearly this does not assist the buyer if the yard is unable to meet its obligations. There is an argument which favours the issue of costs being made part of the terms of the refund guarantee. The provider of the guarantee may of course argue that costs as between the buyer and the yard should be between those parties only. However, where the provider of the refund guarantee is directing the steps that are being taken by the yard to contest the lawfulness of any termination that provider should necessarily be responsible for the costs.

Of course if the refund guarantor fails to meet its obligations under the guarantee then the costs of this claim would, under English law, be recoverable in the normal way.

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