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“REFUND GUARANTEES – LESS THAN PERFECT SECURITY”

by **Simon Curtis**

As readers of these pages will be aware, the global financial crash which commenced in September 2008 has led to a swift and massive decline in new ship values. Whilst most of the so-called “noughties” saw demand at its highest for decades, shipyards worldwide now struggle to fill their order books and newbuilding purchasers seek, sometimes in desperation, to renegotiate contract prices or to cancel orders placed in happier economic times. Shipbuilding lawyers are in consequence now faced not with the previous problems of enforcing the shipbuilder’s performance of the project, but rather of ensuring that, if and when the newbuilding is no longer wanted, the shipowner and his financiers can recover their pre-paid instalments of the contract price together with interest.

The security usually given to the shipowner for repayment of these monies is a refund guarantee i.e. a guarantee or undertaking given by a bank that, if the project is cancelled for reasons attributable to the shipbuilder but the latter fails to make the payment, the bank will do so on the shipbuilder’s behalf. Refund guarantees governed by English law are the financial cornerstone of the majority of international shipbuilding projects, but their importance has been somewhat downgraded in recent years while newbuilding demand remained strong - many literally lay unread in the fire safes of the shipowners or their financiers for the duration of the construction project until they were handed back to the shipbuilder on delivery.

How times change! As shipowners decide whether to maintain, renegotiate or cancel their newbuilding commitments, the terms of the refund guarantee have suddenly become a key element of the equation. And this in turn has led many newbuilding purchasers and their bankers to appreciate, often for the first time, the considerable limitations of such guarantees in terms of the security they provide – whilst many of these limitations have been self-evident for decades, their significance has probably never been more pronounced than in current market conditions.

The key issue is the scope of the coverage provided. In their overwhelming majority, shipbuilding refund guarantees “respond” only if the instalments of the price become repayable to the purchaser pursuant to the express termination provisions of the contract – and these are themselves normally limited to specific circumstances of delay in delivery and failure to meet defined technical parameters such speed and deadweight – there is no obligation whatever resting upon the guarantor if the contract comes to an end for any other reason.

The primary circumstance in which termination can occur other than under the express provisions of the agreement is where the shipbuilder commits a very significant, so-called “repudiatory”, breach of contract and the purchaser chooses under English common law principles to “accept” this as bringing the contract to an end. Whilst the purchaser’s acceptance of the breach will end the primary obligations arising under the contract, which are replaced by secondary obligations to pay damages and, normally, to

refund the purchaser's instalments, this obligation rests upon the shipbuilder alone and performance is not guaranteed by the refund guarantor.

Thus, for example, in a recent matter in which CDG was involved, a small Asian shipbuilder failed to progress the construction of the vessel in accordance with the agreed specification – the European purchaser was perfectly entitled to treat this as a repudiatory breach of contract but, having paid two instalments of the contract price against the security of a refund guarantee which responded only to a contractual termination, simply could not risk doing so and losing his right of recovery against the refund guarantor. The purchaser is therefore currently awaiting the date in 2011 when his right to terminate for delay in delivery will arise under the express provisions of the contract. To add insult to injury, he will also probably have to pay further instalments of the contract price before he can "trigger" repayment under the refund guarantee.

The scope of coverage issue is particularly acute where, whether by accident or design, the refund guarantee will expire before the contractual right of termination for delay in delivery can validly be exercised. In such circumstances, the purchaser can be faced with a horrible dilemma – does he seek to treat the shipbuilder's lack of progress as a repudiatory breach (which will not invoke the refund guarantee) or risk the possibility of having to pay further instalments of the contract price after the expiry of the refund guarantee but before delivery of the vessel?

In addition to this principal problem, there are other deficiencies inherent in many shipbuilding refund guarantees. In particular such guarantees often do not cover events for which the shipbuilding contract may be "automatically" terminated, such as the total loss of the vessel, typically by a fire, during the course of construction, or the frustration of contract, mainly because of war or sanctions. It has been many years since the last shipbuilding contract frustration case was decided in England, but more than half the world's ships are built in South Korea and the possibility of frustration by reason of war with North Korea simply cannot be ruled out.

It is therefore to be hoped that more attention will be paid in future to the scope of coverage of these crucial guarantees and, from the shipowner's perspective, that market conditions more in his favour than for many years will allow the negotiation of guarantees of more practical value than have customarily been offered.

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