



Shipbuilding contracts and related finance issues
Enforcing the Refund Guarantee – practical problems

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Ladies and Gentlemen, good evening. I am very pleased to have the opportunity to participate in the London Shipping Law Centre's 2009-2010 lecture programme and in these talks tonight relating to shipbuilding contracts and ship finance. I would like to spend a few minutes discussing a topic which is currently of considerable relevance to commercial newbuilding purchasers, shipyards and their respective financiers, namely the problems that can arise in enforcing a refund guarantee in respect of a cancelled shipbuilding contract.

As all of you will be aware, commercial shipbuilding projects, at least in the international sector, are frequently conducted under contracts governed by English law and providing for London arbitration. The contract normally provides for a shipbuilder to construct the vessel within an agreed timescale, in accordance with a defined specification, for a lump sum contract price payable by the buyer in several instalments prior to and upon delivery. The buyer is usually entitled to certain rights to cancel the contract if the vessel is late or if she fails to comply with certain specified performance parameters such as speed, fuel consumption and deadweight.

Where the buyer lawfully exercises a right to cancel a shipbuilding contract, this brings to an end the parties' respective obligations to construct and purchase the new ship. Under most shipbuilding contracts the builder then becomes obliged to refund to the buyer the amount of the instalments paid on account of the contract price, together with interest from the date of payment until repayment.

There is the obvious risk, however, that the builder will not be able to refund the pre-paid instalments upon the buyer's cancellation. The refund guarantee, under which a third party, usually a bank, guarantees to the buyer the performance of this repayment obligation, is therefore almost invariably the financial cornerstone of the shipbuilding contract and of the project. Such guarantees are again typically subject to English law and jurisdiction and often assigned to the buyers' financiers as part of the security for the funding of the newbuilding project.

Now as everyone here will be aware, the collapse in world shipbuilding demand which followed the beginning of the global financial crisis in mid-September 2008 has led to a situation in which significant numbers of newbuilding contracts, many of which had been placed with smaller Asian shipyards of limited financial strength, have been, or will be, cancelled. And this in turn has meant that many refund guarantees which would otherwise have been allowed quietly to expire without ever being seriously read have had to be "dusted off", checked as to their legal enforceability and in a minority of cases actually enforced in the UK and elsewhere.

This has in numerous instances highlighted practical or legal problems with the form of these guarantees. It is in our experience quite common, in circumstances in which the shipyard in question is in financial difficulties, for the refund guarantor to take full advantage of any deficiencies in the form or substance of the relevant guarantees. I would emphasise that, whilst many of these problems are not "new" (in the sense that some of these problems have been apparent for years), global economic conditions have made them of much greater significance today than, say, three years ago. Whereas between 2005 – 2007 many shipowners were struggling to hold on to shipbuilding contracts which the yards were seeking to renegotiate upwards in price, these same shipowners are now themselves trying to divest themselves of their shipbuilding contract commitments and recover the instalments they have paid from financially weak shipyards and their refund guarantors.

So let's look briefly at some of the problems that characteristically arise in relation to the enforcement of refund guarantees governed by English law. There in my

experience a number of general and specific deficiencies which affect instruments of this type and their value to shipowners and their financiers.

The first and most significant issue is that the scope of the coverage provided. In a nutshell, the problem is that the commitment on the part of the refund guarantor is *only* to refund against cancellation of the shipbuilding contract strictly in accordance with its express terms. In the overwhelming majority of refund guarantees issued for international projects, particularly by shipyards in the largest shipbuilding nations, Korea, China and Japan, the refund guarantee provides that it will respond if the instalments become repayable pursuant to express cancellation of provisions of the contract – there is therefore no obligation upon the guarantor if the contract comes to an end by reason of the buyer's acceptance of the builder's conduct as a repudiatory breach.

This limitation is very often misunderstood by shipowners. As a firm specialising in this area, we have, whether in the boom period between 2003 – 2008 and in the “crash” that followed, been involved in numerous instances in which a ship owning client has come to us wanting to terminate the shipbuilding contract as a result of a breach, actual or imagined, on the part of the shipyard, but we have to advise him not to do so because this would have deprived him of a right to recovery under the refund guarantee.

Let me give you a practical example which occurred earlier this year. We were instructed through one of the P & I Clubs represented here this evening on behalf of an Italian shipowning company which had entered into a contract with a Chinese shipyard for two ships. The Italian shipowners paid two instalments of the contract price during the design and engineering phase of the project before they realised that the shipyard, which was facing significant problems in meeting the deadweight performance guarantees under the contract, was intending to build the vessels to a radically different design to that which had been agreed in the specifications.

This was plainly an anticipatory or actual breach of the shipbuilding contract, which was probably repudiatory in nature, but the contract entitled the shipowner to cancel only in the event of 180 days of non-permissible delay following the Contractual Delivery Date or a breach of various performance parameters determinable only upon delivery, including the vessel's deadweight. And in these circumstances, to the amazement of our clients, which being Italian they were obliged to express rather volubly, we were obliged to advise them that they could not terminate the contract immediately and recover the instalments and interest but had to wait until the cancelling date in order to ensure that they preserved their rights against the refund guarantor. Furthermore, we also advised that, even though the vessels were clearly not in conformity with the specifications, the clients would run significant risks of forfeiting the first two instalments if they refused to pay the subsequent third and fourth instalments of the contract price pending cancellation for delay in delivery of a conforming vessel - I can assure you that this advice was about as well received as Italy being knocked out of the qualifying stages of the World Cup by San Marino.

The problem of the refund guarantee responding only to a cancellation in accordance with the terms of the shipbuilding contract is, as I will mention again later, particularly acute where the refund guarantee is going to expire before the shipbuilding contract can be cancelled in accordance with its express terms - even if the shipbuilder is bound to miss the cancelling date by reason of his dilatory, and possibly repudiatory, progress of the construction project, the buyer cannot normally risk terminating early in accordance with common law principles because he cannot then trigger the refund guarantee.

But, as you will see from the Italian example, the problem doesn't arise only in relation to delay and is relevant in any situation in which the buyer might legitimately be entitled to bring the contract to an end under common law principles - there is, of course, nothing to stop him from doing so if he is entirely confident that the shipbuilder is going to be able to repay his instalments of the contract price with interest, but given the capital values involved in most international shipbuilding projects, this is very rarely a risk that the shipowner is willing to run.

Furthermore, and perhaps even less well appreciated, is the fact that the shipbuilding contract may also come to an end by reason of circumstances other than the exercise by the buyer of an express contractual or common law right. The most obvious examples of this are "automatic" termination of the shipbuilding contract by reason of a total loss of the vessel, typically by a fire, during the course of construction, which circumstance is often not covered by the terms of the refund guarantee, and frustration of contract. Whilst the overwhelming majority of English law cases involving frustration of shipbuilding contracts concern projects which have been prevented or impeded by war or war related sanctions, this possibility cannot be ruled out. This is particularly the case in the context of newbuildings constructed in South Korea, the world's largest shipbuilder, where the risk of a conflict with North Korea is (as recent events have made clear) very real.

Although it is well established practice in international shipbuilding for refund guarantees to be limited to circumstances of express termination by the shipowner, I continue to find it extraordinary that shipowners and, more importantly, their financing banks are prepared to contract on this basis. Perhaps the changed economic climate, and the lead shown by the draftsmen of the NEWBUILDCON form, which more liberally provides that the required form of refund guarantee must respond "*if the Builder becomes liable under the Contract to repay any part of any Instalment*", may lead to a change in general practice on this issue - but I am not very confident. Meanwhile, my firm will continue to advise shipowners entering into new projects to look very carefully at the terms of the refund guarantee offered to them and ask themselves whether they wish their rights of recovery to be limited to those restricted circumstances expressly defined in the shipbuilding contract. Significantly, such a limitation is not usually acceptable in offshore oil and gas construction contracts where the oil companies are normally much more careful about their money!

The second deficiency we regularly see in refund guarantees relates to their date of expiry - this is a specific, rather than a general, problem but one which is in our experience common. We are in other words often confronted by clients holding refund guarantees - hopefully not ones we have ourselves drafted or approved - which provide for their expiry on a fixed calendar date which does not reflect the accrual of the client's cancelling rights under the shipbuilding contract. As I have indicated already, even if the builder is very late in completing the vessel, it is not an answer for the buyer to try to terminate on common law grounds before the refund guarantee expires, because the guarantee will simply not respond to this type of termination.

The key to avoiding this situation is obviously to ensure that there is a sufficient time margin between the accrual of the right to cancel and the expiry of the refund guarantee to allow the latter to be called in all circumstances. Where, as is usual, the shipbuilding contract provides for the contractual delivery date to be extended by reason of events of permissible delay, principally force majeure, it is vital that the builder's entitlement to claim such extension should be subject to a "cap" or limit which prevents the postponement of the cancelling right to a date beyond expiry of the refund guarantee. Alternatively, and in my view preferably, the shipbuilding contract should

provide for a "drop dead" cancelling date on which, regardless of the reasons for the delay in construction, the buyer is entitled to cancel, and the refund guarantee should only expire on a date falling thereafter. The "gap" between the two dates should obviously be sufficient to allow notice of demand to be made upon the shipowner for repayment of the instalments and, if this is rejected or ignored, for a further demand to be made upon the refund guarantor.

A particular problem we have experienced in this context arose between 2005-2008 when shipbuilding markets were extremely strong. As I have said, in these market conditions, many shipowners struggled to enforce performance of the shipbuilding contract at the original contracting price and faced threats by shipyard to abandon the contract and sell the building slot or the vessel elsewhere unless the contract price was increased. We saw several situations in which, in pursuance of unlawful demands for a contract price increase, shipyards quite deliberately slowed down the progress of construction of the vessels in the knowledge that the buyer would not cancel and that the refund guarantees for the project would in consequence expire, leaving the buyer completely exposed without any security from the project. This was particularly difficult issue to address - the commencement of proceedings for a declaration that the builder was not constructing the vessel in a timely fashion would not in itself extend the validity of the refund guarantees and most of these situations had to be resolved by some form of compromise with the shipyard involving an additional payment. It may be many years before we are again in similar "boom" conditions but, when these return, it may well be appropriate for shipowners and their bankers to question whether a fixed expiry date is acceptable where the project is particularly complex or the shipyard is of questionable pedigree.

The third issue is often linked to the issue of the expiry dates and concerns the requirements which must be met before the guarantee can be validly triggered, in particular whether the guarantee is "callable" upon the buyer's simple demand or only after the builder's liability to make the refund has been independently determined in arbitration or court proceedings.

Most refund guarantees given in relation to international projects fall into the latter category i.e. the guarantor's obligation to refund is made conditional upon either the builder's admission of liability or an arbitration award or court judgement determining such liability. It is, however, obviously advantageous to the purchaser to be able to demand the return of his pre-paid instalments without the need for lengthy court battle and, often by inadvertence rather than design, this is sometimes agreed by the shipbuilder.

In the recent decision in *Rainy Sky SA v Kookmin Bank* [2009] EWHC 2624 (Comm), QBD the High Court cited with approval the principles applicable to the interpretation of refund guarantees set out in *Gold Coast Ltd. v Caja de Ahorros del Mediterraneo and others* [2002] EWCA Civ 1806 [2002]. In *Rainy Sky* the defendant bank argued the guarantees it had issued were not "on demand" instruments because the buyer was required in any demand for payment both to state that the builder had failed to perform the contract and to specify in what respects this failure had occurred. The bank argued that if the statement in the demand was really meant to be conclusive of the bank's liability, there would have been no need to specify further in which respects the builder had failed to perform. This could only mean that the buyer was required to set out the material facts of the alleged breach so as to enable the guarantor to decide for itself whether the obligation to refund had arisen.

The court rejected this argument and held in favour of the buyer that the wording of the instrument created an "on demand" obligation which arose independently of the

contract. In the absence of fraud, the guarantor was obliged to pay against a simple demand in the form in which it had been made. I would obviously recommend that you try to follow this formula when you are negotiating your next refund guarantee and the shipyard is offering a conventional guarantee dependent upon the outcome of legal proceedings.

If you fail in these endeavours, and payment under the guarantee need not be made until a final decision has been rendered by the arbitration tribunal or court, don't forget to make sure that the bank also guarantees the payment of interest in the period until liability under the shipbuilding contract is determined. And if you don't want your E & O insurers to have very large litter of kittens, make sure that appropriate provision is made against the risk of expiry of the guarantee pending the outcome of any legal proceedings, including any appeal against the first instance decision.

The fourth nightmare scenario concerns side agreements or variations to the underlying contract which may render the refund guarantee unenforceable.

As you will all be aware, in relation to any contractual performance guarantee governed by English law, it is essential to ensure (i) that the guarantor is made aware of the true nature of the contractual arrangements for which he is providing security and (ii) that, unless the guarantee expressly provides otherwise, the guarantor's consent is obtained before any material variation is made to the underlying contract. So make sure that the cheeky little side letter which your shipowner client has agreed with the shipbuilder to provide for a different contract price from contained in the agreement and disclosed to the trade press is known to, and agreed by, both your client's own financiers and the refund guarantor before any instalments of the contract price are paid. And most importantly of all, check the refund guarantee to ensure that it contains effective wording allowing the shipbuilding contract to be varied in the future without the refund guarantor's prior consent. If you don't believe me as to the importance of such a clause, I suggest you take a few quiet minutes to read the Court of Appeal's recent decision in *Associated British Ports v Ferryways NV and another* [2009] EWCA Civ 189 where the parties' agreement, without the guarantor's knowledge or consent, to extend the time allowed to one party to perform certain contractual obligations rendered the performance guarantee completely unenforceable.

Fifthly and finally, we occasionally see enforcement problems which have arisen from a failure by the shipowner to ensure compliance with legal formalities in the country in which the refund guarantee has been issued or the guarantor is based. For example, in China, foreign currency guarantees issued by Chinese banks must be registered with State Administration of Foreign Exchange ("SAFE"). Whether or not you can still obtain an English High Court judgement against the Chinese bank in the absence of SAFE registration is an interesting legal question, but not one you will find many shipowning clients are happy to pay to have determined simply because you did not know the local rules and did not bother to instruct a suitable Chinese lawyer to check for you.

And for an interesting, if rather fact specific, example of the problems associated with ensuring that the refund guarantee has been duly issued, I would refer you to the recent High Court decision in *Sea Emerald SA v Prominvest Bank* EWHC 1979 (Comm) where the refund guarantee was held unenforceable against the Ukrainian guarantor bank because the bank's regional manager had no actual or ostensible authority to issue it on the bank's behalf.

So in summary, take care in drafting or advising on refund guarantees in the current market – in straitened economic circumstances, with your clients' shipyard failing to

complete the vessel and perhaps heading for financial oblivion, such guarantees are not always what they might seem, or what your client or his bankers might in a more ideal world wish them to be.

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