

30th June 10

War in Korea - A Cause of Serious Frustration?

by Simon Curtis and Marco Potenza

The loss in March 2010 of the South Korean corvette “CHEONAN”, together with 46 crew members, and the evidence which has emerged to suggest that she was torpedoed by a North Korean submarine, has led to a significant increase in tension between the two Koreas, who technically remain at war notwithstanding their July 1953 ceasefire. As recently as 3 June, North Korea’s deputy ambassador to the United Nations, Ri Jang Gon, told a conference on nuclear disarmament in Geneva that “*The present situation is so grave that a war may break out at any moment*”. In parallel, the international community remains extremely concerned by the efforts of North Korea’s government to develop an independent nuclear capability.

These developments should be of particular concern to the maritime community. Although, notwithstanding the rhetoric, the likelihood of a full-blown war in Korea remains limited, the military situation could deteriorate very quickly, in which event the consequences for shipping of a resumption of hostilities would be significant. South Korean shipyards currently build more than the half the world’s newbuilding tonnage and are dominant in a number of market sectors. The down payments made for vessels under construction in South Korea represent in aggregate a massive level of financial exposure for newbuilding purchasers and their bankers worldwide.

From a legal perspective, the issues raised by a possible war in Korea are, however, surprisingly little discussed. The overwhelming proportion of Korean export newbuildings are constructed under shipbuilding contracts, and secured by refund guarantees, which are in each case governed by English law and provide for London arbitration or High Court jurisdiction. The key concern is the potential effect on those contracts and guarantees of the English doctrine of frustration of contract.

In English law, frustration applies where an event occurring after signature of a contract makes performance of the contract impossible or so changes the nature of the parties’ rights and obligations that it would be unjust to hold them to their original bargain. Where this occurs, both parties are automatically discharged from further performance, irrespective of the financial impact this may have upon them. However, the doctrine applies only in limited circumstances and requires in particular that the contract should make insufficient provision for the circumstances which have affected performance – if one of the parties has fully accepted the risks of the alleged frustrating event, neither party will be discharged from performance.

War is the classic circumstance in which the doctrine applies, and most of the English law decisions in which commercial contracts have been held to be frustrated relate to the two world wars. The Second World War also led to enactment of The Law Reform (Frustrated Contracts) Act 1943 which for the first time permitted the possibility of recovery of monies paid under an English law contract which had been discharged by frustration. Under the Act, a contract party can recover deposits paid to the other party where it is equitable for him to do so and subject to an allowance to the other party for performance rendered before the occurrence of the frustrating event.

However, the critical point in a shipbuilding context is that the repayment of monies paid under a frustrated shipbuilding contract is not secured by the form of refund guarantee usually issued on behalf of Korean (and other Asian) shipbuilders. As the recent *Rainy Sky* decision of the Court of Appeal made clear in a related context, refund guarantees are in practice rather limited in scope – they typically respond only where the contract is terminated pursuant to an express cancelling right exercised by the purchaser and not where termination occurs by reason of the operation of common law doctrines, including frustration.

Thus if a war between North and South Korea prevented performance of an English law shipbuilding contract, a critical question would arise as to whether the agreement made sufficient provision for such event to exclude the frustration doctrine.

The answer will, as usual, depend on the circumstances. Shipbuilding contracts typically include a *force majeure* clause which allows the shipbuilder to claim an extension of the delivery date where his performance has been hindered by events, including war, outside his control. Furthermore, the termination provisions of the contract usually allow the purchaser to terminate where *force majeure* delays claimed by the shipbuilder exceed a certain agreed maximum level, typically 180 days.

But this may not be conclusive. Although no certain rules can be defined from the relevant caselaw, there is in English law a serious prospect that a war in Korea which not merely delayed the shipbuilder's performance but rendered this practically impossible (for example, by causing massive damage to his shipyard) might entitle the shipbuilder successfully to argue that the contract had been discharged by frustration. The buyer would then have a potential remedy against the shipbuilder under the 1943 Act but, because the contract has ended, almost certainly no claim against the refund guarantor.

From the shipowners' perspective, the optimum solution is that Korean shipbuilding contracts should provide expressly that the shipbuilder accepts all risks associated with a possible war with the North, which would not constitute a frustrating event, and that the coverage provided by Korean refund guarantees should expressly encompass this risk. If these precautions are not taken and the ultimate catastrophe was to occur in Korea, shipowners and their financiers could be both frustrated and seriously out of pocket...

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