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Courts reverse course on refund guarantees

by **Justin Turner and Keith Krut**

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The decision in *Rainy Sky S.A. & others v Kookmin Bank*, that we reported on in this column last December has now been overturned on appeal.

In High Court, the buyer had claimed repayment of pre-delivery instalments paid to a Korean shipbuilder under ‘advance performance bonds’ (in essence refund guarantees) when the builder applied for protection from its creditors under the Korean Corporate Restructuring Promotion Law 2007.

Under the shipbuilding contract, the buyer did not have a right to terminate the contract in such circumstances, but was entitled to repayment of the pre-delivery instalments. The question was whether the bond guaranteed that repayment or not. The High Court identified two conflicting provisions in the bond: the first guaranteed the repayment of “*all such sums due ... under the Contract*” which plainly included sums repayable in the event of insolvency, and the second provided (in a separate paragraph) that the refund could only be claimed from the defendant bank in the event of rejection of the vessel, total loss or “*termination, cancellation or rescission of the Contract*”. The defendant bank argued that on its proper construction, the bond responded to a demand for a refund only if there had first been such a termination, cancellation or rescission.

In the High Court proceedings, Mr Justice Simon had dismissed the bank’s argument, finding that the words “*all sums due...under the Contract*” were clear and unambiguous, and the bank’s construction had the “surprising and uncommercial result that the buyers would not be able to call on the bond on the happening of the event which would be most likely to require the first class security”.

On appeal, Sir Simon Tuckey agreed with the judgment of Mr Justice Simon. He pointed out that if, as in this case, there are two possible constructions of a contract, the Court is entitled to reject the one which is unreasonable and, in a commercial context, the one which flouts business sense. Sir Simon also considered that it made no commercial sense for the parties to have agreed that the bond would not guarantee the refund of instalments in this instance.

However Lord Justice Patten (delivering the majority judgment) allowed the appeal. He found that although the buyer’s construction was arguable (i.e. that the bond could be claimed upon even where there was no termination, cancellation or rescission) this was not the meaning the document would convey to a reasonable person reading it with knowledge of the terms of the shipbuilding contract.

Lord Justice Patten, furthermore, did not agree with Mr Justice Simon or Sir Simon Tuckey that the bank’s construction of the bond was uncommercial. He reaffirmed that unless the most natural meaning of the words produces a result which is so extreme as to suggest that it was unintended, the Court has no alternative but to give effect to them. In the present case, there might have been 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 and, accordingly, this was not a case in which the construction contended for by the bank would produce an absurd or irrational result. He warned against “substituting our own judgment of the commerciality of the transaction for that of those who were actually party to it”.

It is unlikely that the vast majority of existing refund guarantees will be affected by this judgment, which turned very much upon the specific provisions of the bonds in question. However the case highlights the importance of considering the terms of the refund guarantee in light of the buyer’s termination rights under the relevant shipbuilding contract and of ensuring that all instances in which the buyer is entitled to a refund of pre-delivery instalments are specifically reflected in the refund guarantee.

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