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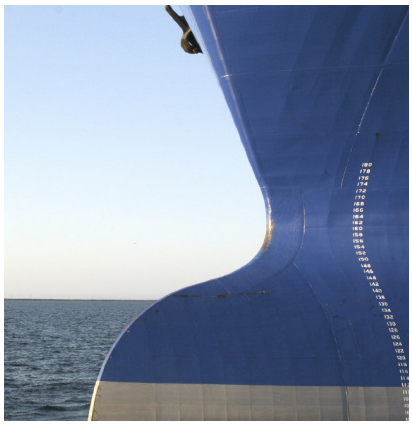

Shipping update
Refund guarantees: 'all sums due'?

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Background

Refund guarantees are an increasingly important element of any shipbuilding contract. The trading environment for all parties remains difficult and there are clear advantages to obtaining security for key aspects of performance under a shipbuilding contract wherever possible.

In difficult market conditions, banks who may previously have regarded the provision of such guarantees as relatively low-risk business have found themselves exposed to significant liabilities. This has resulted in guarantee wordings coming under detailed legal scrutiny in the face of a large number of very significant claims.

This update considers the implications of the recent Court of Appeal decision in *Kookmin Bank v Rainy Sky & others* [2010] EWCA Civ 582 in which a bank refused repayment under "advance payment bonds" in respect of purchase price instalments, the shipyard having become insolvent.

The Facts

Kookmin bank issued six on demand advance payments bonds to secure certain obligations assumed by its shipyard customer under six shipbuilding contracts made with the claimants as buyers, each on materially identical terms.

Each shipbuilding contract required the buyer to pay the contract price in pre-delivery instalments, and entitled him, in the event of the shipbuilder's insolvency, to a refund of any instalments paid.

Paragraph 2 of the bond entitled the buyer, on certain specified grounds including rejection of the vessel, to repayment of any pre-delivery instalments. By para.3 of the bond, the bank guaranteed *"all such sums due to you under the contract".*

After the buyers had paid the first instalments the shipyard became insolvent and the buyers sought repayment of US$46,652,000 plus interest under the bonds. The bank argued that it was entitled to review "evidence" in relation to the underlying dispute and therefore form a view about the underlying merits. The buyers argued that this was a form of on demand guarantee which was payable immediately once notice was given in accordance with its terms, in the absence of fraud.

A further issue between the parties was whether the words "all such sums due to you under the contract" in para.3 of the bond referred to the instalments becoming repayable in any circumstances under the shipbuilding contracts (including the insolvency of the shipyard) or whether, as the bank contended, the guarantee was restricted to covering only the circumstances described in para.2 of the bond, namely;

> *"…upon your rejection of the Vessel in accordance with the terms of the Contract, your termination, cancellation or rescission of the Contract or upon a Total Loss of the Vessel."*

Significantly, the circumstances listed in para. 2 did not include the insolvency of the shipyard.

The High Court

In the High Court, the judge agreed with the buyer in summary judgment proceedings. Mr. Justice Simon said that where an instrument issued by a bank relating to an underlying transaction contains an undertaking to pay "on demand" and does not contain clauses excluding or limiting the defences of the bank, it will almost always be construed as a demand guarantee.

All that was required in such circumstances was a statement by the Claimant specifying in what respect the Builder had failed to fulfil the terms and conditions of the Contract.

Crucially the judge held that the words *'such sums'* as used in para. 3 of the bond were intended to apply to the pre-delivery instalments rather than the repayment obligations recited in para. 2. A key aspect of the judge's analysis was his finding that the bank's construction had the 'surprising and uncommercial' result that the buyers would not be able to call on the bond upon the insolvency of the shipyard; an event which he considered would be most likely to require the provision of first class security.
The bank obtained leave to appeal to the Court of Appeal.

The Court of Appeal

By a majority decision (Sir Simon Tuckey dissenting) the bank's appeal was upheld and the decision of the High Court was overturned in relation to the interpretation of "all such sums due … under the contract".

It was agreed by all the judges that there was a case to be made for either of the differing interpretations of the bond contended for by the parties. The key area for debate was the extent to which Simon J was correct in rejecting the bank's interpretation on the basis that it produced an outcome that was surprising or uncommercial.

In his dissenting judgment, Sir Simon Tuckey felt that the views of an experienced commercial judge on such a matter should be given considerable weight by the Court of Appeal. He agreed with the judge that it *"defies commercial common sense"* to think that the insolvency of the shipyard, of all such other obligations, was the only one which the parties intended should not be secured.

By contrast Lord Justice Patten (supported by Lord Justice Thorpe) felt that the wording of the contract should be given its true meaning so far as possible. As he put it:

> *"In a commercial contract (like any other contract) the parties have chosen to define the limits of the obligations which they have undertaken by the language they have used. The purpose of the contract is to provide an objective record of what has been agreed so as to regulate the legal relationship between them. The Court's function is to give effect to those obligations by respecting the terms in which they are cast."*

With this in mind he went on to note:

> *"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 it its terms. To do otherwise would be to risk imposing obligations on one or other party which they were never willing to assume and in circumstances which amount to no more than guesswork on the part on the Court."*

On this basis Patten LJ had little difficulty in adopting an interpretation in favour of the bank that excluded repayments in the event of insolvency under the bond. The fact that cover for this eventuality may have been desirable from the perspective of the buyer was insufficient in his view to depart from what would otherwise be the natural and obvious construction of the bond.

Comment

The fact that four judges (one in the High Court and three in the Court of Appeal) are evenly divided as to the correct interpretation of the guarantee in this case indicates the difficulty and uncertainty that can surround litigation concerning bank guarantees in a shipbuilding context. In the circumstances an appeal to the Supreme Court may well be likely in this case.

Given the rarity in the past of situations where such guarantees were called upon, the parties to this litigation may perhaps be forgiven for adopting contract wordings that have proved so difficult to interpret. However, in light of recent experience and market conditions there can no longer be any doubt that guarantee wordings of this type require the most careful attention.

As this case illustrates, if an 'on demand' guarantee is required then the clearest possible language should be adopted if the intended effect is to be achieved. By the same token, there is no reason why such a guarantee should not contain a provision requiring that the underlying dispute should be determined before payment is made if that is the intention of the parties.

The approach to be adopted will doubtless depend on market conditions and negotiating strength in any given case. However, whichever the approach chosen, it is clear that the price for adopting language that is less than precise is likely to be long and expensive litigation.

Further information

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