Refund guarantees: more traps for the unwary

Introduction

Refund guarantees provide vital security for reimbursement of prepaid pre-delivery instalments in the event that a purchaser of newbuildings cancels a shipbuilding contract. Such cancellations occur more frequently than might be supposed, because shipyards often get into delay, for a number of reasons. Sometimes they contract to build ships within overly optimistic timeframes, or for prices which are either loss-leading or become loss-making if costs increase, or exchange rates fluctuate, during construction. Or they take too many orders onto their books or run out of funds to complete on-going projects.

In the boom years leading up to the global economic downturn that began in 2008, ship-owners and shipyards were falling over themselves to enter construction contracts, sometimes with delivery dates as far ahead as 2013 or even later. Since the downturn, where yards have given buyers any opportunity to cancel, there has been a stampede to do so. A cash refund returns the buyer’s pre-delivery instalments, typically up to 80% of the contract price, in full with interest, often at a generous rate. By contrast, delivery of an overpriced ship in today’s market can cause a buyer intense financial hardship or even ruin if pre-delivery finance is not in place.

The success of such cancellations depends not only on the buyer being entitled to cancel the shipbuilding contract but also on the refund guarantee being valid and binding. As a recent case has shown, it also depends on the buyer making its demand under the refund guarantee correctly.
Common traps in refund guarantees

Ship-owners and their lenders have, over the past few years, become all too aware of the many pitfalls when placing reliance on refund guarantees. In particular:

> If a demand is not made promptly, a refund guarantee may expire before a valid demand can be made. This is not least because refund guarantees are typically expressed to expire 30 days after the ‘drop dead’ date under the shipbuilding contract, giving a small window of opportunity which may disappear where time extensions are agreed under the shipbuilding contract without a corresponding extension being obtained from the refund guarantee bank.

> Material changes to the shipbuilding contract which the refund guarantee bank has not approved will discharge the bank from liability (unless the guarantee includes express wording to provide that the bank waives objection to such changes).

> An unsigned refund guarantee will be unenforceable (under s. 4 Statute of Frauds 1677). Numerous refund guarantees without signature blocks were issued by Far Eastern banks to buyers’ banks through the SWIFT messaging system, causing not inconsiderable nervousness in the lending market until the court held (albeit obiter) in *WS Tankship II BV v The Kwangju Bank Ltd [2011] EWHC 3103 (Comm)* that SWIFT authentication was akin to signature.

Despite these pitfalls, it is perhaps surprising that refund guarantees typically remain 2-3 page, short-form contracts, often drafted in convoluted language which has been neither negotiated nor advised upon by lawyers, issued in a series of SWIFT messages, in block capitals, with few paragraphs, no numbering, little punctuation and in imperfect English.

Invalid demands: the recent *Sea-Cargo* case

Introduction

A recently reported judgment of the Commercial Court in London, *Sea-Cargo Skips AS v State Bank of India [2013] All ER (D) 255*, has further highlighted the precariousness of refund guarantee claims.

In the *Sea-Cargo* case, although validity of the refund guarantee itself was not in dispute, the buyer’s demand was contested, and was held to be invalid. Accordingly, the buyer’s claim for reimbursement failed.

The refund guarantee required the buyer’s demand to be supported by a signed statement which, *inter alia*, set out the basis of the buyer’s cancellation and certified that the shipyard had failed to make refund. Requirements of this kind in ‘demand’ or ‘see to it’ guarantees and performance bonds are commonplace. They require the beneficiary of the guarantee (in the case of a refund guarantee, the buyer) or sometimes the beneficiary’s/buyer’s bank, to certify in good faith the buyer’s entitlement to cancel and to make demand. This can give the guarantor some protection against demands made fraudulently or in bad faith.
Refund guarantees: performance bonds or true guarantees?

It is important to appreciate that refund guarantees will, typically, be regarded as demand guarantees and not ‘conditional’ or ‘true’ guarantees. The effect is that the doctrine of ‘strict compliance’ will apply to demands made under them. At first blush, this classification may seem surprising because refund guarantees almost invariably provide that, in the event that the shipyard disputes the buyer’s cancellation, the refund guarantor may defer payment until this issue is determined in arbitration and an award published. Where buyers cancel shipbuilding contracts with Far Eastern yards, the yards’ response will invariably be to dispute the buyers’ cancellation and to refer the dispute to arbitration. If nothing else, this will at least buy time for the yard to negotiate a settlement and to postpone its indemnity to the refund guarantor which will be triggered as soon as the refund is paid. To buyers and their lenders, therefore, reactions of this kind have, in recent years, become so predictable, and the arbitrations they generate so tiresome and so protracted, that they do not tend to think of refund guarantees as performance bonds, but rather as true guarantees, which are conditional upon the yard’s primary liability being established in arbitration.

However, refund guarantees are typically worded as demand guarantees and only provide for the refund to be deferred if and to the extent that the buyer’s cancellation is disputed and the dispute referred to arbitration under the underlying shipbuilding contract.

So, for example, in Meritz Fire & Marine Insurance Co Ltd v Jan de Nul NV [2011] 1 All ER (Comm) 1049, the court held a refund guarantee to be a performance bond even though it was issued by an insurance company (rather than a bank) and that it contained the following words:

“Notwithstanding the provisions hereinafore, in the event that within Thirty (30) days from the date of your claim to the Builder referred to above, we receive written notification from either you or the Builder stating that your claim for refund hereunder is disputed by the Builder and has been referred to arbitration in accordance with the provision of the Contract, we shall, under this Advance Payment Guarantee (Letter of Guarantee), refund to you the sum as per the award issued under such arbitration immediately upon receipt from you of a demand for the sum so adjudged together with a copy of the arbitration award, and not before”.

The court relied on the fact that the refund guarantee expressly incorporated the ICC Uniform Rules for Demand Guarantees – that were expressed to cover guarantees issued by insurance companies.

In that case, no such arbitration had been commenced by the shipyard, which had gone into insolvent liquidation. Had such an arbitration been commenced, obviously the refund guarantor could have deferred payment.

More recently, in the WS Tankship II BV case, the court approved the decision in Meritz and held a refund guarantee to operate as a demand guarantee because (i) the yard had failed to refer a disputed buyer cancellation to arbitration within the period prescribed under the refund guarantee (see para 116) and (ii) the refund guarantee incorporated the ICC Uniform Rules for Demand Guarantees (at para 123).

Even more recently, in the case of Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece SA [2012] EWCA Civ 1629, the court considered and applied these principles to an
advance payment guarantee issued to a yard by a buyer’s bank to guarantee the buyer’s payment of the pre-delivery instalments due under a shipbuilding contract.

**Sea-Cargo: the facts**

In *Sea-Cargo*, the buyer’s cancellation appeared to be grounded on a 270 day delay in reaching a construction milestone. That was a right of cancellation additional and entirely separate to the buyer’s right to cancel the shipbuilding contract for a delay of 270 days beyond the delivery date. It was a fairly unusual right of cancellation specifically negotiated into the shipbuilding contract, which set out fixed dates by which, respectively, commencement of steel cutting, keel laying and launch were to have been completed.

Exactly why the buyer grounded its cancellation on a failure to reach a construction milestone in this case is unclear because the yard had also failed to complete and deliver the ship within 270 days after the delivery date and, thereafter, had failed to complete the ship by a final ‘drop dead date’ of 30 October 2012, that was recorded in a 3rd addendum to the shipbuilding contract. It appears that a fear on the buyer’s part that the refund guarantor was not bound by that addendum prompted the buyer to frame its demand more opaquely.

Whatever the reason, the buyer’s demand stated that: “*the Builder…has been delayed in the construction of the vessel for more than 270 days…*”. More than 270 days beyond what point? The buyer’s demand did not make this clear, which perplexed the court. Indeed the judge wondered why the demand did not “…slavishly follow the wording of the refund guarantee”.

The judge went on to hold that the demand wording did not comply strictly with the requirement in the refund guarantee that the demand state “*the causes that entitle the buyer to cancel the contract*” and that, accordingly, it was invalid. The buyer’s notice simply referred to a 270 day delay, without reference to whether this was delay beyond a milestone or the delivery date. Further, the court held that the buyer’s demand had failed to certify that the yard had failed to refund the buyer and was also invalid on that ground.

In most cases, if a buyer’s demand under a refund guarantee transpires to be invalid, the refund guarantee will have expired long before the demand can be corrected and refreshed. In this case, the buyer appears to have been fortunate in that respect, because it appears from the case report that the buyer had made a second demand only three days before the trial. Assuming that demand were valid, the only adverse consequence would be a considerable loss of time and wasted costs. In most cases, buyers of newbuildings will have no second bite of the cherry. This decision serves as a salutary warning to those who neglect to draft refund guarantee demands with care, thought and precision.

**Issues highlighted by Sea-Cargo:** (i) if the refund guarantee is assigned, who is the proper party to make demand?

Buyers’ lenders will normally take an assignment of the refund guarantee as part of their security for their pre-delivery loan advances.

Typically, such assignments are expressed to be “absolute”. However, such assignments are usually expressed only to entitle the assignee bank to ‘step in’ and to deal directly with the refund guarantor following the occurrence of an ‘Event of Default’ under the loan agreement, with the assignor buyer covenanteeing not to make demand under the refund...
guarantee without its bank’s consent. The implication is that, until the occurrence of an Event of Default, the right to make demand under a refund guarantee remains with the buyer.

Good assignment drafting should make this clear. For example, in *Sea-Cargo*, the assignment expressly stated that: “…unless and until a Default shall occur and the [bank] shall have given notice to the Builder, the Refund Guarantor and the Borrower that the [bank] intends to enforce all its rights under this Deed, the Borrower shall be entitled to exercise all its rights under the Assigned Documents (subject as provided in this Deed)” which the judge held to permit the buyer validly to make demand under the refund guarantee.

Wording of this kind has been included in security assignments for many years. In *The “Balder London”* [1980] 2 Lloyd’s Rep. 489, an assignment contained an express proviso that, until the assignee’s security became enforceable, “all rights and benefits would remain vested in the assignor”. The judge described that assignment to be ‘suspensory’ and only to convert from an equitable assignment (under which legal rights remained vested in the assignor buyer) into a legal assignment (under which legal rights vested in the bank) when the bank served notice on the debtor (here the refund guarantor) following an event of default.

In the absence of such an express proviso, an assignment, given to a bank long before the assignor buyer’s right to cancel the shipbuilding contract arises, will be an assignment of a future thing, or chose, in action which can only take effect in equity (see *The “Mount I”* [2001] 1 Lloyd’s Rep. 597). Accordingly, legal title to make demand will remain with the buyer. This is somewhat of a relief to pre-delivery financing banks, who usually prefer not to become directly involved in their borrowers’ disputes. That said, banks are usually content to inform yards and refund guarantors that they have approved the buyer’s cancellation and demand. Given that the assignment itself will usually stipulate for such consent to be obtained, the sending of such confirmations dispels any doubt on the part of the recipient as to whether consent has indeed been obtained.

**Issues highlighted by *Sea-Cargo*: (ii) if the refund guarantee is assigned, who is the proper party to sue?**

There is a procedural rule that both equitable assignor and equitable assignee need to be joined into an action to avoid the risk of ‘double jeopardy’ – i.e. the risk of the defendant having to pay twice (see *Three Rivers DC v Bank of England* [1996] QB 292).

However, this is a mere procedural rule. An action commenced, even by the equitable assignee alone, who has no legal title, will not be a nullity (as made clear in e.g. *Weddell v JA Pearce & Major* [1988] Ch 26 and *Sim Swee Joo Shipping Sdn Bhd v Shirlstar Container Transport Ltd* [1994] CLC 188). The other party can be joined at any time into the action.

Where a buyer brings proceedings against a refund guarantor, the buyer should be able to avoid having to join its lender either by notifying the defendant that it is suing in a representative capacity on behalf of its lender or by having its lender confirm directly to the refund guarantor that it will make no separate claim in respect of its assigned interest.

Sometimes, shipyards and refund guarantors see it to their advantage to require buyers to join their lenders into actions against them, hoping that the lender will not wish to become involved. In reality, such joinder can probably be avoided and, even if it cannot, it will achieve little more than to increase the refund guarantor’s costs liability.

“This is somewhat of a relief to pre-delivery financing banks, who usually prefer not to become directly involved in their borrowers’ disputes.”
Conclusion: lessons to be learned from Sea-Cargo

The Sea-Cargo case serves as a further reminder that refund guarantors will be quick to take any point to defend a claim.

Against that background, it is crucial for buyers and their lenders to ensure to get their demands right. So, for example:

> It is advisable ‘slavishly’ to follow the guarantee wording.

> If the refund guarantee requires a statement or certificate of entitlement, it must be provided.

> If the refund guarantee requires interest to be computed, it must be.

> If a certain method of notification of the demand is required, it must be adhered to. It is often advisable to notify demands through various channels, and sometimes even to involve court bailiffs locally.

> Ideally, a well drafted refund guarantee will authorise notification by authenticated SWIFT message. But if it does, it is important to ensure that the buyer’s financing bank and refund guarantor have shared authentication codes and that any demand message is sent using the correct SWIFT code (MT 799), which may involve sending several messages, as most demands will exceed the maximum permitted characters.

Should you wish to discuss any of the matters raised in this briefing, please speak with the author, Charles Buss, another member of our team below, or your regular contact at Watson, Farley & Williams.

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