The Importance of Refund Guarantees in Shipbuilding Contracts

Refund guarantees are commonly provided in new build vessel transactions. Given that the purchaser will normally be paying for a substantial part of the vessel in advance of delivery actually taking place, the refund guarantee provides a form of security in respect of those instalments.

By virtue of the refund guarantee, the builder’s bank undertakes that in the event the purchaser ends the contract for good reason (for example, due to the builder’s insolvency), if the builder for any reason fails to refund the advance instalments of the contract price the bank will refund those instalments on the builder’s behalf. Where the purchaser has taken a loan to finance the instalments, the purchaser will usually be required to assign the benefit of the refund guarantee to the financier. In this situation it is important to check that such an assignment is not prohibited in the refund guarantee.

In the current economic climate, it is likely that shipbuilders will experience difficulties in financing new orders, making refund guarantees a very important tool in protecting the purchaser and its lender’s interests. It is therefore vital for the purchaser to ensure that the refund guarantee provides as much protection as possible and, importantly, that the refund guarantee is actually enforceable.

Negotiating the Refund Guarantee

The refund guarantee will normally be in place throughout the vessel’s construction and outfitting period and will have a cut-off date, which will usually make allowances for potential delays. It is important for the purchaser to ensure that the cut-off date takes into account any delay which could occur as a result of the arbitration of any disputes.

Negotiation is often required in relation to the question of whether the guarantee can be called up on demand from the purchaser, or whether it should only be called up when an arbitrator or court has held that the builder should be liable. The purchaser and its lender will prefer the former, due to the fact that legal or arbitration proceedings can be lengthy and they will want reimbursed as quickly as possible.

Often the purchaser’s financing arrangements will state the loan is repayable when the purchaser rescinds the contract, therefore it will be in the particular interests of the purchaser for the refund guarantee to be called up on demand. The builder on the other hand, will wish to avoid the situation where the guarantee is cancellable even though the purchaser’s rescission is being contested.

In most cases the calling up provisions will be in the builder’s favour. The builder’s bank will make the guarantee expressly conditional on either the builder’s admission in writing that it is liable to make the refund or an arbitration award or court judgment determining the liability.

It is essential that clear language in relation to calling up procedures is used in the refund guarantee, as illustrated in the 2001 case of Caja de Ahorros del Mediterraneo and others v Gold Coast Limited (2001)\(^1\). In the case, a refund guarantee stated that the builder’s bank would repay an instalment “if and when the instalment becomes refundable from the builder under and pursuant to the terms of the shipbuilding contract”. Confusingly, the bank also undertook in the guarantee to make payment to the purchaser on receipt of a certificate from the purchaser’s bank in the event of the purchaser choosing to rescind the contract.

The purchaser rescinded due to delay in delivery of the vessel, and steps were taken to begin arbitration proceedings as a result. While the arbitration was pending, the lender issued a certificate as stated in the refund guarantee, demanding repayment.

The refund guarantor argued that on its true interpretation, this did not allow the purchasers to demand payment without the builder’s liability being independently determined by an arbitrator.

However, on appeal the court held in favour of the purchaser, stating that the wording of the refund guarantee created an on demand obligation which arose independently of the shipbuilding contract. In making the judgment, the court was influenced by the omission in the refund guarantee of any reference to the builder’s liability in the shipbuilding contract.

It is therefore essential that the wording of the refund guarantee clearly sets out the procedure in relation to calling up the guarantee. In this case the purchaser benefited from unclear wording.

**Is the Refund Guarantee valid?**

The August 2008 English case of *Sea Emerald SA v Prominvestbank*\(^2\) serves as a timely reminder to purchasers of vessels to ensure that refund guarantees which are issued with shipbuilding contracts have been properly signed by a person who has authority to sign on the bank’s behalf. Failure to do so could invalidate the refund guarantee and expose the purchaser and the purchaser’s bank to a serious risk.

In the case, the purchaser purchased 19 vessels from a Ukrainian builder’s yard. The purchase price was in excess of $200million.

The contract stated that the yard had to provide the purchaser with a refund guarantee. The refund guarantee had to be signed on behalf of the builder’s bank, Prominvestbank. It was signed by the head of one of the bank’s regional departments.

The yard subsequently ran into difficulty and was unable to obtain the necessary funds to construct the vessels. Some time later it went into administrative bankruptcy.

The yard failed to complete and deliver one of the vessels purchased by Sea Emerald. At this point, Sea Emerald had paid at least $17million in advance payments to the yard. As a result, Sea Emerald held the yard to be in default and sought to make a claim under the refund guarantee.

However, the yard’s bank argued that their employee did not have the authority to sign on its behalf, thus invalidating the refund guarantee.

In considering whether or not the employee had such authority, the court examined the bank’s articles of association. These provided that the bank’s departments should have delegated to them rights to carry out operations in foreign currencies and that those rights included the right to:

> “*effect settlements connected with clients’ export and import operations in foreign currencies in the form of a documentary letter of credit, collection of payments or bank transfer, and in other formats used in international banking practice*”

The articles also provided that:

> “*the right of signature of foreign economic agreements to be entered into by a department on behalf of the bank shall be granted to the head of the department, without a power of attorney, with subsequent notification of the bank*”

Sea Emerald argued that the articles were open to a wide interpretation and provided that the employee had actual authority to enter into the refund guarantee on the bank’s behalf. Further, they argued that the employee had ostensible authority to give the refund guarantee and that the bank had ratified this.

Unfortunately for Sea Emerald, the court found in favour of the bank and held that the articles did not provide that the bank employee had an express or implied power to issue the refund guarantee. The articles were not broad enough to encompass issuing a refund guarantee. A refund guarantee was considered to be a contractual commitment rather than a method of making payment.

The court also held that it was not within the scope of the employee’s usual authority to enter into a refund guarantee and that the bank had not held the employee out as having the authority to do so. In order for the bank to have ratified the refund guarantee, the chairman of the bank or its management board would have had to have adopted it, and there was insufficient evidence to show that this had taken place.

It is therefore vital to ensure that refund guarantees have been signed on behalf of the bank in question by someone who has the necessary power. Failure to do so will result in the guarantee being invalid and the performance of the contact will not be guaranteed.

Purchasers and lenders must ensure that the refund guarantee is drafted to provide them with as much protection as possible in order to limit their exposure to risk during the construction period. This is particularly relevant during turbulent times where cash-strapped builders will find it more difficult to comply with their obligations under shipbuilding contracts.

---

\(^2\) (2008) EWHC 1979 (Comm)