Some Issues concerning Guarantees given in connection with Shipbuilding Contracts in China: 3 recent English cases

Ian Gaunt
Maritime Arbitrator

Disputes over refund and other bank guarantees issued in connection with shipbuilding contracts remain very common. In this paper I look at 3 decisions of the English High Court and Court of Appeal in the period 2012 to 2015:

- **Wuhan Ocean Economic & Technical Cooperation Co Ltd v Schiffahrts-Gesellschaft “Hansa Murcia” MBH & Co**

- **Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece S.A.**

- **Spliethoff’s Bevrachtingskantoor BV v Bank of China Ltd**

Each of these cases was connected with a contract for the building of a ship in a shipyard in China. The first and third cases were concerned with refund guarantees given by Chinese banks for the obligations of the shipyard and could be called on by the buyer if it validly terminated the shipbuilding contract. The second case was concerned with a guarantee given by the buyer’s bank in Greece to secure payment of an instalment of the contract price of the newbuilding before delivery.

Each of the guarantees and the underlying shipbuilding contracts were expressly governed by English law. The shipbuilding contracts were expressly subject to arbitration in London. The guarantees were in each case subject to the jurisdiction of the English High Court.

---

1 I am grateful to Richard Lord Q.C. for permission to quote from his notes of the Hansa Murcia and Wuhan Logistics cases published in the LMAA Newsletter (Winter 2012-3) although my conclusions expressed here are not quite the same.

2 [2012] EWHC 3104

3 [2012] EWCA Civ 1629 (CA)

4 [2015] EWHC 999
The first case, *The Hansa Murcia* for short, was an appeal to the English High Court from a London arbitration award concerning a dispute under the shipbuilding contract. The case is interesting in the shipbuilding context for its facts, but also of more general legal interest because of the way in which the judge found the arbitrators’ decision was wrong and could be overturned because it was a decision of law rather than a decision of fact.

The facts were quite simple. The shipyard had agreed in writing by an addendum to the contract to extend the delivery date from 30 June 2010 to 31 October 2011. At the same time the shipyard undertook to extend the validity of the supporting Refund Guarantee until 31 May 2012.

The Refund Guarantee, given as usual by a third party bank, read, in the material part, as follows:

"""This Letter of Guarantee shall remain in force until the Vessel has been delivered to and accepted by [the Buyers] or refund has been made by the Seller or ourselves (the Export Import Bank of China) or until June 30th 2010, whichever occurs earliest, after which you are to return it to us by airmail for cancellation. In case arbitration initiated by either Seller or Buyer before delivery of the Vessel, the validity of this guarantee shall be extended to 60 calendar days after the final arbitration award is issued."

By 28 June 2010 no extension of the Refund Guarantee had been effected. The Buyers were keen to get out of the shipbuilding contract if they could and treated this as a repudiation of the contract. The extension of the refund Guarantee was in fact made on the following day.

On these facts the arbitrators held that:

1. It was an implied term of the contract as amended that the extended guarantee would be procured within a reasonable time;
2. This term was an "innominate" term;
3. A reasonable time expired on 16 June 2010, 14 days before expiry of the Refund Guarantee;
4. The breach became serious enough to be repudiatory on 23 June, a week before expiry and thus the buyer was entitled to terminate.

The sellers obtained permission to appeal. Much of the argument focused on the relative protection which would have been afforded to the buyer, after 30 June 2010, by on the one hand an extended guarantee and on the other by an unextended guarantee which could still be subject to automatic extension by commencement of arbitration by either party.

The three key issues on which the shipyard obtained permission to appeal were:
(1) Was there an implied term as to extension within a reasonable time?
(2) Was there breach of it by 28 June?
(3) Was this a repudiatory breach, that is, one which was so serious that the buyer would be entitled to terminate the contract?

I should pause here to explain that English law recognises 3 categories of contractual terms: (1) terms (sometimes called warranties”) the breach of which does not give rise to a right to terminate the contract but only to claim damages ; (2) terms (sometimes called “conditions”) the breach of which will automatically give rise to a right to the innocent party to terminate the contract and (3) so-called “innominate” terms, that is, terms which do not fall into either of the first 2 categories and where the question whether there is a right to terminate on breach will depend on the nature and seriousness of the breach and its consequences for the innocent party.

On the first issue (was there an implied term?), the judge answered the question on the simple basis that wherever an obligation had to be performed by a party and the contract did not specify the time of performance, the obligation had to be performed within a reasonable time.

On the second issue (was there a breach by 28 June?), the Judge held that it was a question of fact, with which he could not interfere, as to when a reasonable time had elapsed. This was especially so as the buyer’s rights under an automatically extended guarantee, triggered by arbitration, were less than those afforded by an extended guarantee as required under the Addendum to the contract. As this was a question of fact the judge could not interfere with the tribunal’s finding that by 17 June (and thus also as at 28 June) the shipyard was in breach of the Addendum.

On the third question (was the breach repudiatory?) the judge held that the arbitrators had correctly directed themselves on the legal test for repudiation. However he found that they had made an error of law in holding that the breach was serious enough to be repudiatory. The judge found that the tribunal had failed to give enough importance to the effect of the automatic extension provision. The fact that the extension provision had been included did not make the obligation to procure an extension a mere “warranty” as the shipyard contended but it did prevent the breach from being repudiatory as at 28 June.

So the buyers did not succeed with their argument that the finding as to seriousness of breach was one of fact. Why?

The judge identified the error of law as a failure to give effect to legal finding as to the effect of instituting arbitration (i.e. resulting in an automatic extension of the refund guarantee).

The judge recognised that decisions as to what constitutes a repudiatory breach are “fact driven”, especially where “the commercial consequences of a breach fall to be evaluated".

The judge referred to the decision in *The Chrysalis*¹ which distinguishes, for purposes of appeals, between questions of fact, questions of law, and mixed questions of fact and law. He concluded that the issue of repudiation was a “mixed” question.

This conclusion is in itself uncontroversial. However it raises the question of the extent to which the issue remains a mixed one if the tribunal has correctly identified the legal test, especially as the tribunal did not misconstrue the guarantee or shipbuilding contract (questions of legal construction being issues of law).

The answer is that issues which are apparently factual ones, may be characterised as legal ones if the conclusion on them is “one that no reasonable arbitrator could reach”.

Where the arbitrators are found to have failed in this respect, it is said that this is an error in the second of the three processes of (i) ascertaining the facts (ii) ascertaining the law (iii) reaching a decision in the light of (i) and (ii). This is a pragmatic solution which may be effective in remedying injustices caused by unreasonable findings which are short of perverse but does the use of such language really make the issue one of law? It might be argued that the proper analysis is that the tribunal made an unreasonable error of fact in either (a) what the (factual) benefit of the contract was or (b) whether the party was (in fact) deprived of it, as opposed to inevitable inference of error of law.

This approach operates as a kind of legal fiction to turn base issues of fact (findings on which cannot be appealed) into issues of law (on which an appeal is possible). I have commented in my conclusions as to whether this should be regarded as a good thing in practice as it enables judges to second guess the decisions of commercial arbitrators on questions which arbitrators might be regarded as better qualified to decide.

*The Hansa Murcia* involved the common type of refund guarantee given for the obligation of the shipyard to refund to the buyer the pre-delivery instalments made on account of the contract price of a newbuilding in the event of a valid termination of the shipbuilding contract by the buyer. Such a guarantee may be in the form of a suretyship or in the form of an on demand performance bond. In either case it is usual for the guarantee or bond to provide that the bank issuer will not be liable to make payment, if a dispute is referred to arbitration under the underlying shipbuilding contract, until the arbitration tribunal has made an award in favour of the buyer.

The issue of the interpretation of a guarantee as a primary or secondary security came before the Court of Appeal in the case of *Wuhan Guoyu Logistics Group Co. Ltd v Emporiki Bank of Greece S.A.* In this case the guarantee was given on behalf of the buyer and guaranteed payment of the second instalment of the contract price of a newbuilding vessel. There was a

---

¹ [1983] 1 Lloyd's Law Reports 503. It is accepted that the same considerations apply to appeals under the 1996 Act: see *London Underground v Citylink* [2007] EWHC 1749, paras 57-59
dispute between the buyer and the shipyard as to whether the second instalment had in fact fallen due and this dispute was referred to arbitration. In the meantime the shipyard demanded payment of the amount of the instalment under the guarantee, alleging that the guarantee was in the nature of an on demand performance bond, independent of the underlying obligation of the buyer, rather than a “see to it” guarantee or secondary security. The Court of Appeal decided that the guarantee was indeed in the nature of a performance bond following the principles of construction set out in Paget on Banking 11th edition (approved in Gold Coast Ltd v Caja de Ahorros del Mediterraneo [2001] EWCA Civ 1086 and adopted in subsequent cases including Meritz v Jan der Nul [2011] 2 Lloyd's Rep. 379).

Paget states the following principle of construction:

“Where an instrument (i) relates to an underlying transaction between the parties in different jurisdictions, (ii) is issued by a bank, (iii) contains an undertaking to pay "on demand" (with or without the words "first" and/or "written") and (iv) does not contain clauses excluding or limiting the defences available to a guarantor, it will almost always be construed as a demand guarantee.”

In Meritz v Jan der Nul the document in question was held to be an on demand bond. The issuing bank relied in particular on the presence of a term restricting the right to call on the guarantee if there was an arbitration commenced between shipyard and buyer. This was however held to postpone the obligation to pay but not to change the nature of the bank’s primary obligation. The courts, at first instance and on appeal, emphasised the importance of provisions requiring payment against a simple demand, whether also to be accompanied by a certificate or similar document. However, the conclusion in that case was also influenced strongly by the presence of wording which applied the ICC Rules on “on demand” bonds, a factor pointing to the nature of the instrument in question.

In Wuhan Logistics, Clarke J. at first instance decided that the document created a secondary liability. The Court of Appeal reversed the first instance decision. The court suggested that the issue was a “comparatively simple matter of construction”, which should apparently not be too “exhausting” although the court did not find the case “particularly easy”. The court disapproved the “tick box” approach of tallying factors for and against a particular construction. It emphasised the need for certainty, and essentially allowed the appeal on the basis of the application of the Paget factors and the “presumption” that the document created a primary liability, even though one of the Paget tests was not satisfied. The Court of Appeal decided that the 9 factors found by the first instance judge to favour the construction that the document was a secondary security were not of sufficient weight to displace the presumption based on the fact that 3 of the 4 Paget tests were satisfied. The court also expressed the view that such documents would be “almost worthless” if the underlying dispute prevented payment and that, as the document may have been drawn up by those with a less than total command
of English language, the wording should not be accorded “the reverence with which one would construe a statute”.

In endorsing the “Paget criteria” the Court of Appeal has in effect emphasized a distinction in the construction of “international” and “domestic” guarantees. The former are now much more likely to be construed as on demand performance bonds despite the conditionality introduced by a moratorium on payment pending the outcome of an arbitration on the underlying contract as in Meritz and despite decisions such as Heald v O’Connor [1971] 1WLR 497 rejecting the idea that the primary debtor wording necessarily imports an indemnity rather than a suretyship.

The decision in Wuhan Logistics was followed recently in Spleithoff’s Bevrachtingskantoor BV v Bank of China Ltd. This case concerned the liability of Bank of China Limited (BOC) under refund guarantees given for repayment obligations of a Chinese shipyard (the Builder) and a co-seller in respect of contracts for the construction of 2 ships for Spleithoff’s Bevrachtningskontoor (SBV), the beneficiary of the Refund Guarantees.

This case is particularly interesting firstly in the context of the legal construction of refund guarantees given for obligations of Chinese shipyards generally, and secondly also for the analysis of the effect in English law on the guarantor’s obligations of an attempt to stop payment out under the guarantee in Chinese proceedings alleging that the shipbuilding contract was tainted by fraud. As in the other cases mentioned above the guarantee issued by BOC was subject to English law and the jurisdiction of the English High Court.

The newbuildings in this case had not been delivered on time and SBV had acted to terminate the contracts and claimed repayment with interest of the advance payments made to the Builder under the contracts.

In separate proceedings in China the Builder had obtained judgment against SBV and Wärtsilä against whom fraud had been alleged in relation to the supply of the main engines of the newbuildings. The Chinese court (firstly the Qingdao Maritime Court and subsequently the Shandong High Court) had issued orders prohibiting BOC and any domestic or overseas branch of BOC from making any payment to SBV anywhere under the refund guarantees. The shipbuilding contracts were subject to English arbitration. There were ongoing disputes between SBV and the Builder as to SBV’s entitlement to terminate the shipbuilding contracts and the scope of jurisdiction of the arbitration tribunal.

Demands for payment were made under the refund guarantees but BOC declined to pay because of the orders of the Chinese court. BOC was unable to have the Chinese court orders set aside despite a number of applications to do so. SBV successfully applied to the English High Court for anti-suit injunctions to retrain the Chinese proceedings alleging breach by the Builder of the arbitration agreement in the shipbuilding contracts. The Chinese proceedings continued nonetheless.

The arbitration tribunals appointed in relation to claims submitted to arbitration under the shipbuilding contracts published awards confirming that the
disputes relating to the engines of the newbuildings fell within the jurisdiction of the tribunal, rejecting the argument that SBV had submitted to the jurisdiction of the Chinese courts in relation to the relevant claims and requiring the Builder and Co-seller to discontinue the Chinese proceedings.

The English court was firstly required to construe whether the refund guarantees were in the nature of demand guarantees or performance bonds and not given by way of secondary security. Following the Court of Appeal's approach in Wuhan Logistics and the Paget tests, the judge concluded that the instruments were indeed in the nature of performance bonds and that the express provision for postponement of payment for 30 days until after an arbitration award did not make the refund guarantees “see to it” guarantees dependent on the underlying obligations under the shipbuilding contracts.

The court was also required to determine whether SBV had submitted to the jurisdiction of the Chinese courts by fully defending the Chinese proceedings and decided that SBV had submitted by going further than merely challenging the jurisdiction of the Chinese court.

SBV argued that the judgments and orders of the Chinese court should not be recognized as a matter of English public policy. There was no doubt that the Builder had acted in flagrant disregard of the arbitral anti-suit injunction in pursuing the Chinese proceedings. Mrs Justice Carr however found that as SBV had voluntarily submitted to the jurisdiction of the Chinese court for the purpose of section 32 of the Civil Jurisdiction and Judgments Act 1982, there was no scope for the English court to take a public policy objection to recognition of the Chinese court judgments and orders by reference to the arbitral anti-suit injunction.

Nevertheless the judge held that BOC was, as a matter of English law, liable to make payment under the refund guarantees (whether or not they were properly construed as performance bonds or secondary securities). The fraud alleged in the Chinese proceedings did not represent illegality under the law of the place of performance (which was not China) or a ground for the English court to refuse to order payment. On the basis of Chinese expert legal evidence, the judge held that it was “difficult to see how enforced payment by BOC pursuant to an English judgment could be seen as a “refusal” on the part of BOC to provide assistance to the Chinese court for the purpose of Article 114(4) of the Chinese Civil Procedure Law or Article 313 of the Criminal Law of the PRC and thus a breach of the restraining order made by the Chinese court”. Nor, on a reading of Article 37 of the Regulations of the Chinese Supreme Court would BOC be at risk of execution and having its monies taken away; it would not have to “make payment” thus exposing itself to a risk of being ordered to reconstitute the fund under Article 37.

Mrs Justice Carr further observed:

“Finally, even if there were real risks in this regard [of BOC being compelled to pay SBV and being compelled to pay monies into the Qingdao Maritime Court], these are matters inherent in the risks which BOC agreed to undertake when entering into the Guarantees on the terms that it did. BOC is an international commercial organisation in the business of providing external guarantees in return for the taking of fees
and security. The clear scheme under the Guarantees (which are governed by English law) in respect of obligations under the Contracts (which are also governed by English law and the subject of English arbitration agreements) is that the obligation on the part of BOC to pay on demand should not be affected by extraneous matters such as the [Chinese court order restraining payment by BOC] (or judgments in fraud or otherwise against SBV in separate proceedings in China).

This conclusion is not to disrespect in any way the Chinese courts (or principles of international comity) but rather to give effect to the contractual bargain between SBV and BOC and to recognise the commercial purpose behind that arrangement.”

In the final result the judge was not satisfied that there were special circumstances which make it inexpedient to order payment by BOC or to order immediate enforcement and refuse the stay applied for by BOC.

Conclusions

What can we draw from these decisions other than that as a matter of fact they are all connected with the process of contracting for newbuildings in China?

(1) Whether a breach is repudiatory on particular facts can be determined by the courts

From the *Hansa Murcia* it seems that the courts have the right to “second guess” decisions of commercial arbitrators on whether a particular set of facts amounted to a repudiatory breach of contract, even where it is acknowledged that the arbitrators have applied the correct legal test. This is arguably not only surprising but also contrary to the intention of the parties in opting for arbitration as a means of resolving disputes under the contract. It is to be questioned whether judges have a better insight than commercial arbitrators into what is commercially important to the parties or the commercial acceptability of risk or, in legal language, what breaches go to the root of the contract and are therefore repudiatory. The courts have shown some reluctance to interfere with the decisions of fact and mixed fact and law made by arbitrators in other areas: see for example, in relation to the possibility of overturning a conclusion on affirmation *Primera Maritime (Hellas) Ltd v Jiangsu Eastern Heavy industries Co Ltd* [2013] EWHC 3066 (Comm). It seems however that, at least in relation to repudiation, decisions of arbitrators may be relatively easily challenged in the courts. Considering the difficulties which the commercial courts have had in determining whether a term is or is not a “condition” or whether a breach is repudiatory in particular fact situations¹, this may be regarded as an not entirely satisfactory conclusion.

---

¹ See for example *Kuwait Rocks Co v AMN Bulkers Inc (The MV “Astra”)* [2013] EWHC 865 (Comm) and *Spar Shipping AS v Grand China Logistics Holding (Group) Co Ltd* [2015] EWHC 718 (Comm); *Telford Homes (Creekside) Ltd v Ampurius NU Homes Holdings Ltd* [2013] EWCA Civ 577; *Januzai v Vaillas* [2014] EWCA Civ 436.
(2) The “Paget” tests are the starting point in deciding whether a guarantee is a secondary guarantee or performance bond – but they may not all need to be satisfied

From the Wuhan Logistics case we can see the endorsement of a particular set of construction criteria as giving rise to a strong presumption that a guarantee will be treated by the English courts as a primary obligation or performance bond. That is if it is issued by a bank for an international obligation of a customer and stated to be payable “on demand”. This is if 3 of the 4 “Paget” tests are satisfied. In other words the document may still be treated as a guarantee if one of the “Paget” criteria is not satisfied, namely the requirement that the document should not contain the “protective” clauses customary in secondary securities. If it does contain these “protective” clauses, but is issued by a bank for payment in an international transaction and is expressed to be payable “on demand”, it is likely to be construed as a performance bond. If, on the other hand, if the guarantee is issued by a company other than a bank or an individual, it may be that it will be much less likely to be construed as a performance bond. These questions of construction may be particularly important if there is a problem with the underlying contractual obligation, as for example if the underlying obligation is unenforceable by reason of illegality, fraud or bribery.

(3) English courts will recognise decisions and order of Chinese courts but this may not prevent Chinese banks being forced to pay on refund guarantees

The Spliethoff’s case shows that the English courts will recognise Chinese judgements and orders as such under the Civil Jurisdiction and Judgements Act, particularly if the buyer has defended the Chinese proceedings. However, a Chinese bank guarantor will not easily be able to escape the obligation to make payment under a refund guarantee by reference to a Chinese court order in proceedings in relation to the underlying shipbuilding contract. The bank may still be successfully sued on the guarantee in the English courts if it has submitted to their jurisdiction in the guarantee. As most banks issuing refund guarantees will have at least some assets outside China against which a judgement of the English court can be enforced, beginning proceedings under the underlying contract in China may not necessarily prevent an effective payment out under the refund guarantee.