

# Risk Control of Refund Guarantee in Shipbuilding Contract

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The refund guarantee is a critical part of shipbuilding contracts in the People's Republic of China ("PRC"). It is also important in the banking industry. However, there is a lack of uniformity in the drafting of refund guarantee clauses within the PRC and overseas.

The industry has not paid full attention to the risks associated with refund guarantee. This will inevitably result in legal complications and disputes.

## **I Introductory notes on the refund guarantee**

In a typical shipbuilding contract, a ship-owner has to pay a deposit and progress payments ranging from 10% to 90% of the total contract price to the shipbuilder. The sums involved are usually large and the shipbuilding duration may take more than 2 years.

During this period, the shipyard may not be able to deliver the vessel for various reasons or there may be serious discrepancies arising from the construction of the ship according to design and specifications provided by the ship-owner.

Under such circumstances, the ship-owner may choose to terminate the shipbuilding contract and claim for a refund of the pre-delivery installments. However, the shipyard may be reluctant or financially unable to do so. As such, there is no security for the ship-owner.

Few countries provide for a mortgage registration system for ships under construction. For instance, there is no such procedure in England, even though most international shipbuilding contracts are governed by English law.

Article 185 of *The Real Right Law of China* and Article 14 of *China Maritime Code* ("CMC") provide for the mortgage registration of ships under construction. The law is not clear on the identity of the mortgagor.

Article 12 of CMC generally provides the owner of a ship or those authorized to establish the mortgage of a ship. This makes the subject ambiguous as both the shipyard and the ship-owner possess such rights. The ship-owner will obviously like to have this additional security in addition to the refund guarantee.

However, the *Provisional Regulation on Construction of the Ship Mortgage Registration* ( issued on June 9, 2009 ) provides clarity on mortgage of ships under construction.

Article 4(1) of the Regulation provides that the mortgagor is the shipbuilding enterprise capable of meeting the requirements of the country or the relevant authorities.

Article 4(3) further provides that the mortgagor has the sole ownership of the mortgaged ship.

Given the above Articles, it is clear that ship-owners are excluded from the mortgage registration system.

As such, refund guarantee plays an important role in safeguarding the interests of ship-owners. The refund guarantee is issued by either an insurance company or a banking institution. It provides for payment to the ship-owner in the event of a default caused by the shipyard.

In the shipbuilding contracts, refund guarantee clause is a condition. Failure to provide such a document will normally result in termination of the contract.

## **II Forms and nature of the Refund Guarantee**

Refund guarantees can be categorized as (a) bank guarantee and (b) demand guarantee.

The former refers to the guarantee from a bank or insurance company ensuring that the obligations of a debtor are met. In other words, if the debtor fails to satisfy a debt, the bank will cover it.

The bank's liability to pay is secondary and will arise only when the shipyard defaults and the parties resort to resolve the dispute by an agreed procedure. The final result will be determined by the arbitration award or the court judgment!

Such a guarantee will be slow and onerous on ship-owners since it takes a long time to settle the substantive disputes.

Consequently, a highly efficient form of guarantee emerges. This is the demand guarantee which is widely accepted by both foreign ship-owners and shipyards in the PRC,

In such a case, the bank assumes the primary obligation for the liability. As a guarantor, the bank does not involve in the underlying contract disputes. Once

the ship-owner establishes the default of the shipyard and provided documentary evidence to support the claim against the bank, the bank is required to pay immediately and unconditionally.

Therefore, a demand guarantee is an independent guarantee. Once the guarantee relationship is established, it will be separated from the underlying contract and become an independent security relationship between the guarantor and the beneficiary. Any invalidity or ineffectiveness will not affect the validity of the guarantee contract.

Under Chinese law, there is no concept of "independent guarantee".

Article 5 of *The Security Law of the People's Republic of China* stipulates:

*"A guaranty contract is an ancillary contract of the principal contract. If the principal contract is null and void, the guaranty contract shall be null and void accordingly. Where it is otherwise agreed in the guaranty contract, such agreement shall prevail".*

Article 172 of *the Real Right Law of China* contains similar provisions.

In the absence of special agreement, the guarantee contract is deemed to be an ancillary contract. The validity and the performance of the principal contract do not affect the guarantor's responsibilities under the guarantee contract.

The provision allows for the possibility of an independent guarantee in China<sup>ii</sup> even though it may be construed as an ancillary contract. Provided that the parties' intentions are to ensure the realization of obligatory rights, the agreement based on the principles of equality, voluntariness, fairness and good faith will be valid.

To avoid confusion hereafter, the refund guarantee has to be clearly drafted either as a bank guarantee or a demand guarantee. However, in practice, the refund guarantee is often not written clearly enough because of the lack of relevant knowledge, which makes it open to potential disputes and increases both parties' risks under the refund guarantee.

### **III The Risks under the Refund Guarantee**

#### **i The Validity Risk**

Refund guarantee is a guaranty contract, provisions referring to invalidation of contracts referred to in Article 52 of the *Contract Law* apply. Furthermore, since foreign shipbuilding refund guarantee is an external guarantee, it has to be subjected to the management and supervision of the government. In other words, the guarantee needs approval and registration in the Administration of Exchange Control.

In the *Supreme Court's Interpretation of Several Issues on the Application of the People's Republic of China Guarantee Law*, Article 6(1) provides:

*"Without the approval or registration of the competent authorities, the external guarantee contract is null and void."*

In the *Regulations of the People's Republic of China on Foreign Exchange Control*, Article 19 states:

*"Where an external guarantee is provided, an application to an exchange administration agency shall be submitted. The agency would decide whether or not to approve the application by taking into account the applicant's assets and liabilities. When, as provided by the State, the applicant's business scope is subject to a approval of the relevant department, all approval procedures shall be completed before tendering an application to the exchange administration agency. After conclusion of an external guarantee contract, the applicant shall register the external guarantee with the exchange administration agency."*

Obviously, the approval and the registration are two separate procedures. Approval amounts to an administrative licence and registration is to give effect to public notice.

Article 40 of the *Interim Measures for the Administration of Foreign Debt* provides

*"Where a domestic institution fails to complete the required examination and approval procedures or registration according to provisions when it borrows foreign debts or provides security to foreign entities, the loan contract or security contract shall not have any legal binding force."*

A foreign ship-owner has to ensure compliance with the approval and registration process; otherwise, it may face the possibility of accepting a null and void refund guarantee.

In *2010's State Administration of Foreign Exchange Notice on the Issue of Domestic Institutional External Guarantee Management* (hereinafter referred to as the

"Notice"), the supervision and the approval requirements of the refund guarantee issued by different subjects are treated differently.

According to Article 13 of the *Notice*, any refund guarantees issued by non-financial institutions and enterprises need to be examined, only subject to certain conditions in which the method of balance management shall be adopted.

Article 3 of the *Notice* provides that the bank guarantee is divided into financing guarantee and non-financing guarantee. The former is subject to balance index management. It can be issued by the bank without application for approval to the Administration of Exchange Control provided that the guarantee amount is within the quota. The latter is not limited to the quota and does not require the approval to the Administration of Exchange Control, but should be consistent with the risk management requirements laid down by the industry regulatory authorities.

The shipbuilding refund guarantee is a kind of non-financing external guarantee. Therefore, no examination or approval is needed for a bank issued guarantee but only a registration. However, a refund guarantee issued by non-financial institutions still needs both the approval and registration.

In practice, in order to circumvent the above-mentioned rules, some ship-owners and shipyards agree to apply the laws of foreign countries or regions in which foreign exchange control is not implemented. Since the approval and registration system of external guarantee is a part of economic supervision and affects the public interest in the PRC, the parties cannot evade or eliminate the mandatory requirements by applying foreign laws or international customs. PRC's courts will not grant an Order for validity of the external guarantee which is subjected to a foreign applicable law.

## **ii The Text Risk of the Refund Guarantee**

As a guarantee contract, the refund guarantee under the shipbuilding contract enjoys the same freedom of contract.

For example, if the refund guarantee is ambiguous on its status as either a bank guarantee or demand guarantee, it will be determined by either the court or arbitration tribunal.

A typical case is *Esal(Commodities)Ltd. v. Oriental Credit Ltd.(1985)2 Lloyd's Report*. In this case, the text of the refund guarantee is: "We undertake to pay the

*said amount on your written demand in event that the supplier fails to execute the contract in perfect performance....”*

“On your written demand” is the normal wording for a demand guarantee. However, it also emphasized that only in the event that the supplier failed to perform the contract . it would trigger payment by the bank. It did not appear to be a demand guarantee, but the Court of Appeal held that it was a demand guarantee on the basis that the main purpose of the guarantee was to ensure that the beneficiary was paid promptly.

*In Rainy Sky SA and others v. Kookmin Bank*<sup>iii</sup>, the disputes also arose as a result of the unclear wording of refund guarantee agreements.

The main issue in the case was whether the insolvency of the shipyard would fall within the agreed scope of guaranty.

Paragraph [2] (the paragraphs in the letter comprising the Bonds were not numbered but both the Judge and the Court of Appeal referred to them by number for convenience of reference) of the bond stipulates:

*“the buyers are entitled, upon the buyers’ rejection of the vessel in accordance with the terms of the contract, buyers’ termination, cancellation or rescission of the contract or upon a total loss of the vessel, to repayment of the pre-delivery instalments of the contract price paid by the buyers.”*

In the shipbuilding contract, the buyer was able to terminate and cancel the contracts due to delay, insufficient speed, excessive fuel consumption, deficient deadweight or cargo capacity.

Paragraph[3] of the bond provides that

*“in consideration of your agreement to make the pre-delivery instalments under the contract and for other good and valuable consideration, we hereby as primary obligor, irrevocably and unconditionally undertake to pay to you, your successors and assigns, on your first written demand, all such sums due to you under the Contract provided that the total amount recoverable by you under this Bond shall not exceed US\$2,664,000...”*

Subsequently, the shipyard went bankrupt and the buyers claimed against the bank for the instalments prepaid.

The Bank argued that insolvency event was not covered by the specifically mentioned obligations of repayment listed in paragraph [2].

However, the buyers asserted that terms in paragraph [3] were wide enough to cover the insolvency of the builder and the bank needed to take the responsibilities.

The case went right up to the UK Supreme Court. The Supreme Court considered two possible approaches. It decided the case in accordance with common business sense and that the scope of liabilities covered the insolvency of the shipyard. The decision was consistent with the commercial purpose.

In practice, many refund guarantees stipulate that the buyers have the right to retrieve the advance payments when the shipbuilding contract is terminated due to the excessive delay of delivery of the ship, serious shortage in speed, fuel consumption, deadweight, etc. However, the event of insolvency is not specifically covered.

Although the parties' intention should be determined according to the wording of the contract, it is difficult for parties to cover all possible scenarios. It will be most baffling to see payment to the ship-owner due to a major default like delay and there is no recourse under the refund guarantee due to insolvency of the shipyard.

In fact, the two cases above reflect that the UK courts will take rational standard and give efficacy to commercial interpretation when dealing with the disputed contractual terms.

The wording of the refund guarantee has to be concise and consistent with the terms of the shipbuilding contract. Otherwise, there will be legal consequences costly for all contractual parties to both the refund guarantee and shipbuilding contract.

### **iii The Interest tax and Exchange Rate Risks of the Refund Guarantee.**

Unless the contract provides otherwise, refund guarantee usually stipulates that the guarantor will be liable for interest accrued and arising out of the advance payments.

For example, *NEWBUILDCON* provides:

*“pay to you ...any installment together with Contractual interest and Award interest (if any).”*

Article 3(3) of the *Enterprise Income Tax Law of the People's Republic of China* stipulates:

*“where non-resident enterprises that have not set up institutions or establishments in China, or where institutions or establishments are set up but there is no actual relationship with the income obtained by the institutions or establishments set up by such enterprises, they shall pay enterprise income tax in relation to the income originating from China.”*

Therefore, the buyer under the shipbuilding contract has to pay the enterprise income tax arising from the interest income.

Article 37 of the above-mentioned law clearly defines the agency empowered to levy the tax

*“the payable income tax from income obtained by non-resident enterprises in accordance with para 3 of article 3 hereof shall be subject to tax withheld at source, with the payer as the withholding agent. The tax payment shall be withheld from the amount paid or the payable amount due from each tax payment and payable amount of the withholding agent.”*

Thus, the guarantor under the shipbuilding refund guarantee has to pay the agency withholding tax while repaying the advance payments to the foreign ship-owner. In practice, the guarantor generally promises that *“paying without any deduction, and if deductions must be made in accordance with the law, the guarantor would make up for the balance.”*

Due to the long duration of the shipbuilding contract which involves considerable amount of advanced payments, the interest amount can be considerable. Also, there may be currency fluctuations and risks due to advanced payments in RMB and remittance in US dollar. This is a factor to be considered when drafting a refund guarantee.

#### **iv The Risk of Negotiating the Refund Guarantee**

Ship building requires a substantial amount of money. The main financing approach for a buyer to obtain ship financing from a commercial bank. . Taking

the commercial risk into account, the lending bank usually requires an assignment of the refund guarantee given to the buyer.

*Article 10 of the United Nations Conventions on Independent Guarantees and Stand-by Letters of Credit* supports the legal obligations of the beneficiary under the assignment.

According to *The Contract Law of China*, the guarantor has to pay to the assignee if the guarantor is given written notice of the assignment. If payment is made only to the ship-owner notwithstanding the notice to the guarantor, the guarantor will be liable to pay the financing bank of the shipowner...

As a result of the assignment given to the financing bank by the buyer, it is now the party who will replace the shipowner in becoming a party of the guarantee and entitled to claim against the guarantor in his own name when the payment terms are satisfied.

In this case, since the assignee is not the party to the shipbuilding contract, the complexity and indirectness of a claim may enlarge the guarantor's risk. Therefore, in the international conventions and domestic legislations, the assignment of legal rights arising from a refund guarantee may be subjected to some restrictions.

For example, in the *United Nations Conventions on Independent Guarantees and Stand-by Letters of Credit*, Article 9 stipulates that

*"the beneficiary's right to demand payment may be transferred only if authorized in the undertaking, and only to the extent and in the manner authorized in the undertaking."*

In the PRC, *Domestic Institutions External Guarantees Management Regulations*, Article 44 states:

*"The assignment by a Beneficiary of its rights under a security shall be subject to the prior consent of the Security Provider and the approval of the Administration of Foreign Exchange. If the consent of the Security Provider and the approval of the Administration of Foreign Exchange have not been obtained, the Security Provider shall be released automatically from its security obligations. If the contract of security contains different provisions, the matter shall be handled in accordance with such provisions. However, where, according to these Rules, the provision of security to a foreign party does not require prior approval from the Administration*

*of Foreign Exchange, the Beneficiary's assignment of its rights under the security shall not be subject to approval from the Administration of Foreign Exchange."*

It is concluded that any assignment of benefits under the refund guarantee require the prior approval of the guarantor as well as the Administration of Foreign Exchange.<sup>iv</sup>

It is to be submitted that this is a legislative defect and the strict restrictions imposed on the assignment of the proceeds entitled under a refund guarantee are not necessary, and do not meet the needs of the international commercial practice.

In practice, the assignment clause under refund guarantee often has the following wordings "*security provider unconditionally agree*" or "*negotiation shall be subject to the security provider's approval with an exception of "unreasonably withhold"*".

Conclusion:

Shipbuilding is the foundation of the shipping industry and the refund guarantee is a significant part of the shipbuilding contract. Thus, the quality of the refund guarantee may affect the signing and performance of the contract. Getting a favorable guarantee contract is dependent not only on the party's strong bargaining power but also the familiarity to risks under the shipbuilding refund guarantee. The shipping industry, in particular shipbuilding, is now in doldrums. It is timely for legislations and by-laws to be enacted in the PRC and to bring this more in line with commercial practice in major shipping countries.

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<sup>i</sup> Ge Anxia, Zhao Jinsong. The Legal Risk under Demand Guarantee.[J] Ship economic and trade.2010,(7)

<sup>ii</sup> Li Guoan, The Practice and Innovation of International Financing Guarantee. Peking University Press, 2005-6-1

<sup>iii</sup> Rainy Sky SA and others v. Kookmin Bank. [2012] 1 Lloyd's Rep. 34

<sup>iv</sup> Liu Liang, The Research of Legal Problems under Ship Refund Guarantee. Master's Thesis of Dalian Maritime University ,2012.