PARENTAL GUARANTEES

SHANGHAI SHIPYARD CO LTD v REIGNWOOD INTERNATIONAL INVESTMENT (GROUP) COMPANY LIMITED [2021] EWCA CIV 1147

In a previous article on parental guarantees,[1] we discussed the impact and problems of the first instance decision in *Shanghai Shipyard Co. Ltd v Reignwood International Investment (Group) Company Ltd* [2020] EWHC 803 (Comm). As noted in that article, the decision seemed wrong, in that it departed from a clear approach based on the wording of the guarantee. In a welcome decision, the Court of Appeal (Sir Geoffrey Vos, Lord Justice Baker and Lord Justice Popplewell) unanimously overturned the decision of the High Court (Knowles J).

The decision returns the application of normal principles of construction to guarantees and avoids the unattractive outcome reached by the High Court whereby similarly worded guarantees could having quite different meanings if issued by a bank or insurer on the one hand, and a parent company on the other. Apart from anything else, that situation would only drive up the costs of shipbuilding contracts by requiring firm bank guarantees to be procured.

Background

Shanghai Shipyard Co. Ltd ("the Builder") and Reignwood International Investment (Group) Company Ltd ("the Guarantor") were parties to a guarantee (the "Guarantee") which was given to secure a final payment of USD 170m by Opus, for a drillship under a shipbuilding contract (the "Contract"). Opus rejected the vessel for alleged significant defects. The Builder claimed the final instalment from the Buyer on 11 January 2017. When the Buyer failed to pay, it made a demand of the Guarantor under the guarantee on 23 May 2017.

The issue in dispute was whether the Guarantee was a demand guarantee, such that the Guarantor's liability arose upon and by reason of the demand or was a "see to it" guarantee or a conditional payment obligation, such that the Guarantor's liability arose upon the demand only if the Buyer was liable to pay the final instalment under the terms of the Contract.

Decision

At first instance, the High Court judge held that the Guarantee was a 'see to it' guarantee so liability under the Guarantee only arose if Opus was liable to pay the final instalment. The Guarantor could refuse to pay under the Guarantee until the dispute as to whether the final instalment was payable by Opus had been resolved. It did not matter that the arbitration was not commenced until after the demand was made under the Guarantee.

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[1] *www.preston-turnbull.com/insights/parental-guarantees-what-security-do-they-provide*

Appeal

The Court of Appeal reversed the High Court decision, concluding that it was a demand guarantee, and the Guarantor was therefore liable to pay following the demand. It could not invoke the contractual clause to delay payment because the arbitration had not been commenced before the demand was made.

The Court held that the identity of the guarantor should not create any presumption as to the nature of the instrument, so just because the Guarantor was not a bank, it could not be said that the Guarantee was more likely to be a 'see to it' guarantee. The wording of the contract is the definitive factor and there were a number of phrases and words that strongly indicated it was a demand guarantee. Those were based on the strong line of authority set out in recent cases, starting with *Meritz Fire & Marine Insurance Co Ltd v Jan De Nul NV and another* [2011] EWCA Civ 827 and *Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece SA* [2012] EWCA Civ 1629.

In brief, the Court relied on:

1. The use of "ABSOLUTELY and UNCONDITIONALLY", which indicated that the Guarantor's obligations were not conditional on the liability of the buyer.
2. Clause 1 set out the main guarantee obligation and stated that the Guarantor contracted "as primary obligor and not merely as surety".
3. Payment against “first written demand”. As the name suggests, payment against demand is a classic hallmark of a demand guarantee.

Clause 4 of the Guarantee provided some confusion as it allowed the Guarantor to defer payment where there was a dispute between the buyer and the Builder, until an arbitration award was produced. The Court of Appeal considered that, contrary to the judge's view, this supported the position that it was an on demand guarantee. The deferral of the payment did not change the Guarantor's obligation from primary to secondary. This is because where there is a secondary obligation in a surety guarantee, the guarantor is not bound by any arbitration award and could challenge a conclusion by the Tribunal that the buyer was liable. Clause 4 did not permit that; the Guarantor remained obliged to pay on the issue of a document, but that document changed from written demand to the arbitration award.

The final issue was whether Clause 4 required the dispute to be submitted to arbitration before the obligation to pay on demand was suspended. The Court of Appeal held that it did, as to provide otherwise would be to remove the Builder’s right to payment on a valid demand, and clearer language would be needed to remove such right.

Commentary

Guarantees are an integral part of shipbuilding projects, and this case has demonstrated the importance for the parties involved to have a clear understanding of how English law guarantees work. There have been a series of disputed cases concerning the nature of a guarantee in shipbuilding contracts since 2011, all with much the same result in holding wording similar to this case to be an on demand bond. This decision corrects the judgment at first instance that ran against the line of authorities on the subject.

The Court of Appeal has helpfully restored certainty to the construction of guarantees, by refusing to accept that the identity of the issuer should be determinative of the nature of the guarantee and instead the key factor is the language used.

The decision also clarifies the effect of arbitration carve outs to a guarantor's obligation to pay on demand where a dispute arises over payment between builder and buyer and that dispute is referred to arbitration. Such carve outs make the point that absent a timely reference to arbitration, the on demand bond requires payment by the Guarantor no matter what the dispute. Any party wishing to contest payment therefore must be sure to commence legal proceedings before a demand is made.

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