SCHJØDT

*Topic: Shipbuilding; Guarantees; On Demand Guarantees vs See to it Guarantees under English law*

# Mind the fine line between on demand and see to it guarantees!

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**Shanghai Shipyard Co. Ltd v Reignwood International Investment (Group) Company Limited & Anor [2020] EWHC 803 (Comm)**

**Summary**

In this English Commercial Court judgment, the judge (Knowles J) considered legal issues that are of particular significance to parties who regularly deal with guarantees, especially in a shipbuilding context. The judgment demonstrates just how fine the distinction can be, on the wording, as between an on demand guarantee and a see to it guarantee. It also underlines the very high threshold for a beneficiary to be able to establish that a guarantee is to be treated as an on demand guarantee where the guarantor is not a bank nor otherwise a financial institution.

The effects of the distinction are usually very significant. A guarantor's obligations under an on demand guarantee are triggered simply on the beneficiary making a demand under the guarantee. This often means that the guarantor must make payment, even where there is an unresolved dispute between the principal and the beneficiary as to whether – or what – amounts are due. Under a see to it guarantee, the guarantor's obligations are secondary to those of the principal, and the guarantor's obligations are only triggered on the principal being shown to be in default.Background to the case

In the background of the dispute was a contract for the construction of a drillship. Shanghai Shipyard, the claimant in the Commercial Court action, was the builder, and Reignwood International Investment ("Reignwood"), the first defendant, was its original buyer, subsequently becoming a guarantor. Opus Tiger 1 ("Opus"), the second defendant, was the replacement buyer following a novation of the shipbuilding contract, an indirect subsidiary of Reignwood, and a special purpose company. Opus' payment obligations towards Shanghai Shipyard under the novated shipbuilding contract were guaranteed by Reignwood, by way of a separate payment guarantee.

Reignwood is a significant and diversified Chinese investment company, but it is not a bank nor is it otherwise categorised as a financial institution. It has, however, in other contexts described itself as a company offering "investment services".

On Shanghai Shipyard preparing to deliver the drillship, it demanded payment of the final instalment from Opus, of USD 170million. Opus refused delivery and to make the payment, asserting that the ship was not in a deliverable state. Shanghai Shipyard then made a formal demand on Reignwood under the guarantee. Reignwood too refused to pay. Shanghai Shipyard commenced Commercial Court proceedings in 2018 pursuant to the guarantee, and in June 2019, arbitration proceedings were commenced in relation to the shipbuilding contract as between Shanghai Shipyard and Opus.

**The preliminary issues before the Commercial Court**

The Commercial Court judgment, handed down in April 2020, was confined to preliminary issues

submitted by the parties to the Court for its determination, concerning the construction of the guarantee. Those issues were essentially as follows:

1. Was the guarantee (a) an on demand guarantee or (b) a see to it-/performance guarantee?

2. If the answer to the first preliminary question was "(b) – it is a see to it guarantee", would Reignwood then not be entitled to withhold payment under the guarantee pending an arbitration award under the shipbuilding contract as to Opus' obligation to pay the final instalment, due to the arbitration having been commenced after Shanghai Shipyard served its demand on Reignwood under the guarantee?

**First preliminary issue: An on demand or a see to it guarantee? Marubeni and Paget's Principles**

As to the first issue, Knowles J concluded that the guarantee was a mere see to it guarantee. Accordingly, it would require evidence by Shanghai Shipyard of breach of obligation on the part of Opus before Reignwood's guarantee obligations would be triggered.

The judge's reasoning, and in particular his analysis of the guarantee wording, serves as a good illustration of how an on demand guarantee and a see to it guarantee can be worded very similarly – even almost identically – and yet be legally categorised entirely differently, under English law. That difference in categorisation will usually have a very significant effect on the nature of the beneficiary's rights and on the guarantor's obligations under the guarantee.

The subject guarantee in that case stated, inter alia, the following:

*"...[the Guarantor] hereby IRREVOCABLY, ABSOLUTELY and UNCONDITIONALLY guarantee[s] in accordance with the terms hereof, as the primary obligor and not merely as the surety, the due and punctual payment by [Opus] of the Final [I] nstalment of the Contract Price amounting to USD 170,000,000..."*

Further that:

*"...In the event that[Opus] fails to punctually pay the First Instalment guaranteed hereunder in accordance with the Contract...and any such default continues for a period of fifteen...days, then, upon receipt by [Reignwood] of [Shanghai Shipyard's] first written demand, [Reignwood] shall immediately pay to [Shanghai Shipyard]...all unpaid Final Instalment..."*

In the course of the barristers' arguments before Knowles J, it was highlighted that payment guarantees and the conditions that trigger payment under them would often be of critical importance to a shipbuilder. Further, that this importance is particularly so in situations where the buyer is a special purpose company, as Opus is, having no assets of its own beyond its interest in the shipbuilding contract, until the subject vessel is fully paid for and has been delivered to it.

Central to Knowles J's conclusion – that this was a see to it and not a demand guarantee – was his finding that, even if Reignwood was an investment company, the guarantee was not, or at least it was not squarely, given in a "banking context".

The judge went on to discuss and to follow what is known as the "Marubeni principle" under English law, which derives from the English Court of Appeal's judgment in the case of Marubeni Hong Kong and South China Ltd v Government of Mongolia [2005] 1 WLR 2497. In that 2005 case, the Court of Appeal held that, in relation to those guarantee instruments that are created outside a banking context, there will be a strong presumption against interpreting them as on demand guarantees or as bonds, and a presumption to instead treat them as performance (ie see to it) guarantees.

Against the background of this well-established Marubeni principle, Knowles J found in this present case that the parties' usage of express terminology in the guarantee such as "irrevocably, absolutely and unconditionally guarantee", "as primary obligor and not merely as surety" and "upon receipt of first written demand" (and as would on their face seem to require no further action by Shanghai Shipyard against Opus as a pre-condition to Shanghai Shipyard proceeding against its guarantor, Reignwood) were insufficient to displace the strong presumption that with Reignwood not being a bank, this was not an on demand guarantee.

Knowles J was not swayed by arguments put forward

on behalf of Shanghai Shipyard, referenced to another reported case where a guarantee had been found to be an on demand guarantee and which guarantee had been almost identically worded to this subject guarantee, that this present guarantee should be classified the same. Knowles J stated that the Court would always have to address the specific instrument before it. He made the somewhat surprising comment that references made to numerous other judgments, dealing with other guarantee instruments, would therefore not necessarily be helpful to the Court in determining the categorisation of the guarantee before it.

In the judgment, reference was also made to the so-called "Paget's presumption" (taking its name from the textbook "Paget's Law of Banking", where it is formulated). This states that where a guarantee has been given by a bank and that guarantee contains an undertaking by the bank to pay on demand, then it usually will be construed as an on demand guarantee.

**Would different wording have made a difference to the outcome?**

In a nutshell, Knowles J's judgment confirms that there will need to be exceptionally clear wording deployed in order for a beneficiary to be able to displace the presumption that a guarantee not given by a bank is not an on demand guarantee, and similarly for a bank to displace a presumption that what it has given is an on demand guarantee. Indeed, it is likely the case that if Reignwood had been a bank or a financial institution, rather than "a provider of financial services", and if the wording of the guarantee had for all intents and purposes been the same, only with logical amendments, then it would have been categorised instead as an on demand guarantee, and Reignwood would have been obliged to pay Shanghai Shipyard on the demand being made.

**Second issue: Did the timing of the demand, ahead of the arbitration, matter?**

Turning to the second preliminary issue that the Court was asked to determine, Shanghai Shipyard had argued that, even if the guarantee was to be construed as being only a see to it guarantee, then that categorisation, as a performance guarantee, could only operate as a defence to a claim made under it if arbitration had been commenced under the shipbuilding contract before Shanghai Shipyard presented its demand to Reignwood. In this case, there had been a significant time lag between those events, with the arbitration being commenced long after the demand was made under the guarantee.

In its key parts of relevance to this second preliminary issue, the guarantee stated that if there was any dispute as between Opus and Shanghai Shipyard as to the liability to pay the final instalment, then:

*"If such dispute is submitted either by [Opus] or by [Shanghai Shipyard] for arbitration in accordance with Clause 17 of the [shipbuilding] Contract, [Reignwood] shall be entitled to withhold and defer payment until the arbitration award is published. [Reignwood] shall not be obligated to make any payment to [Shanghai Shipyard] unless the arbitration award orders [Opus] to pay the Final Instalment. If [Opus] fails to honour the award, then [Reignwood] shall pay you to the extent the arbitration award orders."*

On this issue, Knowles J found that Reignwood was indeed entitled to refuse payment under the guarantee, regardless of the fact that Shanghai Shipyard had made its demand under the guarantee before the arbitration under the shipbuilding contract was commenced. He found that there was nothing in the particular wording of the guarantee that should be deemed to place any such condition requiring the commencement of arbitration to precede the demand, as the lawyers for Shanghai Shipyard had argued for.

**The key take-aways**

As this judgment underlined, the beneficiary under a payment guarantee given by an entity that is not a bank may provide that beneficiary with very little assurance that it will be receiving payment under it expeditiously, and provide minimal assurance that the guarantee will enable the beneficiary to avoid having to commit to and to await the outcome of what are often protracted proceedings under the underlying contract before payment under the guarantee will be triggered. Typically, the beneficiary under such a see to it guarantee will have to face committing very significant funding and other resources to such lengthy, substantive legal processes, without having any certainty as to the likelihood of ultimately obtaining payment until the very end of the matter, even where it is the winning party in those

proceedings. In most cases, this will be precisely the sort of situation that the beneficiary will believe that it will have avoided by entering into the guarantee with a sizeable parent or similar company, either at the outset during the contracting stage, or when the contract was being novated to a special purpose company (as is usual in a shipbuilding context) and it was at the same time given the guarantee.

For those of us who have been regularly litigating international shipbuilding cases, and in particular during market downturns, it has been observed that some guarantors and the companies whose obligations they are guaranteeing have taken advantage of this legal position, forcing a deferral of payments under guarantees by commencing arbitration proceedings under the underlying contract. This has regularly happened even where there may be no genuine claim or defence, and even no real dispute under that contract, only a reluctance to pay and/or to take delivery, that reluctance often resulting from a change in market conditions since the contract was entered into. Accordingly, certain arbitration claims and proceedings have been ”engineered” purely for the strategic purposes of deferring payments (and delivery) and to place the beneficiary in a difficult position, funding-wise, and an uncertain position, outcome-wise. (For good order, there is no indication in this judgment, or otherwise, that this was the position in this case, nor has it been indicated that the argument about the drillship not being deliverable were not considered genuine.)

These very same concerns as to the status of a guarantee will apply in a shipbuilding contract whether you are the buyer and beneficiary under refund guarantees, or the builder and beneficiary under payment guarantees.

Because of these complexities and the very firm way in which the respective Marubeni and Paget’s presumptions tend to be applied under English law, it is important for parties who are involved in the negotiation and in the drafting of guarantee wording to seek early and thorough legal advice on the formulation of the guarantee. As the judgment illustrates, highly subtle differences in guarantees’ respective wordings can lead to very significantly different legal effects. Further, that the same wording can have entirely different legal effects in different circumstances, depending on who the guarantor.

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