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On demand guarantees: don't tie your hands!

Shanghai Shipyard Co. Ltd. v Reignwood International Investment (Group) Company Ltd [2021] EWCA Civ 1147

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Facts

Perhaps not coincidentally amidst the sustained period of high oil prices in the early part of the last decade, in September 2011 Reignwood International Investment ("Reignwood") – a company with (at that time anyway) no obvious connection to the offshore drilling sector – came to be involved as an investor in the purchase of a newbuilding offshore drillship from Shanghai Shipyard Co Ltd ("the Shipyard") for US$200 million. This was in fact one of four drillship newbuilding projects in which Reignwood invested very substantial sums: in total it funded US$120 million by way of pre-delivery instalments for each of the four drillships.

Reignwood itself initially entered into the shipbuilding contract for the drillship, but it was always envisaged that the contract would be novated to a special purpose company (the "SPV Buyer") owned (indirectly) by Reignwood and, we assume, its (unnamed) partners. The terms of the shipbuilding contract required Reignwood to provide an unconditional letter of guarantee to the Shipyard securing payment of the final (delivery) instalment in the sum of US$170 million. That guarantee (the "Guarantee") was issued by Reignwood shortly after the contract was concluded, although it was not until a year later that the shipbuilding contract was novated to the SPV Buyer.

The Guarantee included, amongst various others, the following provisions:

> Clauses 1, 3 and 10: that Reignwood "*IRREVOCABLY, ABSOLUTELY and UNCONDITIONALLY*" guaranteed "*as the primary obligor and not merely as the surety*" payment of the delivery instalment and interest thereon at a rate of 5% (capped to a maximum of 60 days interest).
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> Clause 4:
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> - if the SPV Buyer defaulted in payment of the delivery instalment for 15 days, then, upon the Shipyard's "*first written demand*", Reignwood was to immediately pay the instalment;
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> - however, in the event (i) there was a dispute between the Shipyard and the SPV Buyer related to payment of the delivery instalment and (ii) that dispute was submitted to arbitration, then Reignwood was entitled to withhold payment until publication of an award ordering the SPV Buyer to pay the delivery instalment.

It is not clear if the project purely fell in to delay, or whether other factors such as the oil price crash in 2014 also played a part, but through various addenda to the shipbuilding contract the original delivery date of April 2014 was extended. In the end, it was not until December 2016 that the Shipyard gave notice of completion of the drillship. Thereafter, in January 2017, the Shipyard demanded payment of the delivery instalment by the SPV Buyer. By this stage it seems that Reignwood had fallen out with its partners and the SPV Buyer did not pay the delivery instalment. It is not clear if payment was withheld due to a genuine dispute about the deliverability of the drillship or due to cashflow issues (perhaps emanating from the oil price crash). Reignwood subsequently took steps to

take control of the SPV Buyer, however it was not until June 2019 that Reignwood commenced arbitration proceedings (in the name of the SPV Buyer) against the Shipyard under the shipbuilding contract – arguing (we assume) that the delivery instalment was not due on the basis that the drillship was not in a deliverable condition.

Meanwhile, the Shipyard had not been idle and in May 2017 (some two years before the above arbitration proceedings were commenced), it made a demand against Reignwood under the Guarantee. When Reignwood failed to pay, the Shipyard commenced court proceedings in September 2018, which Reignwood defended on the basis it was not obliged to pay. At first instance the Commercial Court found in favour of Reignwood, a decision that was overturned by the Court of Appeal.

The issues

Both the Commercial Court and the Court of Appeal were asked to determine as preliminary issues:

a) Whether the Guarantee provided by Reignwood was a "see to it" guarantee (whereby Reignwood's liability would be contingent on the Shipyard demonstrating the SPV Buyer's liability under the shipbuilding contract) or a "demand" guarantee (whereby Reignwood's liability was independent); and

b) Whether a submission of a dispute to arbitration must be made before a demand was made by the Shipyard, in order for the obligation of Reignwood to pay under the Guarantee to be suspended under Clause 4.

The nature of the Guarantee

At first instance in the Commercial Court[1], Mr Justice Knowles found that the Guarantee was a "see to it" guarantee, relying heavily on a "presumption" concerning demand guarantees as articulated in Paget's Law of Banking and approved in *Wuhan v Emporiki Bank*[2]. This presumption was said to operate on the basis that if certain criteria were met, one of which being that the issuing party was a "bank", then the underlying agreement would almost always be construed as a demand guarantee. After finding that the other criteria were largely unhelpful, Knowles J held that the primary question was whether the guarantor was a "bank". Therefore, because Reignwood was not a "bank", the Guarantee was unlikely to be a demand guarantee, absent strong contraindications.

The Court of Appeal rejected this analysis. Lord Justice Popplewell, giving the only judgement, emphasised that the idea of such a presumption "*does not sit entirely comfortably with the statements of this court*" and held that the "*primary focus must always remain on the words used by the parties in their context*".

Additionally, Popplewell LJ noted that the commercial utility of a guarantee, mitigating counterparty risk, is agnostic to the nature of the business carried out by the guarantor. Provided that a guarantor is sufficiently financially strong it should not matter whether they strictly engage in the business of a bank. Adding further strength to this argument is the fact that whether a company can be considered a "bank" is not a simple binary question (Reignwood, in this case for example, was performing a financing function without being a bank, *stricto sensu*).

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[1] *Shanghai Shipyard Co Ltd v Reignwood International Investment (Group) Company Ltd* [2020] EWHC 803

[2] *Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece SA* [2013] 1 All ER (Comm) 1191

Such a presumption would therefore add a great deal of uncertainty for parties to guarantees not issued by "banks" per se, as they could not be certain whether the "presumption" would apply.

What mattered, for Popplewell LJ, was "*the wording in which the parties have chosen to express their bargain, interpreted in accordance with the well-established rules of construction*". A number of points in relation to the language used brought the Court of Appeal to the ultimate conclusion that the Guarantee, on its true construction, was a demand guarantee.

First, the capitalised words "*ABSOLUTELY" and "UNCONDITIONALLY*", along with "*as primary obligor and not merely as the surety*" (our emphasis), strongly indicated that the Guarantee was a demand guarantee, and therefore did not require that the SPV Buyer's primary liability under the shipbuilding contract be established before Reignwood's liability would arise.

Second, the fact payment was to be made (i) "*immediately*", (ii) upon receipt of a "*first written demand*" and (iii) with a maximum of 60 days' interest payable. It was found that this would not be appropriate in a "see to it" guarantee, where it would be reasonable for the guarantor (Reignwood) to delay payment while verifying the primary liability of the obligor (the SPV Buyer) under the shipbuilding contract.

Third, the fact that Reignwood's obligation to pay, even if suspended by the commencement of arbitration, was resurrected by the presentation of an arbitral award. While this might seem similar to paying only when the SPV Buyer's primary liability is established under the shipbuilding contract, Popplewell LJ did not accept this. If the relevant part of Clause 4 is triggered, the Guarantee at that point becomes an obligation to pay against a document, namely the award, and not against any underlying liability. Popplewell LJ found support for this on the basis that (i) any such award might be issued on a default basis without any consideration of SPV Buyer's liability and (ii) the obligation to pay under the Guarantee arises the moment the award is published regardless of any challenge.

When an arbitration demand must be made in order to suspend the guarantor's obligation to pay

The Commercial Court held that Reignwood's obligation to pay would be suspended upon the commencement of arbitration proceedings, even if this was after a demand was made under the Guarantee (as indicated above, here the arbitration proceedings were commenced some two years after the demand). This was held to be the case because it was unlikely the parties would imagine that "*what should matter was being first to arbitration or to demand*".

The Court of Appeal, however, rejected this and held that a dispute must be referred to arbitration *before* a demand was made under the Guarantee, in order for Reignwood's obligation to pay to be suspended. Popplewell LJ, looking once again at the wording of the clause, found that there was nothing to suggest that an already accrued right would be suspended. Clear language would be required to achieve this.

The shortness of the window for commencing arbitration proceedings (15 days) was also somewhat mitigated by the fact that the Shipyard would need to give the SPV Buyer 10 days' notice that the delivery instalment was due (so that 25 days' notice would really be available). Additionally, there was no contractual requirement that the parties attempt to amicably settle the dispute before referring the matter to arbitration.

Commentary

As Popplewell LJ noted, guarantees are of vital importance to shipbuilding projects. That is so whether in the context of securing a buyer's right to a refund of pre-delivery instalments or, as in this case, where a shipyard seeks to secure its entitlement to payment of instalments by a special purpose buying vehicle that has little (or nothing) in the way of concrete assets. Overall, therefore, the Court of Appeal has brought some much desired certainty to the construction of guarantees, by refusing to accept that the identity of the issuer should be almost determinative of the nature of the guarantee and looking instead at the language used in the document.

The frustration of the Court of Appeal, at having authorities cited as to the construction of terms, was also readily apparent and echoes that of the Supreme Court in *Triple Point Technology v PTT*[3]. This decision therefore serves as a reminder to parties that they should consider the meaning of their documents, using the normal principles of construction, without seeking to rely on interpretations accepted in previous decisions.

The refusal of the Court of Appeal to permit the suspension of the payment obligation, unless a referral was made to arbitration before the obligation arose, also serves as a warning to parties to ensure that they in a position to observe any timing requirements. In this case, it appears very unfortunate that Reignwood (as both a substantial investor in the project and the guaranteeing party) was not able to procure the commencement of arbitration proceedings by the SPV Buyer until over two years after the Shipyard demanded payment of the delivery instalment. At the time of the Court of Appeal judgment, the award in that arbitration was said to be awaited. We obviously cannot know whether the SPV Buyer had legitimate arguments in that arbitration, but on the assumption that the delivery instalment was paid by Reignwood following the Court of Appeal's decision, a subsequent favourable arbitration award may leave Reignwood (through the SPV Buyer) having to recover that payment from the Shipyard. That is a scenario which could have been avoided had the SPV Buyer promptly commenced the arbitration.

[3] *Triple Point Technology, Inc v PTT Public Company Ltd* [2021] UKSC 29