# Maritime
# Briefing – China focus

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## Chinese refund guarantees – a map through the minefield

Over the last few years, with newbuilding buyers feeling nervous about the ability of over-booked Chinese shipyards to fulfil their shipbuilding contract obligations, or worse, to stay solvent, the importance of obtaining valid Chinese bank issued refund guarantees has been thrust into the limelight.

Challenges to the validity of refund guarantees are being seen more frequently in the English courts with two widely publicised judgments at the end of 2011, both of which involved challenges to the refund guarantor's obligation to make payment. Whilst the *Rainy Sky S.A. v Kookmin Bank* and the *WS Tankship v Kwangju Bank* cases involved Korean banks, the resulting principles can be equally applied to Chinese refund guarantors and guarantees.

### Registration and SAFE

It is well-known that foreign currency refund guarantees issued by Chinese refund guarantors require registration with the State Administration of Foreign Exchange (SAFE). SAFE is the Chinese state-run organisation which regulates foreign exchange in China. Registration with SAFE is crucial as without it, the refund guarantees would be rendered invalid against the refund guarantor in China.

### Historical confusion regarding SAFE registration and approval

At the end of 2008, we saw financing banks reacting nervously to the 2008 amendment to the Regulation of the People's Republic of China on Foreign Exchange Administration. The interpretation of the amendment was that approval was required from SAFE in advance of a foreign currency refund guarantee being issued. Of potentially more concern, was the suggestion that such approval was also needed for previously issued foreign currency refund guarantees. Confirmation of such SAFE approval was not easy or quick to secure as the practice, attitude and approach of the Chinese banks/refund guarantors varied from branch to branch and Province to Province.

## Clarifications to the SAFE registration/approval process

The position was clarified on 30 July 2010 as SAFE aimed to improve efficiency to support the globalisation of Chinese entities. SAFE issued a "*Notice Concerning the Administration of Foreign Security Provided by Chinese Institutions*" and the SAFE registration process relating to SAFE registration and approval was simplified considerably.

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Chinese banks/refund guarantors are now able to apply for an annual foreign security balance quota and, once an application for such a quota is approved, are permitted to finance foreign security i.e. issue foreign currency refund guarantees on a 'blanket' basis within that quota without having to obtain

SAFE approval on a case-by-case basis. SAFE approval is to be distinguished from SAFE registration, however, and Chinese banks are still obliged each month to summarise all foreign currency refund guarantees and to report them to SAFE.

According to the new SAFE regulations, the reporting is deemed registration and no written confirmation will be issued by SAFE to confirm the registration. Although the approval and registration process has been simplified, it still continues to be difficult for any beneficiary of a refund guarantee to verify whether its refund guarantee has been registered with SAFE since SAFE no longer issues any certificate confirming the registration.

## A solution to the problem of SAFE registration?

While improving the efficiency of SAFE, it would be hard to argue that the new position has had any considerable impact on the position of newbuild buyers or financing banks. This is due to the fact that firstly, no official evidence can be obtained to prove the registration of foreign currency refund guarantees with SAFE; and secondly, even if the refund guarantee in question has been registered with SAFE, there is no certainty as to whether the refund guarantee is covered by the quota available to the Chinese banks.

Although there is some transparency as to the method for calculating a bank's quota (as a rough guide, it cannot exceed either 50 per cent. of a bank's total RMB and foreign currency actual capital or working capital or the bank's foreign currency net assets), it is challenging to verify whether the quota has been exhausted at the time the refund guarantee was issued and it remains uncertain what the consequences would be for the parties concerned if a refund guarantee is issued outside of such quota.

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## Assignment of refund guarantees

Chinese lawyers have for a long time had varying opinions as to whether an assignment of a foreign currency refund guarantee requires registration with SAFE because there is a change of the beneficiary under the refund guarantee.

On the one hand, no express statutory provisions require such registration, and it is confirmed that if the foreign security becomes enforceable, Chinese banks may process the payment directly to the beneficiary without needing SAFE approval.

On the other hand, regulations require any material changes to a refund guarantee (registered under the quota system) to be notified to SAFE and it remains a commonly held view that the change of beneficiary is a material change that would need to be registered with SAFE (thereby satisfying the requirement to notify SAFE). Risks to financiers are compounded by a lack of consistency from Chinese banks as to whether or not they would agree to register or notify SAFE of such change.

Further, we understand that the current legal position in China is that a Chinese court would not enforce a demand made by an assignee of the refund guarantee unless that assignment had been registered with SAFE, which goes some way to explaining why, in most of the ship financing transactions involving Chinese refund guarantors, Chinese refund guarantors refuse to consent to the assignment to the financing bank of the right to make a demand under the refund guarantee. The right to make the demand under the refund guarantee is of course a fundamental security right for a financier during pre-delivery financing.

Given that at the time of any enforcement of an assignment of a refund guarantee, the cooperation of the buyer of the newbuilding may not be forthcoming, and there is no certainty that a refund guarantor will make payment directly to a financing bank (who is relying on non-specific power of attorney contained in its finance documents) for the purposes of making a demand under a refund guarantee, financiers generally feel uncomfortable if the right to make demand under a refund guarantee is not assigned to it by the buyer of the newbuilding.

Consequently, instruments need to be put in place to ensure that a financier's ability to control the demand process (under an assigned refund guarantee) is not jeopardised or prohibited. Through our experience and transaction history, we now have established wording and means to mitigate this risk which has been accepted by the major players in the Chinese refund guarantee market.

## English law advice still relevant to refund guarantees issued by Chinese Banks

Whilst specific PRC expertise is invaluable to ensure a workable, commercial approach is taken which protects the interest of the debt banks while also working for the refund guarantor and the buyer, it should not be forgotten that almost without exception, refund guarantees issued by Chinese banks for ship finance transactions are governed by English law and must also be considered from that perspective. Invariably, English law advice is required for refund guarantees on many issues.

## *Rainy Sky S.A. v Kookmin*

A refund guarantee cannot be considered in isolation – the interpretation of a refund guarantee in the context of the wording of an English-law-governed shipbuilding contract came to the forefront in the Court of Appeal decision in the 2010 *Kookmin v Rainy Sky S.A.*, a decision which caused assignees of refund guarantees to check their documentation. It was held that the issuing bank had no liability to the buyers under the refund guarantee because the English court of appeal interpreted the scope of the wording of the refund guarantee as being limited in the context of the wording of the shipbuilding contract.

This decision was however reversed by the Supreme Court in 2011 which confirmed that the fundamental rule of construction of contractual documents is that the intention of the parties must be ascertained from the language that they have used in light of the factual situation in which the contract was made; and where there is more than one construction of meaning then the most commercial construction should be adopted.

## *WS Tankship v Kwangju Bank* - refund guarantees issued by SWIFT

A refund guarantee must be duly executed in order to be valid - a seemingly uncontroversial point. This has, however, been the subject of much discussion as a result of refund guarantees being issued by way of SWIFT in recent years in China. Under English law, Section 4 of the Statute of Frauds 1677 requires guarantees to be "signed" in contrast to the increasing practice of refund guarantors – particularly in China – to authenticate rather than sign when issuing refund guarantees by way of SWIFT.

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The issue was untested until the case of *WS Tankship v Kwangju Bank*. The lack of "signature" was raised as a defence by Kwangju Bank and it was held firstly that this defence does not apply to primary or on-demand guarantees (and therefore should not apply to any properly drafted refund guarantee), and that reference to "signed" does not in fact require signature by an individual using an ink pen and that it suffices that the refund guarantor's name is written or printed in the document.

A common sense approach was taken by the court and this method of issuance is now accepted in the market as a conventional means and that SWIFT authentication by sending of a refund guarantee is now seen as a modern equivalent to authentication by signing of a refund guarantee (and therefore within the spirit of the Statute of Frauds).

## Conclusion

Changes to SAFE regulations and recent case-law have both helped to provide some welcome certainty on specific issues however there still remain many potential pitfalls lying in wait for the unwary buyer or financing bank – many of which will not be apparent from reading the refund guarantee document without knowledge of the underlying law.

This risk is enhanced in the case of Chinese refund guarantees due to change in law risk arising out of the practice of Chinese banks to issue a refund guarantee in respect of each instalment rather than in respect of each hull.

Refund guarantees carry a weight which is belied by their short, straightforward, seemingly standard form. They continue to be a part of transactions which is not paid the degree of care and attention which they warrant – particularly given the critical role they play in providing both security to purchasing ship owners and also as credit support for banks engaged in the pre-delivery finance market.

*If you would like to discuss any of the issues raised in this briefing, please get in touch with a member of our team in Hong Kong (below), or your regular contact at Watson, Farley & Williams.*

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