SPC Guiding Case No. 109: Anhui Waijing Construction (Group) Co., Ltd. v. Dongfang Zhiye Real Estate Co., Ltd. (Guarantee Fraud Dispute)

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Unofficial English translation prepared for reference only. The official Chinese text prevails.

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Keywords

Civil / guarantee fraud / examination of the underlying transaction / principle of limitation and necessity / independent counter-guarantee

Holding

1. Where the determination of independent guarantee fraud requires examination of the underlying transaction, the principle of limitation and necessity shall be adhered to, and the scope of examination shall be limited to whether the beneficiary knew that the counterparty to the underlying contract had not committed a breach of contract under the underlying contract, and whether there were facts showing that the beneficiary knew it had no right to demand payment.

2. A beneficiary's breach of contract under the underlying contract does not affect its right to present documents and demand payment in accordance with the provisions of the independent guarantee.

3. In determining whether there is fraud under an independent counter-guarantee, even if there is fraud under the independent guarantee, where payment has already been made in good faith under the independent guarantee, the people's court shall not rule to stop payment of the funds under the independent counter-guarantee.

Basic Facts

On January 16, 2010, Dongfang Zhiye Real Estate Co., Ltd. ("Dongfang Zhiye"), as the developer, entered into the Construction Contract for the Costa Rica Lakefront Huafu Project ("the Construction Contract") in San José, Republic of Costa Rica, with Anhui Waijing Construction (Group) Co., Ltd. ("Waijing Group") as the contractor and Anhui Waijing Construction Central America Co., Ltd. ("Waijing Central America") as the builder, agreeing that the contractor would build three comprehensive commercial and residential buildings of fourteen stories each. On May 26, 2010, Waijing Group applied to China Construction Bank Co., Ltd. Anhui Branch ("CCB Anhui Branch"), using Banco de Costa Rica as the re-issuing bank, to issue a performance guarantee to Dongfang Zhiye as the beneficiary, with the guaranteed matter being the Costa Rica Lakefront Huafu Project. On May 28, 2010, Banco de Costa Rica issued Performance Guarantee No. G051225, with the guarantor being CCB Anhui Branch, the principal being Waijing Group, and the beneficiary being Dongfang Zhiye, in the amount of USD 2,008,000, valid until October 12, 2011, later extended to February 12, 2012. The guarantee stated that it was an unconditional, irrevocable, mandatory, on-demand guarantee. To execute the guarantee, the beneficiary was required to submit two copies of certification documents to the Foreign Trade Department of the Central Office of Banco de Costa Rica, indicating the reason for executing the guarantee, in addition to a notarized statement issued by the beneficiary indicating the date on which Waijing Central America was notified of the claim arising from breach of contract, together with the original guarantee certificate and any amendments that had been issued. CCB Anhui Branch also issued Counter-Guarantee No. 34147020000289 to Banco de Costa Rica, undertaking to pay the funds under the guarantee within twenty days of receiving notice from Banco de

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Costa Rica. The counter-guarantee was “unconditional, irrevocable, and payable on demand at any time,” and agreed to “comply with the Uniform Rules for Demand Guarantees (URDG 458) published by the International Chamber of Commerce.”

During the performance of the Construction Contract, on January 23, 2012, architects Jose Brenes and Mauricio Mora issued a Project Engineering Inspection Report. The report found that the construction project had “poor construction” and “inferior quality” and needed modification or repair. On February 7, 2012, Waijing Central America filed an arbitration request with the Dispute Resolution Center of the Costa Rica Association of Architects and Engineers, with Dongfang Zhiye as the respondent, arguing that Dongfang Zhiye was in arrears on project payments for completed construction work and corresponding interest, and requesting rescission of the contract and an award of damages against Dongfang Zhiye. On February 8, Dongfang Zhiye submitted to Banco de Costa Rica the claim statement, breach notice, breach declaration, the Project Engineering Inspection Report, and other guarantee cashing documents, requesting execution of the guarantee. On February 10, Banco de Costa Rica sent a message to CCB Anhui Branch, stating that Dongfang Zhiye had made a claim and requested payment of USD 2,008,000 under Bank Guarantee No. G051225, and Banco de Costa Rica further required CCB Anhui Branch to pay the above funds before February 16, 2012. On February 12, upon application by Waijing Central America, the Second Chamber of the Administrative Litigation Court of the Republic of Costa Rica issued a provisional protective measure injunction, ruling that Banco de Costa Rica suspend execution of Performance Guarantee No. G051225.

On February 23, Waijing Group brought a guarantee fraud lawsuit in the Hefei Intermediate People’s Court, and simultaneously applied to suspend payment of the funds under Guarantee No. G051225 and Counter-Guarantee No. 34147020000289. On February 27, the first-instance court rendered Ruling (2012) He Min Si Chu Zi No. 00005-1, ruling to suspend payment of the funds under Guarantee No. G051225 and Counter-Guarantee No. 34147020000289, and served the ruling on CCB Anhui Branch on February 28. On February 29, CCB Anhui Branch sent a message to Banco de Costa Rica informing it of the reasons for the first-instance court’s ruling, and on the same day mailed a copy of the ruling to Banco de Costa Rica, which received the copy on March 5.

On March 6, the Second Chamber of the Administrative Litigation Court of the Republic of Costa Rica ruled that Waijing Central America lost its application for preventive measures, and lifted the provisional protective measure injunction. On March 20, at Banco de Costa Rica’s request, CCB Anhui Branch extended the validity of Counter-Guarantee No. 34147020000289.

On March 21, Banco de Costa Rica paid the funds under Guarantee No. G051225 to Dongfang Zhiye.

On July 9, 2013, the Costa Rica Association of Architects and Engineers rendered an arbitration award, finding that Dongfang Zhiye had seriously breached the contract during performance, awarding rescission of the Construction Contract and ordering Dongfang Zhiye to pay Waijing Central America progress payments No. 1 through No. 18 totaling USD 800,058.45 plus interest; the payment for Project No. 19 was not supported because it had not been accepted by the developer; and because the funds under Guarantee No. G051225 had already been paid, Waijing Central America’s request for return of the guarantee was not supported.

Judgment

On April 9, 2014, the Hefei Intermediate People’s Court of Anhui Province rendered Civil Judgment (2012) He Min Si Chu Zi No. 00005: (1) Dongfang Zhiye’s claim under Performance Guarantee No. G051225 constituted fraud; (2) CCB Anhui Branch shall cease payment to Banco de Costa Rica of the USD 2,008,000 under Bank Guarantee No. 34147020000289; and (3) dismissing the other claims of Waijing Group. Dongfang Zhiye was dissatisfied with the first-instance judgment and appealed. On March 19, 2015, the Anhui High People’s Court rendered Civil Judgment (2014) Wan Min Er Zhong Zi No. 00389: dismissing the appeal and affirming the original judgment. Dongfang Zhiye was dissatisfied with the second-instance

judgment and applied to the Supreme People's Court for retrial. On December 14, 2017, the Supreme People's Court rendered Civil Judgment (2017) Zui Gao Fa Min Zai No. 134: (1) revoking Civil Judgment (2014) Wan Min Er Zhong Zi No. 00389 of the Anhui High People's Court and Civil Judgment (2012) He Min Si Chu Zi No. 00005 of the Hefei Intermediate People's Court of Anhui Province; and (2) dismissing the claims of Waijing Group.

Reasoning

The Supreme People's Court held:

I. On the basis for identifying, the jurisdiction over, and the law applicable to the independent guarantee fraud case in issue

The habitual residences of the disputing parties in this case, Dongfang Zhiye and Banco de Costa Rica, were located outside the territory of China, so this case was a foreign-related commercial dispute. According to Article 8 of the Law of the People's Republic of China on the Application of Laws to Foreign-Related Civil Relations, "the characterization of foreign-related civil relations shall be governed by the law of the forum," Waijing Group, as the domestic parent company of Waijing Central America, was the applicant for the issuance of the guarantee in issue; it applied to CCB Anhui Branch to issue a demand counter-guarantee to Banco de Costa Rica, and Banco de Costa Rica re-issued a performance guarantee to the beneficiary Dongfang Zhiye. According to the text of the guarantee, the payment obligations of both Banco de Costa Rica and CCB Anhui Branch were independent of the underlying transaction relationship and the guarantee application legal relationship; therefore, the above guarantee could be determined to be a demand independent guarantee, and the above counter-guarantee could be determined to be a demand independent counter-guarantee. Waijing Group brought the lawsuit in the first-instance court on the ground of guarantee fraud, and the nature of this case was a guarantee fraud dispute. The independent counter-guarantee whose payment was requested to be stopped was issued by CCB Anhui Branch, and the location of that branch should be found to be the place where the tortious result claimed by Waijing Group occurred. The first-instance court, as the court of the place of the tortious act, had jurisdiction over this case. Because the guarantee in issue stated that the Uniform Rules for Demand Guarantees applied, it should be found that the content of those rules formed part of the disputed guarantee. According to Article 44 of the Law of the People's Republic of China on the Application of Laws to Foreign-Related Civil Relations, "tort liability shall be governed by the law of the place of the tortious act," and the standard for determining guarantee fraud not covered by the Uniform Rules for Demand Guarantees should be governed by the law of the People's Republic of China. China had not acceded to the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit, and the parties in this case did not agree to apply that convention or to incorporate the relevant content of the convention into the guarantee as international trade rules. Pursuant to the principle of party autonomy, the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit should not apply.

II. On whether Dongfang Zhiye, as beneficiary, had preliminary evidence under the underlying contract proving that its claim had a factual basis

In trying independent guarantee and counter-guarantee cases related to independent guarantees, the people's court's examination of the underlying transaction should adhere to the principle of limitation and the principle of necessity, and the scope of examination should be limited to whether the beneficiary knew that the counterparty to the underlying contract had not committed a breach of contract under the underlying contract, or whether there were no other facts giving rise to payment under the independent guarantee. Otherwise, examination of the underlying contract would shake the institutional value of the independent guarantee's "payment on demand" mechanism.

According to Article 68 of the Opinions of the Supreme People's Court on Several Issues Concerning the Implementation of the General Principles of the Civil Law of the People's Republic of China (for Trial

Implementation), fraud mainly manifests as fabricating facts and concealing the truth. According to the facts found in the retrial, Banco de Costa Rica issued Performance Guarantee No. G051225, which expressly provided that the documents required to be submitted to realize the guarantee were: certification documents stating the reason for executing the guarantee, the date of notifying Waijing Central America of the request to execute the guarantee, the original guarantee certificate, and any amendments that had been issued. Waijing Group claimed that Dongfang Zhiye's conduct constituted fraud under the independent guarantee, and should submit evidence proving that Dongfang Zhiye, in realizing the independent guarantee, had one of the following acts: (1) presenting documents with false or forged content for the claim; or (2) presenting a claim request entirely without factual basis and credible foundation. In this case, what the guarantee secured was "the quality and durability of materials used during construction, compensation or indemnification for losses caused, and/or payment for the contractor's failure to perform obligations," meaning that the guarantee secured construction quality and other breaches of contract. Therefore, the beneficiary only needed to submit preliminary evidence capable of proving the existence of construction quality problems to satisfy the "certification documents stating the reason for executing the guarantee" required for realizing the guarantee. During the performance of the underlying contract in this case, Dongfang Zhiye's project supervisors Jose Brenes and Mauricio Mora issued a Project Engineering Inspection Report on January 23, 2012. The report found that the construction project had "poor construction" and "inferior quality" and needed modification or repair, and the Project Engineering Inspection Report constituted preliminary evidence proving the existence of construction quality problems.

The parties in this case did not expressly agree in the Construction Contract or under the guarantee that the Project Engineering Inspection Report should be submitted to Banco de Costa Rica when realizing the guarantee. Therefore, Dongfang Zhiye had the right to independently choose the type of certification document "proving the reason for executing the guarantee" to submit to Banco de Costa Rica, and whether it submitted the report to Banco de Costa Rica did not affect the realization of its rights under the guarantee. In addition, the Construction Contract and the guarantee did not provide that the above report had to be issued by the AIA International Architects or by persons with international membership in the American Institute of Architects; therefore, whether Jose Brenes and Mauricio Mora had international membership in the American Institute of Architects did not affect their issuance of the Project Engineering Inspection Report as project supervisors of the developer. Waijing Group was clearly aware that Jose Brenes and Mauricio Mora were both project supervisors of the developer; when the Project Engineering Inspection Report was issued and the project payments were received, it recognized the supervisory status of Jose Brenes and Mauricio Mora. Its use of evidence that it itself recognized as sufficient to prove the supervisory status of Jose Brenes and Mauricio Mora to counter-prove that the Project Engineering Inspection Report issued by them was false was logically inconsistent. Because Waijing Group failed to provide other evidence proving that Dongfang Zhiye's realization of the guarantee in issue was entirely without factual basis or that it submitted false or forged documents, Dongfang Zhiye's application to Banco de Costa Rica to realize the guarantee rights had a factual basis.

In sum, the Project Engineering Inspection Report constituted preliminary evidence proving Waijing Group's breach of contract under the underlying contract; the evidence provided by Waijing Group was insufficient to prove that the above report was false or forged, nor sufficient to prove that Dongfang Zhiye, knowing that the counterparty to the underlying contract had not committed a breach of contract under the underlying contract, or that there were no other facts giving rise to payment under the independent guarantee, nevertheless demanded realization of the guarantee. Dongfang Zhiye's realization of the rights under the independent guarantee, based on Waijing Group's breach of contract under the underlying contract and in accordance with the provisions of the contract, did not constitute guarantee fraud.

III. On whether a beneficiary's breach of contract under the underlying contract necessarily constitutes fraudulent demand under the independent guarantee

Waijing Group argued that, according to items (3), (4), and (5) of Article 12 of the Provisions of the Supreme People's Court on Several Issues Concerning the Trial of Independent Guarantee Dispute Cases ("the Independent Guarantee Judicial Interpretation"), Dongfang Zhiye should be found to constitute independent guarantee fraud. According to Article 25 of the Independent Guarantee Judicial Interpretation, after clarification by the court, Waijing Group still insisted that the handling of this case should not violate the spirit of the Independent Guarantee Judicial Interpretation. In light of Waijing Group's claims, the Supreme People's Court further explained the above issues relating to the Independent Guarantee Judicial Interpretation.

An independent guarantee is independent of the underlying transaction between the principal and the beneficiary; the bank issuing the independent guarantee is only responsible for examining whether the documents presented by the beneficiary comply with the provisions of the guarantee terms and has the right to decide on its own whether to make payment; the guarantor bank's payment obligation is not affected by the defenses under the underlying transaction between the principal and the beneficiary. As the beneficiary, when Dongfang Zhiye presented preliminary evidence proving the existence of construction quality problems, even if it had not initiated any dispute resolution procedure such as litigation or arbitration and had the counterparty's breach confirmed through such procedure, this did not affect the realization of its rights under the guarantee. Even if there were ongoing litigation or arbitration procedures under the underlying contract, as long as the relevant dispute resolution procedure had not made a final determination that the debtor under the underlying transaction had no payment or compensation liability, this would not affect the realization of the beneficiary's rights under the guarantee. Further, even if an effective judgment or arbitration award found that the beneficiary had breached the underlying contract, the existence of that breach would not necessarily become a sufficient and necessary condition for constituting "fraud" under the guarantee.

In this case, what the guarantee secured was construction quality and other breaches of contract, while the beneficiary's breach of failing to pay project payments had no logical causal relationship with the occurrence of construction quality problems. Dongfang Zhiye, as the beneficiary, having its own breach in the performance of the underlying contract, did not necessarily constitute fraudulent demand under the independent guarantee. Item (3) of Article 12 of the Independent Guarantee Judicial Interpretation limits the conditions for determining independent guarantee fraud to "a court judgment or arbitration award finding that the debtor under the underlying transaction has no payment or compensation liability." Therefore, unless otherwise agreed in the guarantee, examination of the underlying contract should be limited to the performance matters within the scope secured by the guarantee, and great prudence should be exercised in including the beneficiary's own breach of the underlying contract in the scope of examination of guarantee fraud. Although the Costa Rica Association of Architects and Engineers rendered an arbitration award finding that Dongfang Zhiye breached the contract during performance, the arbitration procedure was initiated by Waijing Group on February 7, 2012, Dongfang Zhiye did not raise a counterclaim, and the arbitration award rendered on July 9, 2013 only found Dongfang Zhiye in breach in response to Waijing Group's request, but did not find that Waijing Group was exempted from payment or compensation liability because of the other party's breach. Therefore, the content of the above arbitration award could not be relied upon to find that Dongfang Zhiye constituted guarantee fraud under item (3) of Article 12 of the Independent Guarantee Judicial Interpretation.

In addition, the fact that the parties had a dispute over construction quality and the statements in the Arbitration Award rendered by the Dispute Resolution Center of the Costa Rica Association of Architects and Engineers concerning construction quality issues could corroborate that Waijing Central America's obligations under the Construction Contract had not been fully performed, and this case did not involve a situation where Dongfang Zhiye confirmed that the underlying transaction debt had been fully performed or that the payment-due event had not occurred. The existing evidence also could not prove that Dongfang Zhiye, knowing it had no right to demand payment, still abused its rights. Dongfang Zhiye, as the beneficiary, having its own breach in the performance of the underlying contract, although confirmed by the arbitration

award, did not thereby exempt Waijing Group from payment or compensation liability. In sum, even if the Independent Guarantee Judicial Interpretation were applied as Waijing Group claimed, the circumstances of this case did not constitute guarantee fraud.

IV. On the independent counter-guarantee related to the independent guarantee involved in this case

Based on the characteristics of an independent guarantee, the guarantor constitutes a direct payment obligation to the beneficiary separate from the debtor, and the independent guarantee has no accessory subordination of defenses with the principal debt. Even if the debtor exercises defenses in a certain dispute resolution procedure, this does not necessarily confer the benefit of such defenses on the independent guarantor. In addition, even if the beneficiary has made a fraudulent demand under the independent guarantee, it cannot be presumed that the guarantor bank has made a fraudulent demand under the independent counter-guarantee. Only where the guarantor bank, knowing that the beneficiary is making a fraudulent demand and paying in violation of the principle of good faith, demands payment from the counter-guarantor under the independent counter-guarantee, can the guarantor bank be found to have made a fraudulent demand under the independent counter-guarantee.

Waijing Group brought this lawsuit on the ground of guarantee fraud, and should adduce evidence proving that Banco de Costa Rica, knowing that Dongfang Zhiye had committed independent guarantee fraud, still made payment in violation of the principle of good faith, and then, as beneficiary, made a demand under the demand independent counter-guarantee and constituted fraudulent demand under the counter-guarantee. Waijing Group not only failed to prove that Banco de Costa Rica's payment of the funds under the independent guarantee to Dongfang Zhiye was fraudulent, but also failed to adduce evidence proving that Banco de Costa Rica had committed fraudulent demand under the independent counter-guarantee; its claim to stop payment of the funds under the independent counter-guarantee had no factual basis.

Relevant Legal Provisions

Articles 8 and 44 of the Law of the People's Republic of China on the Application of Laws to Foreign-Related Civil Relations

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