

How safe is an 'Un-SAFE' Guarantee

By David Beaves and Peter Murray, Ince & Co



Charles Dickens famously wrote “credit is a system whereby a person who can't pay gets another person who can't pay to guarantee that he can pay”. Many guarantees have been issued by Chinese guarantors over the last few years, some in the context of refund guarantees for shipbuilding contracts, or others, for example, guaranteeing performance under charters. Dickens cynically wrote about a guarantor “that can't pay”, but what if the reason for non-payment is that the guarantee concerned has not been approved by or registered with a Chinese state body? We are referring, of course, to the State Administration of Foreign Exchange ('SAFE').



SAFE is essentially the Chinese state organisation tasked with drafting the regulatory framework by which foreign exchange in China is governed, including, but not limited to the behemoth task of managing and implementing the rules governing China's nearly US\$2 trillion of foreign reserves.

Pundits in the shipping industry regularly talk of the looming problems arising out of shipbuilding contracts. There are indications that these worries are beginning to be realised. A large number of shipbuilding contracts have been entered into with shipyards in China, most of which have been financed. A lot of shipyards in China are being subjected to intense financial pressure. Although the Chinese government is standing behind shipyards, it is not inconceivable that, in the present economic climate, some will go bust or be unable to meet their obligations to build a ship. This will bring the refund guarantee (the security, usually given by a third party bank, guaranteeing repayment of all instalments already paid by the purchaser under the shipbuilding contract if the yard cannot complete the ship) into sharp focus. A crucial part of this is registration with SAFE.

As ship financiers will know, there is limited security available to a bank for a loan advanced for a ship to be built. A vital item of security is the refund guarantee and its assignment by the purchaser concerned in favour of its financing bank. In China, refund guarantees have to be approved by and registered with SAFE. This approval and registration requirement is critical because without it, the security is invalid under Chinese law.

Additionally, just to make ship financiers even more nervous, a change of law last year involving SAFE caused confusion to the extent that many banks became convinced that, as a result, the

assigned refund guarantees that they held as security were worthless documents.

The 2008 amendment

As some of those reading this article will be aware, effective from August 5, 2008, an amendment to the Regulation of the People's Republic of China on Foreign Exchange Administration came in force which rewords the previous 1997 provision in respect of foreign currency guarantees. At the time, some thought that the effect of the amendment was to change the approval process by SAFE whereby each and every refund guarantee required separate pre-approval. In other words, that registration with SAFE of the executed guarantee was no longer enough; an additional step of a case by case approval before issuing every single refund guarantee would also be required, and even worse, that the existing refund guarantees would also need to be re-approved. You can imagine the consternation that this provoked in banking quarters.

However, it is now quite clear that (as in the past, prior to the coming-into-force of the 2008 amendment) both SAFE approval and SAFE registration are required in order for a refund guarantee to be directly enforceable. The effect of the 2008 amendment is simply to clarify that this requirement has always existed, but not, thankfully, to change the requirements as such.

Additionally, it is important to bear in mind, and indeed it is often overlooked, that the majority of notable PRC banks from whom refund guarantees are typically obtained, have already obtained 'blanket' approval from SAFE up to a certain quota in respect of the refund guarantees that they give. As such, there are no requirements for a guarantor to obtain approval for each and every guarantee to be issued.

In practice, it may be difficult to know that the bank concerned has received blanket approval and the only way to ascertain this is to approach the bank and request evidence of such blanket approval. Once evidence is obtained, knowing that a certain bank is blanket approved by SAFE is the first of two steps to ensure proper approval and registration with SAFE. The second step of the registration will involve the Chinese bank registering the guarantees in batches with the relevant SAFE Authority on a monthly basis by submitting a registration schedule for foreign guarantees, along with a feedback schedule to SAFE. Registration with SAFE is the best evidence that can be obtained that the guarantee in question is still within the permitted quota.

Further, it is long established that there is no individual certificate issued as evidence of SAFE registration in respect of a refund guarantee issued by a bank (as opposed to an external corporate guarantee). To prove a guarantee has actually been registered by SAFE, usually a copy of the aforesaid form and schedule with both the bank's and SAFE will suffice. However, various SAFE authorities in different regions may have different attitudes to

providing copies of such documents. As an alternative, in practice PRC banks (or sometimes the head office) may agree to issue written statements confirming due registration of the refund guarantee if required by the beneficiary.

If a refund guarantee issued by a bank which has a blanket approval from SAFE is required to be enforced in PRC, that refund guarantee, having been duly approved and registered, will be able to be enforced.

Is it necessary to register an assignment of refund guarantee with SAFE?

A question that often arises in practice is whether the crucial assignment of refund guarantee must also be registered with SAFE. Under current applicable PRC law, there is no express requirement for registration of an assignment of a bank refund guarantee with SAFE. However, attention should be drawn to the fact that there are certain regulations in China which provide that substantial amendments to an external guarantee that has not been issued by a bank that has been blanket approved by SAFE



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will need to obtain prior consent from the guarantor and SAFE. In practice, there is no consistent indication as to how this issue will be approached by various local SAFE authorities. Given the uncertainty of how a specific SAFE authority will handle an assignment of a refund guarantee, it is regarded as good practice to inform SAFE that an assignment has been made, for example, by making a notation of the assignment of a particular bank refund guarantee in that bank's monthly feedback schedules to be submitted to SAFE. This should be instigated by the bank or guarantor concerned.

In any event, this does not cause a great deal of concern to most assignees as those whose assignments of refund guarantees have not been registered with SAFE would nonetheless be able to enforce it in the name of the assignor pursuant to the power of attorney clause typical in most assignments of refund guarantees.

External corporate guarantee

We have come across situations, in the shipping context, where a Chinese company has given a guarantee for a charter or memorandum of agreement. These guarantees have been accepted by shipping companies who are not as fully aware of the situation concerning approval of guarantees by SAFE as are their banking counterparts. Although the situation when dealing with most PRC banks is that refund guarantees issued by them will likely have been blanket approved, the situation can be quite different when dealing with an external corporate guarantee, that is to say a Chinese company giving a foreign currency guarantee to a foreign company, which are dealt with by SAFE on a case by case basis. It is worth noting that SAFE will, as a matter of course, provide a certificate evidencing proper registration when external corporate guarantees are registered by them (unlike in cases of guarantees issued by a bank).

A Chinese company may only provide an external corporate guarantee to a foreign company if the company for which the guarantee is given is its subsidiary. A prospective holder of any guarantee issued in respect of an external corporate guarantee will need to be very cautious. Unlike when dealing with most Chinese banks, the holder of such a guarantee cannot take it for granted that a guarantee would have been approved or registered by SAFE. Indeed, in all likelihood, SAFE approval would not have been obtained. In the event that approval and registration is not obtained, the external guarantee will be invalid under Chinese law and unenforceable in a Chinese court.

In bald terms, an external guarantee which is not

approved by SAFE is invalid and unenforceable under Chinese law. Certain laws, however, still allow the beneficiary to claim compensation from the bank even where the beneficiary knew that SAFE approval had not been obtained, albeit a recovery under these provisions will only be in part. The Guarantee Law provides a mechanism for a beneficiary in these circumstances to recover up to 50% of its loss. German law – on which most of the Chinese civil code is based – might treat this as the application of contributory negligence. It seems perhaps the hand of Solomon also plays a part in Chinese law.

Notwithstanding the above, another method by which a beneficiary to a guarantee may recover its monies is by seeking to enforce a contractual provision common in many refund guarantees (i.e. that the guarantor will register the guarantee with SAFE). In that situation, a beneficiary may recover some monies owed to them under Chinese contract law for breach of a warranty. Unfortunately, in this situation it is also unlikely the whole amount will be recovered unless the beneficiary can show that it exercised proper due diligence to ensure that its guarantee was registered. For example, in the case of corporate external guarantees, this will usually require the beneficiary asking for the registration certificate from SAFE authorities.

To conclude, SAFE registration, although confusing at the best of times, is not something that should necessarily be causing a ship financier sleepless nights. Indeed, with proper legal advice and appropriate cautionary measures, such as ensuring an external corporate guarantee is indeed given in respect of its subsidiary, it is indeed possible to successfully navigate the thicket of regulations promulgated by SAFE. Now all that bankers need to concern themselves with is whether Dickens' cynicism applies to their transaction. Good old fashioned banking principles are needed for this.

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