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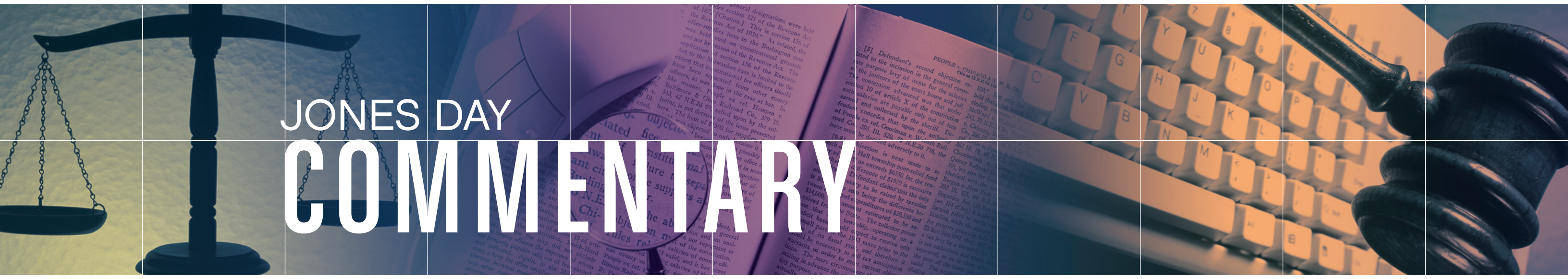

CHINA'S MINISTRY OF CONSTRUCTION ISSUES STANDARD FORMS OF GUARANTEE FOR CONSTRUCTION WORKS

On May 18, 2005, the Ministry of Construction ("MOC") launched 10 standard guarantee forms on its web site for a trial run. The 10 standard guarantee forms include five different types of guarantees and their related entrustment contracts. The five guarantee contracts are two-party contracts to be entered into by the guarantor (*i.e.*, the bank) ("the Guarantor") and the party entitled to the benefit of the guarantee under the construction contract (*i.e.*, the owner in the case of the performance guarantee, or the contractor in the case of the payment guarantee) ("the Beneficiary"). The five entrustment contracts are tri-party contracts to be signed between the Beneficiary, the Guarantor, and the party whose performance is being guaranteed under the relevant contract ("the Performing Party").

The five types of guarantee are:

- Bid bond from contractor's Guarantor to owner as Beneficiary
- Performance guarantee from contractor's Guarantor to owner as Beneficiary
- Payment guarantee for contract works from owner's Guarantor to contractor as Beneficiary
- Payment guarantee for subcontract works from contractor's Guarantor to subcontractor as Beneficiary
- Payment guarantee for supply of goods from contractor's Guarantor to supplier as Beneficiary

We will discuss the first three forms of guarantee in this *Commentary* and will not address the other two forms or the various entrustment contracts.

Before we proceed, however, it is important to note that the MOC forms are not what are commonly referred to internationally as on-demand bonds (*i.e.*, a guarantee to pay a sum of money to the Beneficiary upon the Beneficiary's first demand to do so); rather, they take the form of an undertaking to recompense the Beneficiary up to the specified level of the guarantee in the event of a default by the Performing Party in undertaking its obligations under the contract (often called "default bonds").

On-demand bonds can be categorized as contracts of indemnity that create a primary rather than a secondary liability. This means that the liability under an on-demand performance bond exists quite independently of the liability between the Performing Party and the Beneficiary under the primary construction contract. Default bonds, on the other hand, can be loosely described as contracts of suretyship. A suretyship agreement can be defined as a contract by which one person (the surety or Guarantor) agrees to answer for some liability of another (the Performing Party) to a third person (the Beneficiary). In this case, the obligation is a secondary liability that depends for its existence upon a primary liability existing in the construction contract.

COMMON FEATURES OF THE GUARANTEES

The five guarantee forms are quite similar in structure and share the following features:

- All five standard guarantee forms are default guarantees (i.e., the Beneficiary must provide evidential proof to show that the Performing Party is in breach or default of the underlying construction contract).
- The currency of the guarantee is to be in Chinese Renminbi.
- The Guarantor provides a guarantee of the actual losses suffered by the Beneficiary up to a limit or cap specified in the guarantee.
- The guarantee requires the Performing Party to provide an indemnity to the Guarantor by way of a separate entrustment contract.
- All notices of claim must be made in writing.
- The Beneficiary must state in the notice of claim the amount it is claiming and details of its bank account.
- All claims must be supported by evidence proving default by the Performing Party. If the alleged default relates to quality issues, the Beneficiary must provide a statement prepared by the relevant quality inspection authority as evidence to support its claim. A time period can be set for the Guarantor to verify the claim.
- The Guarantor excludes liability for losses caused by:
  - breach of contract by the Beneficiary
  - waiver by the Beneficiary of the Performing Party's obligations in part or in full
  - variations to the underlying contract that result in additional liabilities being imposed under the guarantee
  - force majeure events.
- The guarantee expires when payments made under the guarantee reach the amount of the cap under the guarantee.
- All disputes arising out of the guarantee shall be resolved by parties' consultation, failing which they will be referred to litigation in court.

POTENTIAL PROBLEMS FROM THE PERSPECTIVE OF INTERNATIONAL INVESTORS AND OWNERS

From the perspective of international investors or owners, there appear to us to be a number of areas for concern in relation to the guarantee forms, and we highlight some of these issues in the following paragraphs.

Not On-Demand Bonds. On-demand bonds are favored by owners on international projects. The primary obligation is therefore very similar to that which arises under a letter of credit because the bank is not concerned with the nature or effects of the underlying construction contract. Accordingly, since the 1970s, owners on international construction projects have insisted that contractors provide such guarantees, and, to compete, contractors have generally had no alternative but to do so. For this reason, today, on-demand guarantees are a fact of life in international construction, whether contractors like it or not.

This is in sharp contrast to the MOC standard forms, which it should be noted are not on-demand bonds insofar as the obligation of the Guarantor is only to (a) provide funds for the

Performing Party to complete the project and (b) provide an indemnity for the Beneficiary's losses up to the cap. In addition, evidence of the Performing Party's default must be presented by the Beneficiary, and the Guarantor has a period of time within which to verify the evidence. Hence these forms are unlikely to find favor with international investors or owners, who will likely continue to insist on a guarantee that is immediately enforceable.

No Governing Law Stated. The guarantees fail to state the law under which they are to be interpreted. This could lead to problems; for example, under the laws of England and the Netherlands, the proper law of a guarantee would be the place of payment (*i.e.*, the residence of the Beneficiary); whereas under the laws of other European countries, the proper law would be the domicile of the issuing bank.

Variations to Underlying Contract. Ordinarily guarantees and bonds on international projects expressly provide that the Beneficiary and the Performing Party are authorized to operate the provisions of the underlying contract without releasing the Guarantor from his obligations. The standard form guarantees do not have such a clause, which is of crucial significance for the enforcement of the guarantee. In fact, they go to the other extreme and provide that any variations to the contract not approved in writing by the Guarantor will exclude the Guarantor's liability for such variations. For example, a variation order or an extension of time under the construction contract could amount to an additional liability placed on the Performing Party, which would have the effect of releasing the Guarantor from its obligations under the guarantee.

Assignable? The guarantees do not state that they are non-assignable and so therefore ought to be freely assignable under PRC law. In practice, owners are often likely to insist that performance guarantees are assignable in order to allow them to assign such guarantees by way of security to project lenders.

Third-Party Verification. In respect of quality issues, both the performance guarantee and the payment guarantee require a report on the quality dispute to be prepared by the relevant quality inspection agency or the supervision company respectively. This could well be a time-consuming and potentially contentious intervention and is unlikely to be favored by international owners.

Dispute Resolution. The guarantees provide for litigation in court, unlike most construction contracts that provide for arbitration of disputes. It is unlikely that international owners will accept litigation in the Chinese courts, and therefore international arbitration would be a better option.

CONCLUSION

The MOC standard forms are unlikely to be attractive to international investors and owners involved in construction projects in China as they do not offer immediate enforcement of the type common with on-demand bonds and letters of credit favored on international projects. On the other hand, Chinese contractors will welcome the standard forms as a good first step in providing guidance on security documentation commonly required for construction projects. The MOC should be applauded for taking this step, and while it may not go far enough to satisfy international practice, it is a positive development for the construction industry in China.

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