

## Projects (Engineering and Construction) - August 2010

### Guarantee Contract and Principal Contract: Conflicts in Jurisdiction

This article analyses Article 129 of an Interpretation published by the PRC Supreme People's Court ("SPC"), and considers different results which may arise under PRC and non-PRC law, where the Principal Contract specifies a dispute resolution mechanism, while the Guarantee Contract does not specify a (or specifies a different) dispute resolution mechanism.

Given that in addition to a Construction Contract (which can be seen as the Principal Contract) between the Employer and the Contractor, either party may be required to obtain a Guarantee Contract (eg by way of a Parent Company Guarantee, Personal Guarantee by a Director, or a Bank Guarantee), care should be taken to avoid unexpected results.

#### Introduction

Picture the following usual situation:

The Employer and the Contractor entered into a Construction Contract, which contract contains an arbitration clause.

The Employer's Parent Company provided a Parent Company Guarantee to the Contractor, guaranteeing payment under the Construction Contract by the Employer. The Parent Company Guarantee does not contain a dispute resolution clause, and in particular there is no reference to arbitration.

Should the Contractor decide to commence proceedings against the Employer as well as its Parent Company, the jurisdictional issue is whether the Contractor should commence arbitration and/or court proceedings.

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If the parties' relationship is governed by Hong Kong or English law, applying the doctrine of privity of contract (ie a person cannot acquire rights, or be subjected to liabilities, arising under a contract to which he is not a party, see *Beswick v Beswick* [1968] AC 58), given that the arbitration agreement in the Construction Contract is between the Employer and the Contractor, and that there is no arbitration agreement in the Parent Company Guarantee, the Contractor would have difficulties in successfully bringing arbitration proceedings against the Parent Company.

However, the results may be different if the parties' relationship is governed by PRC law.

#### Article 129

On 8 December 2000, the SPC published the Interpretation on Certain Issues in the Application of the Guarantee Law of the PRC (Fa Shi [2000] No. 44).

Article 129 of the Interpretation provided as follows:

*"If litigation is commenced because of disputes arising from the principal contract and the contract of guarantee, the jurisdiction over the case shall be determined according to the principal contract. If there are disputes arising from a guarantee contract where the guarantor bears connected liability, when the debtor claims against the guarantor, the matter shall be under the jurisdiction of the court situated at the residence of the guarantor."*

If each of the principal contract and the guarantee contract specifies a court within a different jurisdiction, the jurisdiction of the case should be determined according to the principal contract."

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Thus according to Article 129, jurisdiction over the Principal Contract and the Guarantee Contract shall be determined according to the Principal Contract.

The principle in Article 129 has been applied in both arbitration and court proceedings.

The following case is relevant:

Motorola (China) Electronics Company Limited ("Motorola") v  
Zhong Wei Guo Mai Communication Holdings  
Company Ltd ("Zhong Wei"), and  
Shanghai Qing Hua Ke Rui Industry Co Ltd ("Qing  
Hua")  
(2006) Hu Yi Zhong Min Wu (Shang) Chu Zi No. 131

In the above case, Qing Hua as the seller and Zhong Wei as the buyer entered into a sales contract. The contract contained an arbitration clause at the Shanghai Arbitration Commission.

Motorola provided a memo, acknowledging the sales contract, and agreed to bear responsibilities if Qing Hua fails to perform its obligations. The memo did not contain an arbitration clause.

Zhong Wei commenced arbitration at the Shanghai Arbitration Commission against Qing Hua and Motorola based on the sales contract and the memo respectively.

Motorola applied and challenged the jurisdiction of the Shanghai Arbitration Commission on the ground that there was no arbitration agreement in the memo between Motorola and Zhong Wei.

The Shanghai Arbitration Commission invoked Article 129 of the Interpretation and dismissed Motorola's application.

Motorola appealed to the Shanghai City No. 1 Intermediate People's Court. In the Judgment given

by the Court, the Court rejected the submissions by Motorola and confirmed the decision below, ie given that jurisdiction over the Principal Contract and the Guarantee Contract shall be determined according to the Principal Contract, the arbitration clause in the sale contract was held to be applicable to the memo.

Recently we acted for a western company in arbitration at the Singapore International Arbitration Centre ("SIAC"). Due to confidentiality reasons we cannot provide details regarding the proceedings. Nonetheless, three distinguished arbitrators from Singapore have considered a Principal Contract and a Guarantee Contract, and the Tribunal unanimously applied Article 129 so that the SIAC arbitration clause in the Principal Contract was held applicable to the Guarantee Contract.

### **Discussions**

First - Does it matter if parties to the Principal Contract are different from the Guarantee Contract?

If the matter arose under Hong Kong or English law, the fact that parties to the Principal Contract are different from the Guarantee Contract would be fatal, due to the principle known as privity of contract. However, if the matter arose under PRC law, as can be seen in the above Motorola case and SIAC case, the parties in different contracts need not be identical. Nonetheless, as demonstrated in the Motorola case, perhaps it would make sense if there is at least one common party (ie Zhong Wei in the Motorola case) in the Principal Contract as well as the Guarantee Contract, and that the Guarantor in the Guarantee Contract has a close relationship with the parties in the Principal Contract.

Second - Does Article 129 apply to arbitration?

Article 129 is silent about arbitration, although Article 129 specifically referred to the "*courts*" (法院) as well as "*litigation*" (诉讼). Nonetheless, as can be seen in the above Motorola case and the SIAC case, the

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Shanghai Arbitration Commission as well as arbitrators from the SIAC have applied Article 129 in arbitrations, and the decision has been upheld by the PRC Courts.

Third - What if the Principal Contract stipulates litigation in the Shanghai Courts, while the Guarantee Contract stipulates arbitration at the Shanghai Arbitration Commission?

Article 129 did not specifically deal with the above situation. To take the above situation further, one can envisage a situation whereby the Principal Contract expressly stipulates arbitration, while the Guarantee Contract expressly stipulates litigation in the Shanghai Courts. In this connection, the express wordings of the last sentence of Article 129 is restricted to the situation whereby (1) the Principal Contract stipulating litigation say at the Shanghai Courts, while (2) the Guarantee Contract stipulating litigation say in the Beijing Courts, in which case the Shanghai Courts shall have jurisdiction over the Principal Contract as well as the Guarantee Contract. It will be interesting to watch whether the last sentence of Article 129 would be extended to the situation whereby court proceedings and arbitration proceedings are specified in each of the Guarantee Contract and Principal Contract respectively.

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We have prepared and will prepare a series of articles on the following issues, focusing on various areas of the law by comparing PRC and non-PRC concepts. All the articles are designed to present you with the whole picture so that you will be best equipped to deal with a whole spectrum of critical business and legal issues.

1. Expect the Unexpected: Frustration, Changed Circumstances, and Force Majeure
2. Guarantee Contract and Principal Contract: Conflicts in Jurisdiction

3. Time Bar and Benefitting from One's Own Wrong

4. Liquidated Damages

We value your feedback. Please provide us with suggested topics for articles, as well as any comments, thoughts and ideas.

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