**Guiding Cases**

## A. The Twenty-First Group of Guiding Cases of the SPC

**1. Guiding Case No. 107: Sinochem International (Overseas) Pte. Ltd v. ThyssenKrupp Metallurgical Products GmbH (dispute over a contract for the international sale of goods**

**[Keywords]**

Civil; a contract for international sale of goods; United Nations Convention on Contracts for the International Sale of Goods; application of law; fundamental breach of contract

**[Key Points of Judgment]**

1. Where the countries of the parties to a contract for the international sale of goods are contracting countries of the *United Nations Convention on Contracts for the International Sale of Goods* (CISG), the provisions of the CISG should preferentially apply. For the content where there are no provisions in the CISG, the law as agreed in the contract shall apply. Where the parties have explicitly excluded the application of the CISG in the contract for international sale of goods, the CISG shall not apply.

2. In the contract for international sale of goods, although the goods delivered by the seller have defects, as long as the buyer can use or resell them after making reasonable efforts, it shall not be deemed as fundamental breach of contract as prescribed in the CISG.

**[Legal Provisions]**

Article 145 of the *General Principles of the Civil Law of the People's Republic of China*

Articles 1 and 25 of the *United Nations Convention on Contracts for the International Sale of Goods*

**[Basic Facts]**

On April 11, 2008, Sinochem International (Overseas) Pte. Ltd (hereinafter referred to as “Sinochem Pte. Ltd”) and Thyssen Krupp Metallurgical Products GmbH (hereinafter referred to as “Krupp GmbH”) concluded a Purchase Contract for petroleum coke, stipulating that this Contract should be concluded, under the jurisdiction of, and interpreted in accordance with the then effective law of the New York State, U.S.A. Sinochem Pte. Ltd made the payment for goods in full amount as agreed, but the HGI of the petroleum coke delivered by Krupp GmbH was only 32, which was inconsistent with the typical value of the HGI ranging from 36 to 46 as agreed in the Contract. Sinochem Pte. Ltd held the opinion that the act of Krupp GmbH constituted fundamental breach of contract and it requested the Court to order the rescission of the Contract and Krupp GmbH's refund of the payment for goods and compensation for losses.

**[Judgment]**

In the trial of first instance, the High People's Court of Jiangsu Province held that in accordance with the relevant provisions of the CISG, the HGI of the petroleum coke provided by Krupp GmbH was far below the standard as agreed in the Contract, resulting in failure to sell such petroleum coke at the domestic market and realize the expected objective when the sale contract was concluded. Therefore, the act of Krupp GmbH constituted fundamental breach of contract. On December 19, 2012, the High People's Court of Jiangsu Province entered a Civil Judgment (No. 0004 [2009], First, Civil Division III, HPC, Jiangsu) that: (1) The Purchase Contract concluded by and between Sinochem Pte. Ltd and Krupp GmbH on April 11, 2008 should be declared invalid. (2) Krupp GmbH should, within 30 days after this Judgment came into force, refund the payment for goods of USD2,684,302.9 made by Sinochem Pte. Ltd and pay the interest from September 25, 2008 to the date of payment as determined in this Judgment. (3) Krupp GmbH should, within 30 days after this Judgment came into force, pay Sinochem Pte. Ltd USD520,339.77 as compensation for losses.

After the judgment was pronounced, Krupp GmbH refused to accept the judgment of first instance and appealed to the Supreme People's Court, contending that the judgment of first instance was erroneous in the determination of the applicable law in this case. The Supreme People's Court held that the fact-finding in the judgment of first instance was basically clear, but partial application of law was erroneous and the determination of liabilities was inappropriate, which should be corrected. On June 30, 2014, the Supreme People's Court entered a Civil Judgment (No. 35 [2013], Final, Civil Division IV, SPC) that: (1) Item (1) of the Civil Judgment (No. 0004 [2009], First, Civil Division III, HPC, Jiangsu) entered by the High People's Court of Jiangsu Province should be set aside. (2) Item (2) of the Civil Judgment (No. 0004 [2009], First, Civil Division III, HPC, Jiangsu) entered by the High People's Court of Jiangsu Province should be altered and Krupp GmbH should, within 30 days after this Judgment came into force, pay Sinochem Pte. Ltd USD1,610,581.74 as compensation for losses to the payment for goods and pay the interest from September 25, 2008 to the date of payment as determined in this Judgment. (3) Item (3) of the Civil Judgment (No. 0004 [2009], First, Civil Division III, HPC, Jiangsu) entered by the High People's Court of Jiangsu Province should be altered and Krupp GmbH should, within 30 days after this Judgment came into force, pay Sinochem Pte. Ltd USD98,442.79 as compensation for losses arising from the storage charges. (4) Other claims of Sinochem Pte. Ltd should be dismissed.

**[Judgment's Reasoning**]

The Supreme People's Court held that, this case was about dispute over a contract for the international sale of goods, both parties were foreign companies, and it involved foreign-related factors. Article 2 of the Interpretation of the Supreme People's Court on Several Issues concerning the Application of the Law of the People's Republic of China on Choice of Law for Foreign-Related Civil Relationships (I) provided for that “For any foreign-related civil relationship occurring before the implementation of the *Law on Choice of Law for Foreign-Related Civil Relationships*, the people's courts shall determine the applicable laws in accordance with the relevant laws and regulations at the time of the occurrence of such foreign-related civil relationship; in case there were no applicable laws at that time, the applicable laws may be determined with reference to the *Law on Choice of Law for Foreign-Related Civil Relationships*.” The Purchase Contract involved was concluded on April 11, 2008, which was earlier than the time of implementation of the Law of the People's Republic of China on Choice of Law for Foreign-Related Civil Relationships (hereinafter referred to as the “*Law on Choice of Law for Foreign-Related Civil Relationships*”). Article 145 of the General Principles of the Civil Law of the People's Republic of China at the time when the parties concluded the Purchase Contract provided that “The parties to a foreign-related contract may choose the applicable law for resolution of the contractual disputes, unless otherwise provided by the law. Where the parties to a foreign-related contract does not choose a law, the law of the country with the closest relationship with the contract shall apply.” Both parties to this case agreed in the Contract that it should be concluded, under the jurisdiction of, and interpreted in accordance with the then effective laws of New York State, U.S.A. and the agreement did not violate legal provisions and should be determined as valid. Since Singapore and Germany, the countries where the business places of both parties were located, were contracting parties to the CISG, the U.S.A. was also the contracting party to the CISG, and both parties chose the CISG as the basis for determining their rights and obligations and the application of the CISG was not excluded in the trial of first instance, it was accurate for the High People's Court of Jiangsu Province to try this case by applying the CISG. For issues involved in the trial of this case where there were no provisions in the CISG, the law of New York State, the U.S.A. chosen by the parties should apply. The Digest of Case Law on the CISG was not a part of the CISG and it could not serve as the legal basis for trying this case. However, it may serve as an appropriate reference material for how to accurately comprehend definitions of the relevant clauses of the CISG.

The typical value of the HGI of petroleum coke as agreed by both parties in the Purchase Contract was from 36 to 46. However, the HGI of petroleum coke actually delivered by Krupp GmbH was 32, which was lower than the minimum typical value of the HGI as agreed by both parties and did not conform to the contractual stipulations. It was accurate for the High People's Court of Jiangsu Province to hold that the act of Krupp GmbH constituted fundamental breach of contract.

With respect to whether the aforesaid act of Krupp GmbH constituted fundamental breach of contract, first, from both parties' agreement on the chemical and physical characteristics and specifications that petroleum coke should satisfy in the Contract, the moisture rate, sulphur content, ash content, volatile content, size, calorific value, and HGI of petroleum coke were agreed in the Contract. Based on the current facts, for the petroleum coke delivered by Krupp GmbH, Sinochem Pte. Ltd deemed that only the HGI did not conform to the Contract and it raised no objection to other six indicators. In light of the testimonies of witnesses and the statements made by witnesses in court as submitted by the parties, the HGI referred to the grinding index of petroleum coke. The lower the HGI was, the higher the hardness of petroleum coke was, and the more difficult the grinding was. However, the explanation of the School of Materials Science and Engineering of Shanghai University issued by Sinochem Pte. Ltd did not deny that petroleum coke with the HGI of 32 could be used and it was deemed that the purposes of such petroleum coke would be limited. Therefore, it may be determined that although the HGI of the petroleum coke involved was inconsistent with the value as agreed in the Contract, this batch of petroleum coke still had use value. Second, in the trial of first instance, for the purpose of reducing losses, Sinochem Pte. Ltd made great efforts to resell the petroleum coke involved and in the letters on the relevant issues sent to Krupp GmbH, Sinochem Pte. Ltd explicitly stated that the resale price of the petroleum coke involved “was not lower than the reasonable price at the market.” This fact explained that the petroleum coke involved may be sold at a reasonable price. Third, by taking into full account of the comprehension of clauses of the CISG on fundamental breach of contract in judgments of other countries, non-conformity of quality was not fundamental breach of contract as long as the buyer could use or resell the goods or even sell such goods at a discount after making reasonable efforts. Therefore, the act of Krupp GmbH of delivering petroleum coke with the HGI of 32 did not constitute fundamental breach of contract. The determination of the High People's Court of Jiangsu Province that the act of Krupp GmbH constituted fundamental breach of contract and the Purchase Contract was invalid was erroneous in the application of law and should be corrected.

**2. Guiding Case No. 109 of the Supreme People's Court:**

**Anhui Foreign Economic Construction (Group) Co., Ltd. v. Inmobiliaria Palacio Oriental S.A. (dispute over guarantee fraud)**

**[Keywords]**

Civil; guarantee fraud; review of underlying transactions; principle of limitation and necessity; independent counter guarantee

**[Key Points of Judgment]**

 1. Where it is necessary to review the underlying transaction for determination of an independent guarantee fraud, the principle of limitation and necessity should be followed and the review scope should be limited to whether the beneficiary knows that the opposing party of the underlying contract does not breach the contract under the underlying contract and whether the beneficiary knows that it does not have the right of claim for payment.

2. The breach of contract by the beneficiary under the underlying contract does not affect the beneficiary's right to present documents and raise a claim in accordance with the provisions on an independent L/G.

3. In identifying whether there is a fraud under an independent counter guarantee L/G, even if there is a fraud under the independent L/G, where the bona fide payment has been made under the independent L/G, the people's court is not allowed to ruleto stop the payment of the fund under the independent counter guarantee L/G.

**[Legal Provisions]**

 Articles 8 and 44 of the Law of the People's Republic of China on Choice of Law for Foreign-Related Civil Relationships

**[Basic Facts]**

On January 16, 2010, Inmobiliaria Palacio Oriental S.A. (hereinafter referred to as “Oriental S.A.”) as the developer, Anhui Foreign Economic Construction (Group) Co., Ltd. (hereinafter referred to as “AFECC”) as the contractor, and Chinafecc Central América S.A. as the construction party concluded a Contract for the Construction of the Lakeside Mansion Project (hereinafter referred to as the “Construction Contract”) in Costa Rica in San Jose, the Republic of Costa Rica and it was agreed in the Construction Contract that the contractor executed the construction of three 14-floored comprehensive commercial and residential buildings. On May 26, 2010, AFECC filed an application with Anhui Branch of China Construction Bank Co., Ltd. (hereinafter referred to as “Anhui Branch of CCB”) for issuing a performance guarantee to the beneficiary Oriental S.A. with Bank of Costa Rica as the reissuing bank and the guaranty matter being the Lakeside Mansion Project in Costa Rica. On May 28, 2010, Bank of Costa Rica issued a performance guarantee (No. G051225) with Anhui Branch of CCB as the guarantor, AFECC as the principal, and Oriental S.A. as the beneficiary, and the amount of guarantee was USD2,008,000, valid until October 12, 2011 and extended to February 12, 2012. Notes on the guarantee: It is an unconditional, irrevocable, obligatory, and demand guarantee. To perform this guarantee, the beneficiary should submit a credential in duplicate to the Department of Foreign Trade under the Central Office of Bank of Costa Rica, indicating the grounds for performing the guarantee. In addition, the beneficiary should issue a notarized statement, indicating the date when Chinafecc Central América S.A. was notified of this claim for breach of contract, affixed with the original guarantee and the issued modified version. Anhui Branch of CCB simultaneously issued a counter guarantee (No. 34147020000289) to Bank of Costa Rica and promised that it would pay the fund under the guarantee within 20 days upon receipt of the notice of Bank of Costa Rica. The counter guarantee was “unconditional and irrevocable, and demanded payment at any time” and it was agreed that it “should observe the Uniform Rules for Demand Guarantees (URDG458) published by the International Chamber of Commerce.”

In the performance of the Construction Contract, on January 23, 2012, architects Jose Brenes and Mauricio Mora issued the Project Construction Inspection Report, which determined that there were “poor construction” and “inferior quality” in the construction project and circumstances where modification or repair was required. On February 7, 2012, with Oriental S.A. as the respondent, Chinafecc Central América S.A. submitted an arbitration claim to the Dispute Resolution Center of the Union of Architects and Engineers in Costa Rica, alleged that Oriental S.A. was in arrears of the payable project funds for the completed construction and the corresponding interest, and requested the rescission of the Construction Contract and the adjudication on Oriental S.A.'s compensation for losses. On February 8, Oriental S.A. submitted to Bank of Costa Rica such guarantee payment documents as the statement on the claim, the notice on breach of contract, and the Project Construction Inspection Report and required the performance of guarantee. On February 10, Bank of Costa Rica issued to Anhui Branch of CCB a teletext, stating that Oriental S.A. raised a claim for payment of the fund of USD2,008,000 under the bank guarantee (No. G051225) and Bank of Costa Rica thus required that Anhui Branch of CCB should pay the aforesaid fund before February 16, 2012. On February 12, upon application of Chinafecc Central América S.A., the No. 2 Tribunal of the Administrative Litigation Court of the Republic of Costa Rica issued the injunction of interim protection measure and ruled that Bank of Costa Rica should suspend the performance of the performance guarantee (No. G051225).

On February 23, AFECC filed a lawsuit about dispute over guarantee fraud with the Intermediate People's Court of Hefei City, Anhui Province and applied for suspending the payment of the fund under the guarantees (No. G051225 and No. 34147020000289). On February 27, the court of first instance entered a ruling (No. 00005-1 [2012], First, Civil Division IV, IPC, Hefei) that the payment of the fund under the guarantees (No. G051225 and No. 34147020000289) should be suspended. On February 28, it served the aforesaid ruling upon Anhui Branch of CCB. On February 29, Anhui Branch of CCB sent a teletext to Bank of Costa Rica and notified Bank of Costa Rica of the matters in the ruling and on the same day, it mailed the duplicate of the aforesaid ruling to Bank of Costa Rica. On March 5, Bank of Costa Rica received the duplicate of the aforesaid ruling.

On March 6, the No. 2 Tribunal of the Administrative Litigation Court of the Republic of Costa Rica entered a judgment that Chinafecc Central América S.A. lost the lawsuit regarding its application for the preventive measure and the injunction of interim protection measure was relieved. On March 20, as required by Bank of Costa Rica, Anhui Branch of CCB extended the validity term of the guarantee (No. 34147020000289). On March 21, Bank of Costa Rica paid Oriental S.A. the fund under the guarantee (No. G051225).

On July 9, 2013, the Union of Architects and Engineers in Costa Rica entered an arbitral award, which determined that Oriental S.A. has seriously breached the contract in the performance of contract and ruled to terminate the Construction Contract, Oriental S.A. should pay Chinafecc Central América S.A. the progress payments for projects No. 1 to No. 18, a total of USD800,058.45 and the interest thereof; since the project No. 19 was not accepted by the developer, the relevant claim for the project fund was not supported; since the fund under the guarantee (No. G051225) has been paid, the claim of Chinafecc Central América S.A. for returning the guarantee should not be supported.

**[Judgment]**

On April 9, 2014, the Intermediate People's Court of Hefei City, Anhui Province entered a Civil Judgment (No. 00005 [2012], First, Civil Division IV, IPC, Hefei) that: (1) the claim of Oriental S.A. against the performance guarantee (No. G051225) constituted a fraud; (2) Anhui Branch of CCB should terminate the payment of the fund of USD2,008,000 under the bank guarantee (No. 34147020000289) to Bank of Costa Rica; and (3) other claims of AFECC should be dismissed. Oriental S.A. refused to accept the judgment of first instance and appealed. On March 19, 2015, the High People's Court of Anhui Province entered a Civil Judgment (No. 00389 [2014], Final, Civil Division II, HPC, Anhui) to dismiss the appeal and affirm the original judgment. Oriental S.A. refused to accept the judgment of second instance and filed an application for retrial with the Supreme People's Court. On December 14, 2016, the Supreme People's Court entered a Civil Judgment (No. 134 [2017], Retrial, Civil Division, SPC) that: (1) the Civil Judgment (No. 00389 [2014], Final, Civil Division II, HPC, Anhui) entered by the High People's Court of Anhui Province and the Civil Judgment (No. 00005 [2012], First, Civil Division IV, IPC, Hefei) entered by the Intermediate People's Court of Hefei City, Anhui Province should be set aside; and (2) the claims of AFECC should be dismissed.

**[Judgment's Reasoning]**

The Supreme People's Court held that, first, with respect to issues concerning the basis for identifying a case about independent guarantee fraud, jurisdiction, and application of law involved in this case. Since the habitual residences of the parties to the dispute involved, Oriental S.A. and Bank of Costa Rica, were not within the territory of China and this case was about foreign-related commercial dispute. In accordance with the provisions of Article 8 of the Law of the People's Republic of China on Choice of Law for Foreign-Related Civil Relationships(hereinafter referred to as the “the *Law on Choice of Law for Foreign-Related Civil Relationships*”) that “The law of the court shall apply to the determination on the nature of foreign-related civil relations,” as the parent company of Chinafecc Central América S.A. in China, AFECC was the applicant for issuance of the guarantee involved. It filed an application with Anhui Branch of CCB for issuing a counter demand guarantee to Bank of Costa Rica, which then reissued a performance guarantee to the beneficiary Oriental S.A. In accordance with the text of the guarantee, the payment obligations of Bank of Costa Rica and Anhui Branch of CCB were independent from the underlying transaction relation and the legal relation of guarantee application. Therefore, the aforesaid guarantee may be determined as an independent demand guarantee and the aforesaid counter guarantee may be determined as an independent counter demand guarantee. AFECC filed a lawsuit with the court of first instance on the ground of guarantee fraud and the nature of this case was dispute over guarantee fraud. The independent counter guarantee, the payment of which was claimed to be suspended, was issued by Anhui Branch of CCB and the place where Anhui Branch of CCB was located should be determined as the place where the tort occurred. As a court in the place where the tort occurred, the court of first instance had jurisdiction over this case. Since it was specified in the guarantee involved that the Uniform Rules for Demand Guarantees should apply, it should be determined that the content of the aforesaid Rules constituted a component of the guarantee in dispute. In accordance with the provisions of Article 44 of the *Law on Choice of Law for Foreign-Related Civil Relationships* that “the laws at the place of tort shall apply to liabilities for tort,” the laws of the People's Republic of China should apply to the standards for determination of a guarantee fraud not involved in the Uniform Rules for Demand Guarantees. Since China does not join the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit and the parties in this case did not agree on the application of the aforesaid Convention or include the relevant content of the aforesaid Convention in the guarantee as the international trading rules, under the principle of autonomy, the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit should not apply.

Second, with respect to the issue concerning whether the beneficiary Oriental S.A. had preliminary evidence under the underlying contract to prove that its claim had factual basis.

When the people's court tried a case involving an independent guarantee and a counter guarantee related to the independent guarantee, in the review of underlying transactions, the people's court should follow the principle of limitation and necessity and the scope of review should be limited to whether the beneficiary knew that the opposing party of the underlying contract did not breach the contract under the underlying contract or did not commit other act resulting in payment of the fund under the independent guarantee. Otherwise, the review of the underlying contract would shake the institutional value of independent guarantee, namely, “demand guarantee.”

In accordance with the provisions of 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), a fraud is mainly manifested as making up facts and concealing truth. According to the facts found in the retrial, Bank of Costa Rica issued a performance guarantee (No. G051225), specifying that to perform this guarantee, the following documents should be submitted: the credential with grounds for performing the guarantee, the date when Chinafecc Central América S.A. was notified of performing the guarantee claim, the original guarantee and the issued modified version. Since AFECC alleged that the act of Oriental S.A. constituted a fraud under the independent guarantee, it should produce evidence to prove that Oriental S.A. committed any of the following acts in the performance of the independent guarantee: (1) Oriental S.A. submitted a false or forged document in the claim; or (2) the claim of Oriental S.A. totally had no factual basis or reliable basis. In this case, what was guaranteed under the guarantee included “quality and tolerance of materials used in the construction, losses arising from compensation, and/or compensation for the contractor's failure to perform obligations.” In other words, what was guaranteed under the guarantee included construction quality and other behaviors breaching the contract. Therefore, the beneficiary only needed to submit the preliminary evidence on the existence of construction quality problems so as to satisfy the requirement for performance of the guarantee, namely, “the credential indicating the grounds for performing the guarantee.” In the performance of the underlying contract, on January 23, 2012, Jose Brenes and Mauricio Mora, project supervisors of Oriental S.A., issued the Project Construction Inspection Report, which determined that there were “poor construction” and “inferior quality” in the construction project and circumstances where modification or repair was required. Therefore, the Project Construction Inspection Report was preliminary evidence proving that there were construction quality problems.

In the Construction Contract and under the guarantee, the parties involved did not explicitly agree that the Project Construction Inspection Report should be submitted to Bank of Costa Rica for performing the guarantee. Therefore, Oriental S.A. had the right to independently determine the type of credential “indicating the grounds for performing the guarantee” submitted to Bank of Costa Rica and whether it submitted the Project Construction Inspection Report to Bank of Costa Rica did not affect the exercise of rights under the guarantee. In addition, the Construction Contract and the guarantee did not stipulate that the aforesaid Report must be issued by the American Institute of Architects (AIA) or personnel with international membership of the AIA. Therefore, whether Jose Brenes and Mauricio Mora had the international membership of the AIA did not affect their issuance of the Project Construction Inspection Report as project supervisors of the contract-issuing party. AFECC knew that Jose Brenes and Mauricio Mora were project supervisors of the contract-issuing party and it recognized the identities of Jose Brenes and Mauricio Mora as project supervisors when they issued the Project Construction Inspection Report and received the project funds. AFECC used evidence it recognized that could prove the identities of Jose Brenes and Mauricio Mora as project supervisors as reverse proof that the Project Construction Inspection Report issued by Jose Brenes and Mauricio Mora was false, which was not logically self-consistent. Since AFECC failed to produce other evidence to prove that Oriental S.A.'s performance of the guarantee involved totally lacked factual basis or Oriental S.A. submitted false or forged document, Oriental S.A.'s application to Bank of Costa Rica for realizing the guarantee rights had legal basis.

In conclusion, the Project Construction Inspection Report was preliminary evidence proving the breach of contract committed by AFECC under the underlying contract and the evidence produced by AFECC was insufficient to prove that the aforesaid Report was false or forged and that Oriental S.A. required the performance of the guarantee knowing that the opposing party to the underlying contract did not breach the contract under the underlying contract or carry out other act resulting in the payment of the fund under the independent guarantee. On the basis of AFECC's breach of contract under the underlying contract and in accordance with the stipulations of the contract, Oriental S.A.'s claim for exercise of rights under the independent guarantee did not constitute a guarantee fraud.

Third, with respect to whether the breach of contract by the beneficiary of the independent guarantee under the underlying contract necessarily constituted a fraudulent claim under the independent guarantee.

In the view of AFECC, in accordance with the provisions of 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 (hereinafter referred to as the “judicial interpretation on independent guarantees”), it should be determined that the act of Oriental S.A. constituted an independent guarantee fraud. In accordance with the provisions of Article 25 of the judicial interpretation on independent guarantees, upon interpretation in the court trial, AFECC still insisted that the handling of this case should not violate the spirit of the judicial interpretation on independent guarantees. In light of AFECC's allegation, the Supreme People's Court further interpreted the aforesaid relevant issues involving the judicial interpretation on independent guarantees.

An independent guarantee was independent of the underlying transaction between the principal and the beneficiary. The bank issuing the independent guarantee was only responsible for reviewing whether the documents submitted by the beneficiary conformed to the stipulations of the guarantee clauses and it had the right to decide whether to make payment. The guarantor bank's payment obligation was not affected by the rights of defense of the principal and the beneficiary under the underlying transactions. When Oriental S.A. produced the preliminary evidence proving the existence of construction quality problems as the beneficiary, even though it did not initiate any of such dispute resolution procedures as litigation or arbitration and confirm that the opposing party breached the contract upon the aforesaid procedure, the realization of Oriental S.A.'s guarantee rights was not affected. Even though there was an ongoing litigation or arbitration procedure for the underlying contract, as long as the final determination that the underlying transaction debtor was not liable for payment or compensation was not made in the relevnat dispute resolution procedure, it did not affect the realization of guarantee rights of the beneficiary, either. In a word, even though an effective judgment or arbitral award determined that the act of the beneficiary constituted breach of contract under the underlying contract, such breach of contract was not necessarily the necessary and sufficient condition for the constitution of a guarantee “fraud.”

In this case, the guaranteed matters in the guarantee included construction quality and other acts of breaching of contract and there was no causal relationship in logic between the beneficiary's breach of contract for failing to pay the project fund and the construction quality problem. The breach of contract of Oriental S.A. as the beneficiary in the performance of the underlying contract did not necessarily constitute a fraudulent claim under the independent guarantee. In accordance with the provisions of item (3) of Article 12 of the judicial interpretation on independent guarantee, the requirement for determination of an independent guarantee fraud was limited to that “the debtor under the underlying transaction is deemed to be free of payment or indemnity liability by the court decision or arbitral award.” Therefore, unless otherwise agreed in the guarantee, the review of the underlying contract should be limited to performance matters within the scope of the guarantee and we should be prudent when incorporating whether the beneficiary breached the contract in the underlying contract into the review scope of a guarantee fraud. Although the Union of Architects and Engineers in Costa Rica entered an arbitral award, which determined that Oriental S.A. breached the contract in the performance of the contract, the aforesaid arbitration procedure was launched by AFECC on February 7, 2012, Oriental S.A. raised no counter claim, the arbitral award entered on July 9, 2013 determined that Oriental S.A. breached the contract only with respect to the claim matter of AFECC and it did not determine that AFECC was exempted from the obligation for payment or compensation due to the opposing party's breach of contract. Therefore, it could not be determined according to the aforesaid arbitral award that the act of Oriental S.A. constituted a guarantee fraud as prescribed in item (3) of Article 12 of the judicial interpretation on independent guarantees.

In addition, the fact that both parties had dispute over the project quality and some descriptions of project quality issues in the Arbitral Award issued by the Dispute Resolution Center of the Union of Architects and Engineers in Costa Rica could support each other. The obligations of Chinafecc Central América S.A. under the Construction Contract have not been fully performed and this case did not fall under the circumstances where Oriental S.A. confirmed the full performance of the underlying transaction debts or the non-occurrence of due payment. Nor could the existing evidence prove that Oriental S.A. knowingly abused the right of claim for payment while it did not possess such right. As the beneficiary, Oriental S.A. breached the contract in the performance of the underlying contract. Although the arbitral award confirmed such breach of contract, AFECC's obligation for payment or compensation was not thus exempted. In conclusion, even if the judicial interpretation on independent guarantees applied according to the allegation of AFECC, the circumstances in this case did not constitute a guarantee fraud.

Fourth, with respect to the independent counter guarantee related to the independent guarantee involved in this case.

Based on the characteristics of an independent guarantee, besides the debtor, the guarantor was liable for direct payment to the beneficiary and there was no subordination between the independent guarantee and the principal debts in terms of the right of defense. Even though the debtor exercised the right of defense in certain dispute resolution procedure, it did not necessarily enable the independent guarantor to obtain the benefit of the defense. In addition, even though there were circumstancesof fraudulent demand by the beneficiary under the independent guarantee, it could not be presumed that the act of the guarantor bank constituted a fraudulent demand under the independent counter guarantee. Only when the guarantor bank knew that the beneficiary was making fraudulent demands for payment and violated, and claimed the payment of fund under the independent counter guarantee to the counter guarantor bank, could it be determined that the guarantor bank constituted a fraudulent demand under the independent counter guarantee.

Since AFECC filed this lawsuit on the ground of a guarantee fraud, it should bear the burden of proving that Bank of Costa Rica knew that there were circumstances of independent guarantee fraud committed by Oriental S.A., still made a payment in violation of the principle of good faith , and then raised a claim for payment of the fund under the demand counter guarantee in the identity of the beneficiary, and its act constituted a fraudulent demand under the counter guarantee. Now, AFECC was not only unable to prove that Bank of Costa Rica committed a fraud in its payment of the fund under the independent guarantee to Oriental S.A., but also failed to prove that Bank of Costa Rica committed a fraudulent demand under the independent counter guarantee. Therefore, its claim for suspended payment of the fund under the independent counter guarantee lacked factual basis.

**3. Guiding Case No. 111 of the Supreme People's Court:**

**Liwan Subbranch, Guangzhou Branch of China Construction Bank Co., Ltd. v. Guangdong Lanyue Energy Development Co., Ltd. et al. (dispute over issuance of a letter of credit)**

[**Keywords]**Civil; issuance of a letter of credit; bill of lading; true intention; pledge of rights; priority of compensation

**[Key Points of Judgment]**

1. Whether the holder of a bill of lading obtains the real right due to the delivery of the accepted bill of lading and which type of real right it obtains depend on the contractual stipulations of the parties. When the issuing bank holds the bill of lading in accordance with the contractual stipulations between it and the applicant, the people's court should, in light of the characteristics of the letter of credit transactions, make reasonable interpretation of the contract involved and determine the true intentions of the issuing bank for holding the bill of lading.

2. Where the issuing bank enjoys the pledge right of the bill of lading and the goods under the bill of lading in the documents under the letter of credit, the means by which the issuing bank exercises the pledge right of the bill of lading should be the same as that for exercising the pledge right of movable property under the bill of lading. In other words, the issuing bank enjoys the priority of compensation from the proceeds arising from the discount, disposal, and auction of the goods under the bill of lading.

**[Legal Provisions]**

Article 71 of the Maritime Law of the People's Republic of China

Article 224 of the Property Law of the People's Republic of China

 Paragraph 1 of Article 80 of the Contract Law of the People's Republic of China

**[Basic Facts]**

In December 2011, Liwan Subbranch, Guangzhou Branch of China Construction Bank Co., Ltd. (hereinafter referred to as “Liwan Branch of CCB”) and Guangdong Lanyue Energy Development Co., Ltd. (hereinafter referred to as “Lanyue Energy Company”) concluded a Contract for Trade Financing Quota, a Special Agreement on Issuance of a Letter of Credit, and other relevant appendixes. It was stipulated that Liwan Subbranch provided Lanyue Energy Company with the trade financing quota not exceeding CNY550 million, including issuance of a usance letter of credit (“L/C”) with equivalent quota. Huilai Yuedong Electric Power Fuel Co., Ltd. (hereinafter referred to as “Yuedong Electric Power Company”) and other guarantors concluded guarantee contracts. In November 2012, Lanyue Energy Company filed an application with Liwan Subbranch of CCB for issuing a usance L/C of CNY85.92 million. For the purpose of issuing the L/C, Lanyue Energy Company submitted the Trust Receipt to Liwan Subbranch of CCB and they concluded a Contract for the Pledge of Margins. The Trust Receipt confirmed that from the date of issuance of the receipt, Liwan Subbranch of CCB obtained the ownership of documents and goods involved under the aforesaid L/C, Liwan Subbranch of CCB was the settler and beneficiary, and Lanyue Energy Company was the trustee of the trusted goods. After the issuance of the L/C, Lanyue Energy Company imported 164,998 tons of coal. Liwan Subbranch of CCB accepted the L/C and granted a loan of CNY84,867,952.27 to Lanyue Energy Company, which was used by Lanyue Energy Company to pay back the advance payment for the L/C issued by Seoul Branch of CCB. After performing the obligations of issuing the L/C and making payment, Liwan Subbranch of CCB obtained the full set of documents, including the bill of lading involved. Due to deterioration of business operations, Lanyue Energy Company failed to make payment against the documents. Therefore, in the trial of this case, Liwan Subbranch of CCB still held the bill of lading and the relevant documents. The coal under the bill of lading was seized by the People's Court of Gangkou District, Fangchenggang City, Guangxi Zhuang Autonomous Region due to other disputes. Liwan Subbranch filed this lawsuit with the Intermediate People's Court of Guangzhou City, Guangdong Province and requested the Court to order that Lanyue Energy Company should pay Liwan Subbranch of CCB the principal of the advance payment for the L/C of CNY84,867,952.27 and the interest thereof; confirm that 164,998 tons of coal under the L/C were owned by Liwan Subbranch of CCB and Liwan Subbranch of CCB enjoyed the preferential repayment for the debts under the aforesaid L/C with proceeds arising from the disposal of such coal; and Yuedong Electric Power Company and other guarantors should assume the guarantee liability.

**[Judgment]**

On April 21, 2014, the Intermediate People's Court of Guangzhou City, Guangdong Province entered a Civil Judgment (No. 158 [2013], First, Civil Division, IPC, Guangzhou), which supported the claim of Liwan Subbranch of CCB that Lanyue Energy Company should repay the principal and interest and the guarantors should assume the corresponding guarantee liability. However, on the ground that the delivery of the Trust Receipt and the bill of lading could not be used against a third party, the Intermediate People's Court of Guangzhou City rejected the claim of Liwan Subbranch of CCB for confirmation of the coal ownership and the priority of compensation. Liwan Subbranch of CCB refused to accept the judgment of first instance and appealed. On September 19, 2012, the High People's Court of Guangdong Province entered a Civil Judgment (No. 45 [2014], Final, Civil Division II, HPC, Guangdong) to dismiss the appeal and affirm the original judgment. Liwan Subbranch of CCB refused to accept the judgment of second instance and filed an application for retrial with the Supreme People's Court. On October 19, 2015, the Supreme People's Court entered a Civil Judgment (No. 126 [2015], Review, Civil Division, SPC), which supported the claim of Liwan Subbranch of CCB that it enjoyed the priority of compensation from the proceeds arising from the disposal of goods in the bill of lading under the L/C involved and dismissed the claim of Liwan Subbranch of CCB that it enjoyed the ownership of the goods under the bill of lading involved.

**[Judgment's Reasoning]**

The Supreme People's Court held that a bill of lading had dual attributes including certificate of creditor's rights and certificate of ownership, but it did not mean that the holder of a bill of lading would necessarily enjoy the ownership of the goods under the bill of lading. As for the holder of the bill of lading, whether it could obtain the real right and which type of real right it could obtain depended on the contractual stipulations of the parties. Liwan Subbranch of CCB has performed the obligations of issuing the L/C and making payment and obtained the bill of lading under the L/C. However, since the parties had no intention of transferring the ownership of goods, it could not be deemed that Liwan Subbranch of CCB obtained the ownership of goods under the bill of lading once it obtained the bill of lading. Although it was stipulated in the Trust Receipt that Liwan Subbranch of CCB obtained the ownership of goods and it entrusted Lanyue Energy Company with disposing of the goods under the bill of lading, according to the statutory principle of real rights, such stipulation could not produce the effect of real rights since it constituted transfer of guarantee. However, although the stipulation on transfer of guarantee could not produce the effect of real rights, it still had the effect of contract and it was stipulated in the Special Agreement on the Issuance of a Letter of Credit that when Lanyue Energy Company breached the contract, Liwan Subbranch of CCB had the right to dispose of the documents and goods under the L/C. Therefore, according to the overall interpretation of the contract and characteristics of L/C trading, the true intentions of the parties were to set pledge of the bill of lading through the transfer of the bill of lading. This case satisfied two essential conditions for the establishment of pledge of rights, namely, a written pledge contract and a publication of real rights. As the holder of the bill of lading, Liwan Subbranch of CCB enjoyed the right of pledge of the bill of lading. Where Liwan Subbranch of CCB's right of pledge of the bill of lading conflicted with other creditors' possible rights of goods under the bill of lading, including the right of lien and the right of pledge of movable property, they may be legally settled in the execution of the distribution procedure.