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Newsletter

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Privy Council rules on serious irregularity challenges to arbitral awards

Justin Yuen

In RAV Bahamas Ltd & Bimini Bay Resort Management Limited v Therapy Beach Club Incorporated [2021] UKPC 8, the Judicial Committee of the Privy Council (which is the court of final appeal for the UK overseas territories and Crown dependencies, and for certain Commonwealth countries) considered a challenge to an arbitral award on the basis of "serious irregularity", under s.90 of the Bahamas Arbitration Act 2009 (the Act). That provision is materially identical to s.4 of Schedule 2 of Hong Kong's Arbitration Ordinance (Cap 609) and so will be of interest in relation to Hong Kong seated arbitrations and the interpretation of the Hong Kong provisions. The Privy Council held that, while it is good practice and should be encouraged, it is not a requirement of s.90 of the Act that there be a separate and express allegation, consideration and finding of substantial injustice. It is sufficient that, as a matter of substance, substantial injustice be established and found.

Section 90 of the Bahamas Arbitration Act 2009

S.90 of the Act provides that a party to arbitral proceedings may apply to the court challenging an award in the proceedings on the ground of serious irregularity, affecting the tribunal, the proceedings or the award. S.90(2) provides that "serious irregularity" means an irregularity of one or more of the following kinds, which the court considers has caused or will cause substantial injustice to the applicant:

(a) failure by the tribunal to comply with s.44 of the Act i.e. its general duty (e.g. to act fairly and impartially and give each party a reasonable opportunity to put his case and deal with that of his opponent);

(b) the tribunal exceeding its powers (otherwise than by exceeding its substantive jurisdiction);

(c) failure by the tribunal to conduct the proceedings in accordance with the procedure agreed by the parties;

(d) failure by the tribunal to deal with all the issues that were put to it;

(e) any arbitral or other institution or person vested by the parties with powers in relation to the proceedings or the award exceeding its powers;

(f) uncertainty or ambiguity as to the effect of the award;

(g) the award being obtained by fraud or the award or the way in which it was procured being contrary to public policy;

(h) failure to comply with the requirements as to the form of the award; or

(i) any irregularity in the conduct of the proceedings or in the award which is admitted by the tribunal or by any arbitral or other institution or person vested by the parties with powers in relation to the proceedings or the award.

Background

A dispute had arisen between the parties in relation to the lease by RAV to Therapy of land for the building and operation of a beach club. By an "ad hoc" arbitration agreement, the parties' dispute was referred to arbitration and an arbitral award was made in Therapy's favour. RAV successfully challenged the arbitration award in the Supreme Court of the Bahamas on the grounds, amongst others, of "serious irregularity" under s.90 of the Act, in that the arbitrator had failed:

- to deal with certain issues put to her (s.90(2)(d)); and
- had failed to give RAV a fair opportunity to address certain issues regarding the calculation of damages (s.90(2)(a)).

The Supreme Court remitted the award back to the arbitrator for further consideration. However, the Court of Appeal reversed that decision and upheld the arbitral award, on the basis that the Supreme Court judge had not expressly and separately considered and found that substantial injustice had been caused to RAV by the irregularity that he had found and RAV had failed expressly and separately to plead (in its notice of motion) and establish any such injustice.

Privy Council's findings

The main issue before the Privy Council was one of interpretation, namely whether s.90 of the Act requires there to be a separate and express allegation by the applicant and separate consideration and finding of substantial injustice by the court, for a serious irregularity to be established.

The Privy Council found as follows:

- The test of serious irregularity imposes a "high threshold" or "high hurdle". In order to cross that threshold, the applicant needs to show both that there has been an irregularity of one or more of the kinds listed in s.90 and that that has caused or will cause substantial injustice to the applicant.

- The focus is on due process, not the correctness of the decision reached.

- Even if a case is shown to fall within one or more of the kinds of irregularities listed in s.90, this will only amount to a serious irregularity if the court considers that it "has caused or will cause substantial injustice". This means more than some injustice.

- There will be substantial injustice where it is established that, had the irregularity not occurred, the outcome of the arbitration might well have been different.

- Some irregularities may be so serious that substantial justice is "inherently likely" or "likely in the very nature of things" to result. In such cases, substantial injustice may be inferred from the nature of the irregularity and that inference may be so strong that it almost "goes without saying".

- In general, there will, however, be no substantial injustice if it can be shown that the outcome of the arbitration would have been the same regardless of the irregularity.

The Privy Council held that it is good practice for an applicant challenging an arbitration award under s.90 to set out in its notice of motion, or other originating document, both (i) the listed irregularity in s.90 relied upon and the grounds for contending that there has been such an irregularity; and (ii) that the irregularity has caused or will cause substantial injustice and any written evidence relied upon should be provided at the same time. The Privy Council held that it is also good practice for the judge determining the s.90 application to deal expressly and separately with each of the elements of what constitutes a serious irregularity. However this is good practice, the Privy Council said, and is not a mandatory requirement of s.90, such that an application would fail if such practice is not followed. It is sufficient that, as a matter of substance, substantial injustice be established and found. In this case, the Privy Council was satisfied that as a matter of substance, substantial injustice had been both established and found and it did not make any difference that there had not been an express and separate allegation, consideration and finding of substantial injustice. In this context, it said, substance is more important than form and undue formalism should not be required.

Comments

The above ruling of the Privy Council may be useful in challenging an arbitral award on the ground of serious irregularity under Schedule 2 of the Arbitration Ordinance. However, it should be noted that Schedule 2 is only applicable if it has been opted into by the parties when entering into the arbitration agreement.

"On demand" or "see to it" guarantee?

Joseph Chung

The issue before England's Court of Appeal in Shanghai Shipyard Co Ltd v Reignwood International Investment (Group) Company Ltd [2021] EWCA Civ 1147 was construction of a guarantee given to support the obligation of a buyer to pay the final instalment of the price under a shipbuilding contract. The question was whether the guarantee was an "on demand" guarantee or a "see to it" guarantee in which the guarantor's liabilities were no greater than those of the buyer. Having regard to the wording used in the guarantee, the court found in favour of the builder and held that the guarantee was an on demand guarantee.

Background

Shanghai Shipyard Co (the Builder) entered into a Ship Building Contract (Contract) with Reignwood as the buyer, under which the Builder agreed to build an offshore drillship (Vessel) for US$200 million. Reignwood came to be involved in the purchase of the Vessel at the behest of three individuals who had established a company, Opus Offshore Limited (OOL), with a view to purchasing the drillships for operation in the deep sea offshore drilling industry. Reignwood had agreed with the management of OOL to participate as a financial investor for the purpose of the purchase of the drillships, which would be held by a special purpose vehicle owned by OOL as the holding company. The Contract provided that the US$200 million purchase price should be paid in three instalments, the first (US$ 10 million) within 30 days of the effective date of the Contract, the second (US$ 20 million) six months later, and the third (the final instalment of US$ 170 million) upon delivery.

Reignwood entered into an "Irrevocable Payment Guarantee" in favour of the Builder in the terms required by the Contract (Guarantee). At this stage Reignwood was still the buyer under the Contract, such that the guarantee was not a third party guarantee. The contemplated substitution of the special purpose vehicle did not take place until a little over a year later, when the Contract was novated by an agreement under which all Reignwood's rights and obligations as buyer were transferred to Opus Tiger 1 (Buyer), a 100% subsidiary of OOL.

The Guarantee provided that Reignwood IRREVOCABLY, ABSOLUTELY and UNCONDITIONALLY guaranteed, as the primary obligor and not merely as the surety, the due and punctual payment by the Owner of the Final Instalment of the Contract Price of US$170,000,000. Clause 4 of the Guarantee provided that in the event of a dispute between the Owner and Builder as to whether: (i) the Owner is liable to pay to the Builder the Final Instalment; and (ii) the Builder is entitled to claim the Final Instalment from the Owner, and such dispute is submitted either by the Owner or Builder for arbitration in accordance with Clause 17 of the Contract, Reignwood shall be entitled to withhold and defer payment until the arbitration award is published and shall not be obligated to make any payment unless the arbitration award orders the Owner to pay the Final Instalment and that if the Owner fails to honour the award, Reignwood shall pay the Builder to the extent the arbitration award orders (Proviso).

The Builder gave notice of completion of the Vessel to the Buyer and subsequently made a demand to the Buyer for the final instalment and other sums allegedly due under the Contract. Later, the Builder sent a notice of default to the Buyer for non-payment of the sums allegedly due, and after that, a cancellation notice to the Buyer. The Builder then made a demand of Reignwood, the Guarantor, for the final instalment under the Guarantee. At some stage there arose a dispute between the Builder and Buyer as to whether the Vessel was in a deliverable condition, the Buyer contending that the Vessel contained a number of major and critical defects.

The Builder commenced proceedings against Reignwood under the Guarantee. The claim was defended by Reignwood on the grounds, amongst others that, (i) the Guarantee was a "see to it" guarantee in which the Guarantor's liabilities were no greater than those of the Buyer, and that the Buyer had no obligation to pay the final instalment of the price as a result of defects in the Vessel and/or the absence of Classification Society approvals; and (ii) in any event the proviso in Clause 4 of the Guarantee was engaged and accordingly no sums were due unless and until the subject of a London Arbitration award.

High Court Decision

The issues before the court of first instance were whether:

(1) on a true construction of the Guarantee, it was a demand guarantee, such that the Guarantor's liability under it arose by reason of the demand only, if the Buyer was liable to pay the final instalment under the terms of the Contract, OR it was a "see to it" guarantee or a conditional payment obligation, such that the Guarantor's liability under it arose upon the demand only if the Buyer was liable to pay the Final Instalment under the terms of the Contract.

(2) the Guarantor was entitled to refuse payment under Clause 4 pending and subject to the outcome of the arbitration between the Builder and the Buyer in respect of a dispute as to the Buyer's liability to pay and the Builder's entitlement to claim that Final Instalment, (i) only if the arbitration had been commenced between those parties as at the date of the demand; or (ii) regardless of when such arbitration is or may be commenced.

The court held that the guarantee was a "see to it" guarantee and that the Guarantor was entitled to refuse payment under Clause 4 pending and subject to the outcome of an arbitration between the Builder and Buyer in respect of a dispute as to the Buyer's liability to pay and the Builder's entitlement to claim that Final Instalment, regardless of when such arbitration is or may be commenced.

Court of Appeal Decision

"On demand" or "see to it" Guarantee?

The Court of Appeal reversed the first instance decision, holding that the Guarantee was an on demand guarantee. It found that the critical language of the Guarantee pointed strongly towards it being a demand guarantee, namely:

- The capitalised words "ABSOLUTELY and UNCONDITIONALLY" would convey to a businessman that the obligations were not conditional on the liability of the Buyer.
- The words "as primary obligor and not merely as the surety" were a clear indication that the document was not a surety guarantee.
- The words used that trigger the obligation "upon receipt by us of your first written demand". Payment against demand is the hallmark of a demand guarantee.
- The words used "upon receipt by us of your first written demand we shall immediately pay to you..." Immediate payment would not be appropriate in the case of a surety guarantee, in which some period would be needed for the guarantor to investigate and form a view on whether there was an underlying liability to make the final instalment payment under the Contract.
- Express provision that obligations on the Guarantor are to be unaffected by any dispute under the Contract.
- The Proviso is more supportive of the Builder's case than that of the Guarantor. When triggered, it involved an obligation to pay against a document, namely the arbitration award. It did not involve an obligation to pay in respect of an underlying liability. The Guarantor was not party to the arbitration agreement in the Contract, and but for this Proviso would not be bound by any award in an arbitration between the Builder and Buyer. The award might go by default against the Buyer, without any detailed consideration of the merits, but if the document were a surety guarantee Reignwood would be entitled to challenge whether the Buyer was indeed liable notwithstanding that the tribunal had so held, absent the agreement in the Proviso to abide by the award. The Proviso therefore binds Reignwood to pay what may not be an underlying liability; it involves payment against a document, namely an award. Another indication that it involves payment against a document, not a liability, is that the obligation arises the moment an award is made, irrespective of any subsequent challenge. In other words the Proviso to Clause 4, if triggered, does not introduce a surety obligation.
- Clause 10 limits the interest payable to 60 days' worth. This envisages prompt payment on demand, not the lengthy delay which might be contemplated to resolve a dispute about the Buyer's liability.

Arbitration Proviso

The Builder argued that in order for the arbitration Proviso to be triggered, there must be both a dispute and the commencement of arbitration prior to a valid demand being made. If that has not occurred before a demand is made, the Builder has an accrued right to payment under the Guarantee, which is a right to payment "immediately upon a valid

demand". The court held that the Proviso defined the circumstances in which the demand guarantee ceased to be payable on demand and became payable against an award. It provided, unsurprisingly, that the commencement of an arbitration is necessary to convert the obligation to become one to pay against an award. That, the court said, was the natural meaning of the words: it required not only that there is a dispute but also that the dispute "is submitted" to arbitration. Both were expressed as the condition on which the Guarantor is "entitled to withhold or defer payment." If an accrued right to payment has arisen at the date of demand, there is nothing in the clause to suggest that it is thereafter suspended, or if enforced that there is a right of repayment pending the award. The court said that the language of the Proviso did not suggest that it was triggered by a dispute alone, but only when and if the dispute was submitted to arbitration.

Comments

Whether a performance bond is an “on demand” or “see to it” bond (sometimes called a “default bond”) is a dispute frequently dealt with by the courts. If the parties had consulted lawyers to draft their bonds, this could have been avoided. Simple standard wording should be included in the bond to reflect the true intention of the parties.

Court denies party leave to adduce expert evidence

KK Cheung

The court recently dismissed an application by the Plaintiff in Kader Industrial Company Ltd v Hop Shing Engineering & Construction Co Ltd, [2021] HKCFI 3606, for leave to adduce expert evidence on issues of liability and quantum in a dispute concerning a Guarantee provided by the Defendant to the Plaintiff in respect of waterproofing works. The court dismissed the application, as it was not satisfied that the expert evidence proposed to be adduced would be of any assistance to the court for the determination of the issues in dispute.

Background

Plaintiff’s Claim

The Defendant carried out waterproofing works at the Plaintiff’s premises (Building). The Plaintiff claimed that upon completion of the works on 1 November 2013, defects were found in the works, namely water leakage and water stains on the ceiling of the 12th floor of the Building, which caused plaster to fall off from the ceiling and rust and deformation of the underlying rebar, which became exposed (Defects). The Plaintiff claimed that the Defects were caused by the defective roof waterproofing system installed by the Defendant on the roof level/13th floor of the Building and claimed under a Guarantee said to have been provided by the Defendant to the Plaintiff in respect of the quality of the works and waterproofing materials used.

Defendant’s Defence

The Defendant denied that the Guarantee was valid. In any event, the Defendant claimed that under the Guarantee, the works of the Defendant said to be subject to the Guarantee (roof waterproofing works and lapping to the existing waterproofing membrane) were to be carried out in conjunction with the Defendant’s installation of a green roof system, which was carried out by a third party, Everplant Technology Ltd (ET). The Defendant denied the Defects complained of and that they were caused by any defect in the roof waterproofing system provided by the Defendant on the roof level/13th floor of the Building. It claimed that such was caused by the destructive manner in which ET had removed and reinstalled the green roof system, which had caused damage to the 13th floor of the Building and/or damaged the Defendant’s works, causing the alleged Defects. In particular, the Defendant claimed that after its works had been completed on 1 November 2013, the entire green roof system of the Building had been removed in September 2019 and the remainder of the roof demolished in August 2020, when a third party contractor was engaged by the Plaintiff to carry out works, allegedly to prevent water leakage at the premises affected.

Application for leave to adduce expert evidence

The Plaintiff sought to adduce expert evidence by a Mr Boris Yeung (BY) on whether the waterproofing system installed by the Defendant was defective, the cause and extent of the Defects, and the reasonable cost of necessary repairs to rectify them. The Defendant opposed the application on the basis that the proposed expert evidence would not be cogent, reasoned or relevant to the pleaded issues, to be of assistance to the court at trial. The Defendant also asserted that BY was not qualified to give the expert evidence required.

BY inspected the 13th floor of the Building. The Defendant objected on the basis that the Defendant had not been given the opportunity to inspect the alleged Defects complained of and that BY's own inspection was conducted after the green roof system had been removed and the entire roof had been demolished. BY's inspection could not therefore have been of the Defendant's waterproofing works, and as such, BY could not express any independent expert opinion on whether the works carried out by the Defendant were defective, nor as to the cause of the water leakage.

In the course of the hearing, the court asked the Plaintiff's counsel to identify the factual evidence on the state or condition of the Defendant's works prior to removal of the green roof in September 2019 and demolition of the remainder of the roof after August 2020. The Plaintiff's counsel referred to an inspection report dated 24 April 2020 prepared by Hong Kong Survey Limited (HKSL Report), on water seepage tests conducted in March and April 2020 and pointed out that the HKSL Report had been disclosed in the course of discovery. The Plaintiff's counsel also referred to photographs taken of the ceiling on the 12th floor of the Building, in April and June 2018, and on a CCTV Survey Report of a survey carried out on 29 August 2018, when a CCTV camera was lowered and moved along the drainage pipe serving the relevant parts of the Building. The Plaintiff's counsel explained that this was the evidence to be relied upon by the expert to be appointed, for the expert's opinion on the existence and cause of the Defects.

Court's Decision

The court held that the HKSL Report was inadmissible evidence, on which the proposed expert could not rely. It said that evidence includes not only evidence of opinion, but also factual evidence which goes to an expert issue. Where an expert is drawing an inference from facts, on the basis of his expertise, experience and specialist knowledge, that is part of his expert evidence.

The court said that conduct of hammer tapping and infrared tests require experience and the employment of skills and specialist knowledge. The conclusion made, that damage exists or has been noted from the tonal or other relevant changes detected in the course of tapping tests, is a process of inference made by the operator or examiner, drawn from and dependent on the skill and experience of the operator. The reliability of infrared thermography tests likewise depends on the interpretation of thermal images, and whether the measurement devices were correctly applied with the relevant expertise. On such analysis, the HKSL Report, made on the basis of inspections and tests carried out in March and April 2020, including infrared scans and electrical conductivity sensing, clearly constituted expert evidence for which leave of the court was required. No leave had ever been sought or granted for the HKSL Report to be adduced, for BY to rely upon. The photographs relied upon by the Plaintiff only showed to a layman, the court said, that there were water stain marks or signs of spalling on the ceiling of the 12th Floor in April and/or June 2018. They could not show the cause of the water seepage, or the alleged Defects.

As such, the court said that without having inspected the condition of the roof and state of the Defendant's works prior to the removal and demolishing of the green roof system and roof before September 2019, it was dubious whether BY could form any reliable opinion on the quality of the Defendant's works and materials used, whether the Defects existed, the cause of the Defects, and the rectification works required. The court was not satisfied that the expert evidence proposed to be adduced by the Plaintiff would be of any assistance to the court for the determination of the issues in dispute. The court added that time and costs would be wasted if leave was granted for BY to adduce expert evidence, when there was a clear lack of the necessary factual evidence to form the basis of and to support his opinion. Further, the court was not persuaded that, as an architect, BY had the necessary expertise to give the expert opinion on the cause of the water seepage and leakage complained of, nor on the costs of the necessary rectification works.

Accordingly, the application for leave to adduce expert evidence, as framed, was dismissed.

Comments

Although it is common to adduce expert evidence in construction disputes, the court may not grant leave for the parties to do so as a matter of course. This judgment is also a good reminder to the parties that they should consider whether expert evidence is needed for their case as early as possible. Inspection of defects is usually necessary before the expert is able to form any opinion on them. The expert merely looking at record photos or reports done by others may not be acceptable to the court. In this regard, preservation of evidence is therefore important.

An architect or building surveyor is often appointed as expert on the issue of water seepage and leakage cases. It is not clear why the court was not persuaded that the architect in the above case had the necessary expertise to give an expert opinion. In rejecting the candidate, although not reported in the judgment, the court may have considered his experience in dealing with similar issues and his qualifications.

A new arbitration centre for Hong Kong

Joseph Chung

On 29 November 2021, the Asian-African Legal Consultative Organization (AALCO) announced the establishment of a regional arbitration centre in Hong Kong. Since 1978 AALCO has established a network of regional arbitration centres, functioning under the auspices of AALCO, with the objective of:

- promoting international commercial arbitration in the Asian and African regions;
- coordinating and assisting the activities of existing arbitral institutions, particularly among those within the two regions;
- rendering assistance in the conduct of Ad Hoc arbitrations, particularly those held under the UNCITRAL Arbitration Rules; and
- assisting in the enforcement of arbitral awards.

To date, five such regional arbitration centres have been established - in Cairo, Kuala Lumpur, Lagos, Tehran and Nairobi.

AALCO provides its expertise and assistance to its Member States (currently 47 member states in Asia (including the PRC) and Africa) in the appointment of arbitrators and other matters relating to the conduct of arbitration.

The addition of an AALCO arbitration centre in Hong Kong, will no doubt enhance Hong Kong's status as an arbitration hub.

Joseph Chung wins Lexology Client Choice Award

We are pleased to announce that our Construction practice partner, Joseph Chung, has won a Lexology Client Choice Award. The Client Choice Award recognises law firms and partners around the world that stand apart for excellent client care and the quality of their service. The criteria for recognition focus on an ability to add real value to clients' business, above and beyond other players in the market.

Want to know more?

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