



A Guide to Commercial Contracts under Chinese Law

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I. Introduction

A company conducting business in China, whether from abroad or through a subsidiary in China, may sign various contracts with Chinese companies to secure a particular transaction, such as purchase contracts or agency agreements. The content of the contracts however depends not only on the specifics of the transaction, but also on the laws and practicalities relevant to commercial transactions under Chinese law. This is crucial especially when you want to enforce your rights in a dispute over the transaction.

This article is intended as a guide to key considerations for companies entering into commercial contracts. First we will describe some of the most important clauses of a commercial contract under Chinese (PRC) law. Next, we will take a more descriptive approach to key legal and practical issues such as the legality of a transaction, intellectual property rights protection, dispute resolution, disputes over quantity and quality, the importance of correspondence as evidence, and so forth.

The below is applicable to both domestic contracts (i.e. between two China-registered entities) and international ones (i.e. between one Chinese party and one foreign party), presuming only the application of Chinese law and the relevance of Chinese business conditions.

II. Clauses of a Commercial Contract

Generally, a domestic contract under Chinese law will consist of (but need not be limited to) the terms and conditions relating to the following aspects of the commercial transaction:

1. Title and parties
2. Recitals of background information
3. Definitions
4. Rights and responsibilities of parties
5. Representations and warranties of parties
6. Assignment and sub-contracting clause
7. Force majeure
8. Confidentiality
9. Breaches and remedies
10. Right of termination
11. Conditions precedent contract
12. Execution of contract

Chinese companies usually prefer contracts to be short and simple – and for certain relatively simple transactions, some of the sections can be safely left out. This is also strongly related to the bargaining positions of each party.

1. Title and parties

The title of the contract can be simple or descriptive. The name of a contract cannot be interpreted as main meaning, however in case of dispute over some unclear clauses of the contract, the name of the contract may help to define the appropriate rights and obligations of the parties (e.g. an agency agreement indicates the parties may have an agency relationship rather than a distributor relationship).

The names of the parties must be their legally-registered company names to avoid such parties from easily challenging the binding force upon them. Since a 1999 regulation stipulates that no foreign-invested company will be registered in its English name, we suggest that all companies in China should include their Chinese name.

To avoid potential problems, for simple transactions the counterpart can be requested to provide a copy of its business licenses to certify its Chinese name and legal status. For important or large transactions, or when the legal status of the parties is unclear, we suggest that the following steps may be considered:

- Complete a company search with the registration authorities to check the full legal name(s), legal status and registered legal address of a Chinese counterpart.
- Complete a due diligence of the Chinese counterpart, with focus on registered information with the registration authority, assets status, cash flow, past business practices, and so forth.

A sample description for a proper title and parties is the following:

Storage Contract

Party A: xxx Company, a limited liability partnership duly established and legally existing under Hong Kong law, with its registered address at xxx, Hong Kong SAR (Business License No. xxx);

Party B: xxx Company Limited (Chinese: xxx), a limited liability company duly established and legally existing under PRC laws and regulations with its legal address at xxx, Guangzhou (Business License No. xxx).

2. Recitals of background information

The background information of a contract can be recited in a standard or unique form. Depending on the nature of the transaction and the wording, a recital may provide a basis to interpret the contract if some clause is in dispute or is not clear. In simple transactions this may be unnecessary.

3. Term Definition

Term definition clarifies the accurate meanings of certain terms and helps the parties to reduce misunderstanding of a contract. This too is not always necessary in simple transactions.

4. Rights and responsibilities

Since China is not a case law country and precedents cannot be cited in lawsuits, in most cases, a handling judge has considerable discretion in interpreting commercial transactions. At the same time Chinese law continues to apply many restrictions to commercial affairs. Thus a good contract should expect all possibilities and detail the parties' rights and responsibilities. Some key points to protect one party's rights and clarify the counterpart's obligations are as follows:

For rights:

- Clauses on “rights” or “obligations of the opponent” or other operative provisions
- Clear performance standards and time schedules
- Un-prejudiced by events outside one's control
- Effective remedies for the opponent's failure of performance of its obligations
- No legal obstacles on the opponent's obligations
- Rights of termination of the contract in certain cases (see right of termination)

For example, we can describe a principal Party A's right in an Agency Contract as follows:

Party B shall assist Party A in collecting payment for cargo from the end-user customer in time. If due to reasons of Party B, Party A cannot collect the payment for cargo from the end-user in time, Party A is entitled to claim against Party B for compensation of such payment and all costs and expenses incurred from the collection of the payment from the end-users and/or Party B.

For responsibilities:

- Provided for in operative provisions
- Obligations or liabilities should be limited
- Establish reasonable standards
- Ensure capacity to perform obligations
- No legal obstacles to perform responsibilities

In a Storage Contract, Party A's responsibilities for example may NOT be as follows:

Party A agrees to provide a guarantee in Party C's favor for all the obligations for Party B under this contract. If Party B breaches its obligations, Party C is entitled to claim against Party A for joint and several liability.

[Note: Under China's guarantee law, a guarantee to a foreign company must meet certain requirements and should be approved or recorded with the foreign exchange authorities. Because the above in nature is a guarantee offer to a foreign company, Party A has legal obstacles to perform such responsibility.]

5. Representations and warranties

Considering that a Chinese company may only perform activities within its lawfully approved and registered business scope, representations and warranties can be very useful in contracts involving Chinese parties.

Representations – past and current conditions

- No violation of laws (e.g. restrictions on business scope, approval and licenses)
- Proper authorization by the company or interested parties to sign the contract

Warranties – future actions

- The counterpart will keep its ability to perform its responsibilities
- The counterpart will continue to procure unfinished duties

In a Dangerous Cargo Storage Contract, representation and warranties can be provided as follows:

The storage company hereby represents and warrants to the other parties, as of the date hereof, that:

- *It is an enterprise duly established, legally existing and in good standing under PRC law;*
- *It has all requisites of full power, authority and approval required to enter into this contract and to perform each of its obligations hereunder by the competent authority, government, parties and so forth; and*
- *It has all requisite permits, licenses, approvals and consents of whatever nature under PRC law to provide storage services of the dangerous cargo xxx (name of the cargo to be stored).*

6. Assignment and sub-contracting

A party may not transfer its obligations, but may transfer its rights under a contract in whole or in part, with notice to the other party or parties, except if such transfer is prohibited by (i) the nature of the contract; (ii) agreement to the contrary between the parties to the contract; (iii) Chinese laws or regulations.

It is therefore quite common to include the following clause:

A party cannot transfer its rights, obligations, or its rights together with its obligations under a contract WITHOUT THE CONSENT of the other party or parties.

7. Force Majeure – Act of God

Under Chinese law and according to judicial practice, acts of god may include disasters, governmental acts, and so forth, or may be agreed by the parties. Without a specific clause, a court or arbitrator will determine at its discretion what events are acts of god, especially relating to natural disasters or government actions. A definition of “acts of god” and stipulations on how to deal with such acts will help to clarify what the parties should do under the specified unexpected circumstances.

8. Confidentiality

Including clauses of keeping business secrets and setting penalties of divulgence are often of crucial importance in commercial transactions, because under Chinese law the economic or criminal punishment of illegal disclosure of confidential information is often insufficient to protect the secrets in a commercial transaction. An example of a simple confidentiality clause is as follows:

Any information, data or market information obtained by Party B from Party A in relation to Party B's implementation of the obligations under this contract belongs to Party A's commercial secrets, and Party B shall not disclose such secrets to third parties including employees not involved in the transaction without Party A's express written agreement.

9. Breaches and remedies

Without specific clauses on breaches and remedies, breach of contract will result in the following obligations:

- To continue to perform the responsibilities
- To cure the breach (e.g. repair, replace, return, discount in payment)
- To pay damages or liquidated damages (i.e. penalty)

- To compensate for losses caused by the breach and anticipatory profits

However, the claimant will need to collect strong evidence to prove the breach, the continued performance of its own obligations, damages and costs; in case of anticipatory breach this is made even more difficult, time-consuming and costly. Therefore, the inclusion of more specific clauses is recommended, such as:

If Party B fails to fulfil any and all obligations under this contract, including but not limited to delivery, quality, and confidentiality, and thereby causes damage to Party A, Party B shall compensate Party A for the losses caused hereby, including any compensation Party A pays for the losses or damages claimed by third parties and any legal costs to defend any claims caused by such breach.

The Seller's liability for any and all losses of damages of whatever nature resulting from any cause whatsoever shall in no event exceed the portion of the total Agreement Price attributable to the Product in respect of which the claim is made, or at the election of the repair or replacement of such Product.

10. Rights of termination

The parties to a transaction may agree to terminate the contract without cause, or make termination conditional upon events as agreed in the contract. Typical clauses of rights of termination are as follows:

The Seller shall be entitled to terminate this Agreement without liability to the Buyer by giving notice to the Buyer at any time, and the Seller reserves the right to claim for damages (if any) if:

- *The Buyer files for dissolution or is dissolved, terminated, or liquidated, or is merged with or consolidated into another limited liability company, partnership, or other entity, without the Seller's written consent;*
- *Under the laws of the People's Republic of China, the Buyer is adjudicated as bankrupt or insolvent;*
- *The Buyer ceases, or threatens to cease, to carry on businesses;*
- *The Buyer explicitly expresses or indicates its intention not to perform its obligations under this Agreement; or*
- *The Seller reasonably apprehends that any of the events mentioned above is about to occur in relation to the Buyer, and notifies the Buyer in writing accordingly requesting for guarantee of performance of the contract but Buyer fails to provide such a guarantee to satisfy the Seller.*

11. Conditional precedent

Some contracts are effective on satisfaction of certain conditions, such as:

- Government approval for a project, establishment of a company (e.g. Joint Venture contract)
- Registration of mortgage on real estate
- Approval / registration of a guarantee by foreigners or foreign companies

For commercial consideration, the parties to a contract may also stipulate other conditions for effectiveness:

- Satisfaction of certain documents
- Occurrence of certain events

12. Execution of contract

In China, the execution of a contract is much more complicated than in many other jurisdictions. In judicial practice, in many transactions with apparent authorization, contracts have been declared invalid because the plaintiff could not provide evidence to prove the defendant's due authorization to the representative signing such contracts. The following points should thus be taken into consideration:

Authorization:

- A commercial contract shall be signed under authorization from the legal representative of the legal entity.
- If the contract is signed by an agent, a written authorization signed by the legal representative and chopped by the company is required.

Form of execution:

- The legal full name of the parties should be confirmed before signing the contract.
- If conditions allow, the parties should stamp the company chop and a Chinese party's chop shall be the one registered with the competent Chinese authorities.
- If signed by an agent (including senior representatives of the company), a proper authorization letter shall bear the company's chop and the signature of the legal representative.

III. Practical Suggestions on How to Avoid Problems in the Future

The purpose of signing a contract is to detail a transaction between the parties, and to provide a legal basis for enforcement if one of the parties fails to comply with its promise. Our goal is to briefly introduce several issues that frequently lead to disputes in China, and point to clauses which may help to avoid or resolve such disputes.

First we draw your attention to the importance of the legality of a contract, its practical implementation, and the ability to enforce it under Chinese law. Next we will focus on IPR management, payment security and control of quality / quantity as frequent subjects of dispute. Finally we will discuss the importance of keeping correspondences for evidentiary purposes.

1. Legality, Implementation, Enforcement

If a contract is not legally binding, if it cannot be implemented in a practical way, or if it cannot be properly enforced if necessary, it loses much if not all of its value.

a) Legality of a transaction

A company must be sure that the contract to a transaction is lawful. If the contract or some of its terms are regarded as unlawful, then at a later stage one of the parties could move to invalidate such a contract or certain illegal terms and clauses.

Under Chinese law, a company may only engage in activities as per its approved and registered business scope. Therefore, it is important to confirm a counterpart's business scope before signing a contract, or at the very least to include the counterpart's warranties to that effect. Other grounds for invalidity could be the prohibition of a certain transaction under Chinese law, and legal obstacles in the contract itself. Under the current Contract law, a contract will be deemed as invalid if it does not comply with Chinese laws or administrative regulations. In judicial practice, the court or arbitrator have discretion to hold a contract valid or invalid if a party signs a contract for business outside its business scope. However, if the contractual business is strictly prohibited by laws or administrative regulations, the contract will certainly be held invalid.

b) Practical implementation

While it is not illegal to conclude a contract that is difficult or impossible to implement, it is impractical. And thus companies are encouraged to take careful consideration of the commercial realities of China's business environment. With a careful assessment of risks, with regard to terms of payment and delivery for example, the parties may be able to avoid future disputes. Also the terms of a contract should be balanced: each of the parties to the contract should view it as a fair description of the intended transaction to be carried out.

If one of the parties is not satisfied with the terms, it will likely avoid or try to re-negotiate terms at a later stage. Chinese companies in particular are prone to such tactics – it may be better to come to a mutually beneficial deal beforehand.

c) Practical enforcement – dispute resolution

Foreign parties in particular must carefully consider which law should be applicable to a contract, and how disputes, if they arise, are to be resolved. While an international forum for dispute resolution could be beneficial, one crucial aspect to choosing the forum is to assess whether a favorable judgment can be executed (i.e. enforced against the property of the counterpart) against the assets of the losing party.

If the judgment is made by a foreign court, then execution of the judgment in China is often very difficult. One popular alternative is to designate an arbitration tribunal to resolve any disputes that may arise from the contract. To ensure legality, an arbitration clause must be drafted in the proper way – if it is, then the arbitration award can be executed in China against assets held in China.

A commercial assessment can be made of which arbitration tribunal would be in the best position to handle potential disputes. The China International Economic and Trade Arbitration Commission (CIETAC) in Beijing, Shanghai International Economic and Trade Arbitration Commission (SHIAC) in Shanghai, and South China International Economic and Trade Arbitration Commission (SCIA) in Shenzhen are institutions favored by many to deal with China-related disputes.

2. Potential Issues of Dispute

a) IPR management

Currently, the protection of intellectual property rights (IPR) protection is a serious problem in China. Many IPR disputes arise from business relationships, where suppliers, distributors or business partners take advantage of the IPR of their (foreign) partner. To prevent unnecessary disputes, a good management of IPR in transactions is advised; contract terms may go far to protect IPR ownership in a commercial transaction.

Clauses in a Sales Agreement designed to protect the seller may be as follows:

- *The ownership and usage rights of the intellectual property rights of trademarks, copyright and patents and so forth will not transfer with the transfer of the ownership of the Products;*
- *Without the written consent of the Seller, the Buyer (and/ or other parties, including business partners and employees of the Buyer) may not manufacture, process, copy or print any signboards, packaging, advertising brochures, or any other articles carrying the Seller's trade name, the Seller's trademarks, patents wordings, designs or other contents relating to the Seller; and*
- *In the event that the Buyer (and/ or other parties) violates any provisions of this Agreement, the Seller may terminate this Agreement at any time and reserves the*

right to claim for legal liabilities and damages.

For the buyer, the following clauses may be considered for a Purchase Agreement:

- *The Seller warrants to the Buyer that the Products including packaging do not infringe any patent, copyright, trademark or other intellectual property rights;*
- *The Seller warrants that it will not use any of the trade names, logos, or branding supplied by the Buyer and the Seller warrants that it will not interfere or compete with the Buyer's exclusive right to sell the Products; and*
- *The Seller shall indemnify the Buyer in full against all liability, loss, damages, costs and expenses (including legal expenses) awarded against or incurred or paid by the Buyer as a result of or in connection with any claim that the Products or their packaging infringe, or their importation, use or resale, infringes, the patent, copyright, design right, trademark or other intellectual property rights of any other person, except to the extent that the claim arises from compliance with any Specification supplied by the Buyer.*

b) Loss prevention / payment security

Depending on the financial status and the credibility of a party, payment security and loss prevention measures should be considered during bargaining for a contract or in the course of performance of the contract. Methods of legal and/or commercial nature frequently used in China are the following:

- Due diligence on the opposing party through: (i) credit investigation / D&B (Dun and Bradstreet) report; (ii) company search with registration authorities; (iii) asset investigation with the real estate authorities and other governments; and (iv) on-site visit and physical investigation of the target company;
- To secure the payment, the company can pay by domestic or international L/C, requiring a deposit or advance payment for the transaction, requesting a bank guarantee (practical in special cases only), or claiming legal lien in certain circumstances;
- Where a breaching party is transferring subject matters of the contract or its assets, the other party is entitled to apply for provisional remedies by the court, such as property preservation and evidence preservation.

c) Disputes over quality and quantity

Disputes in sales and purchase contracts, storage contracts, and transportation contracts for example often center on cargo quality and quantity. A general and practical way is to provide in advance for a clear set of procedures for settlement resolution in the contract, with reference to a final and binding inspection report issued by an independent inspector.

A sample clause in a sales and purchase contract on quality and quantity inspection

during the loading of the cargo could be as follows:

The quantity / quality of the Product shall be determined by the commodity inspection agency or independent surveyor as agreed by the Buyer and the Seller (the “Inspection Agency” or the “Independent Surveyor”) before the loading of the Product. The quantity of the Product delivered via truck shall be calculated by_____. The quality of the Product shall be determined by sampling before the Product is loaded onto the truck or bulk ship. The outcome of inspection of quantity and quality of the Product made in accordance with this clause shall be final and binding upon the Buyer and the Seller. Such an outcome shall be taken as the basis for any and all disputes arising from this Agreement over the quantity or quality of the Product between both parties.

3. Correspondences as evidence

Under Chinese evidence law and in judicial practice, documentary evidence prevails over witness testimony. Thus during the performance of a domestic transaction, the parties should keep all important correspondences as potential evidence for any possible dispute. In any case, any correspondence directly relating to the performance of the contract should reach the opponent in a provable way (e.g. by delivery against signature), or as agreed upon in the contract. An example of a clause to regulate correspondence is as follows:

All notices, requests, demands, and other communications required by, or made in connection with, this Agreement or the transactions contemplated by this Agreement (the “Notices”), shall be in writing and shall be deemed to have been duly given on the date of delivery, if delivered in person, or three days after mailing if mailed by certified or registered mail, postage prepaid, return receipt requested, addressed as follows:

If to Party A: _____

If to Party B: _____

If the Notices are in the form of faxed copy, it shall be faxed to Party A at 86-20- or 86-20- and to Party B at 86-20- or 86-20- . If the Notices are in the form of email copy, it shall be emailed to Party A at _____ or _____ and to Party B at _____ or _____. The Notices in the form of fax and email shall be deemed to have been duly given upon the receipt of the same by the party to be notified. Such addresses may be changed, from time to time, by means of a notice given in the manner provided in this Section.

IV. Comments

The negotiation of contracts in China can be a long and arduous task. However, such negotiations are an important step in ensuring that a transaction will go as planned. And without a detailed contract, enforcement will become much more difficult.

But having “just” a contract is insufficient. The aim of the parties should be to have a contract that accurately reflects the agreements between the parties, protects their interests, and – if necessary – can form the basis of proceedings to enforce its terms.

Would you like to receive further information on this or any other topic related to your investment in China?

Please feel free to contact us at:

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