

# Overview of PRC Contract Law and Managing Legal Risks in Contract Drafting

---

**RHK Legal**  
**Richard Kimber**  
**Managing Partner**

# Outline

---

- **Overview of PRC Contract Law**
- **Supreme Court Interpretations**
- **Effective Contract Drafting**
- **Essential Issues in a Sale and Purchase Contract**
- **Case Study**
- **Q & A**

# PRC Contract Law

## 3 Parts:

1. General Provisions-dealing with validity, performance, amendments, termination and liabilities and penalties for default
2. Specific Provisions-sets out the rules applicable to 15 (fifteen) specific types of contracts.

Sales

Loans

Intermediation

Transportation

Warehousing

Brokerage

Energy

Lease and Financial Lease

Construction Projects

Technology

Commission

3. Supplementary Provisions-adopts the UCL and abolishes previous laws.

# Choice of Law

---

## Foreign Related

Foreign-related (shewai hetong) contracts:

- (a) One or both of the parties are foreigners
- (b) Subject matter of contract is in a foreign country
- (c) The contract was made, modified or terminated in the foreign country.

- But note: PRC Supreme Court often has power to apply PRC law if in public interest

# Proper Law

- Also PRC law must apply to 3 types of “foreign-related” investment contract:
  - (i) Chinese-foreign equity joint venture contract
  - (ii) Chinese-foreign cooperative joint venture contract
  - (iii) Contract for exploitation/exploitation of natural resources within China

# Essential Terms

The essential terms of a binding contract:

- (a) offer(要约)
- (b) acceptance (承诺)
- (c) consideration (对价)
- (d) capacity (订立合同的能力)
- (e) intention to create legal relations(创立合同关系的意图)

**However** – no specific content requirement for PRC contracts  
(see Article 12, UCL)

# Formation of Contract

---

## Offer & Acceptance

- PRC contract formed on basis of offer and acceptance
- Note: **no** requirement of **consideration**
- Definition of “offer”: a declaration of intention to conclude a contract which:
  - (1) is sufficiently specific and definite; and
  - (2) indicates that offeror will be bound by acceptance

# Consideration of Certain Contractual Issues under PRC Law

---

- Representations and Warranties
- Exemption / Limitation of Liability
- Standard Terms
- Security for Performance
- Damages for Breach of Contract
- Contracts Subject to Governmental Approval / Registration



# Representations and Warranties

---

- Representations
  - Pre-Contractual statements
  - Present or past facts
  - Made to induce a party to enter into a contract
  - Legal consequence-rescind contract
- Warranties
  - Contractual statements or promises
    - That a fact is true—e.g.—SPA, warranties about the target companies or business being acquired.
  - Legal consequences-claim damages and terminate contract

Therefore – a party who negotiates

a contract in bad faith, or conceals important facts or provides false information (Article 42 of UCL)

Legal Consequence:

- Contract Void – if untrue statement was made to induce a party to enter into a contract by deceit

Or Contract Voidable

- may need to petition court or arbitration tribunal

**Therefore** — check that representations or warranties you give can be substantiated.

# Exemption / Limitation of Liability

---

- **Validity under PRC law?**
- A standard clauses is **void** if circumstances under Article 52 or 53 of UCL exist:
  - (1) it exempts liability; OR
  - (2) it increases the liability of other party; OR
  - (3) it deprives the other party of a major right

- What are some examples of “exemption clauses”?
  - “In no event will company be liable to you for any lost profits, lost savings or direct or indirect, special or consequential damages, arising out of your use or inability to use the Product or the breach of this agreement.”
  - “Neither party’s liability to the other arising out of or related to this agreement will exceed the total costs of the software, services or product. Liabilities limited by the preceding sentence include, without limitation, liability for negligence.”

# Exemption / Limitation of Liability (cont'd)

---

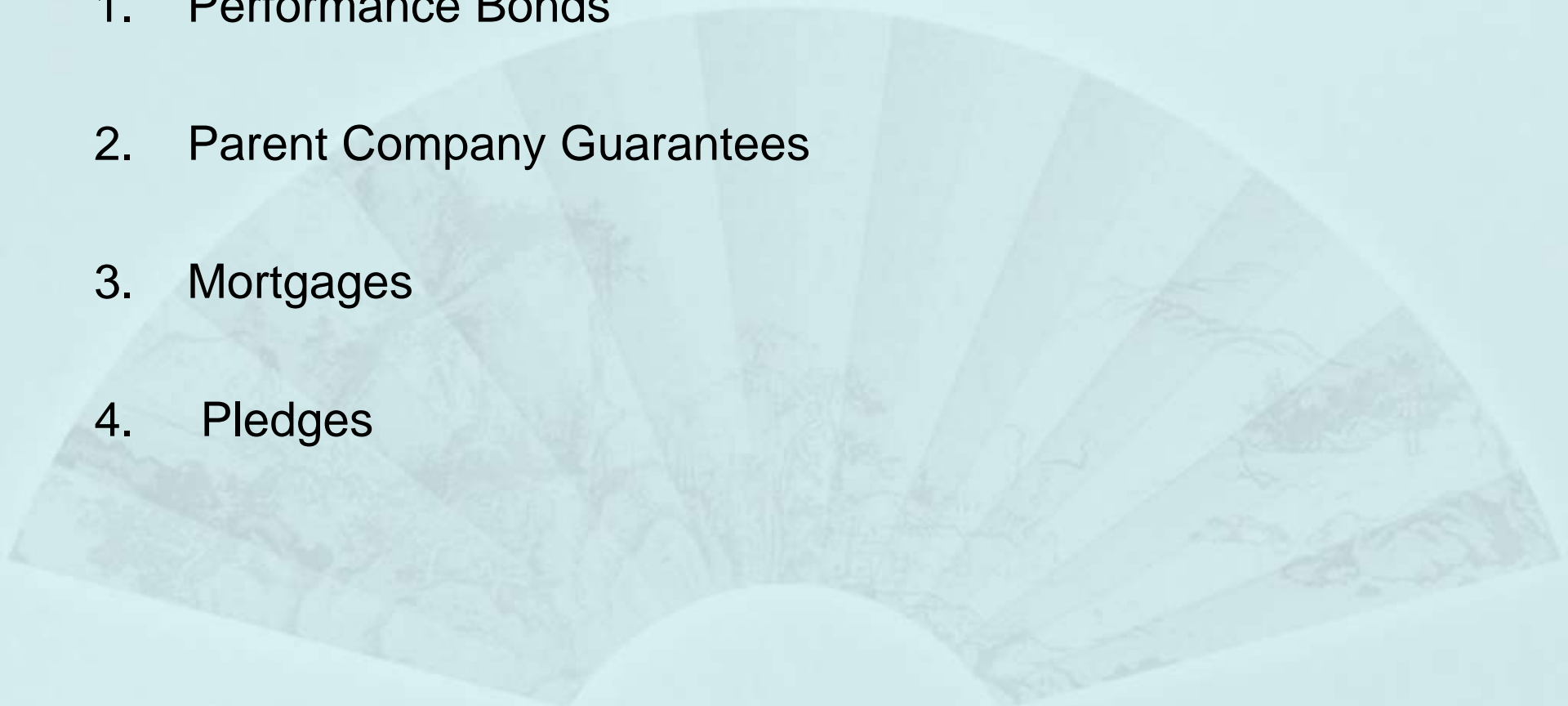
- Article 52
  - Contract void if:
    - Entered into by deceit
    - Harms State or Third Party Interest
    - Harms public interest
    - Illegal purpose
- Article 53
  - Terms Void if:
    - Exclude liability for death or personal injury
    - Exclude liability for property damage due to willful misconduct or gross negligence.

## Therefore:

- Make sure clauses do not contravene Article 52 or 53
- Remember-standard exemption clauses may be voidable or void
- Ensure exemption clauses are clearly stated in contract-highlighted or capitalized - Article 39 UCL

# How to Secure Performance of A Contract

---

1. Performance Bonds
  2. Parent Company Guarantees
  3. Mortgages
  4. Pledges
- 

# Performance Bonds

1. Usually insisted on by a purchaser to guarantee performance by a vendor/supplier where purchaser has made a pre-payment or installment before delivery of product.
2. Issued by a bank or financial institution
3. Often called “on demand” performance bond as the bank has a strict liability to pay the non-defaulting party on presentation of a written demand to the bank by the purchaser.
4. 10% of contract price or equal to advance payment.
5. Bank will charge an administration fee (2%) for provision of Performance Bond.
6. Performance Bond has to be drafted with reference to underlying contract, i.e. detail circumstances or defaults which give rise to a call on the PB.



# Performance Bond

---

- See: Sample Performance Bond Wording
- (what is the deficiency?)
- Remember: if issued for benefit of foreign party it has to be registered with SAFE to be enforceable.
- *See: Administration of the Provision of Security to Foreign Entities by Domestic Institutions Procedures*
- Recommend: include in PB written undertaking by bank to obtain SAFE registration or insist PB be issued by bank in home jurisdiction of beneficiary (purchaser).

# Parent Company Gtee

If no SAFE registration, Supreme Court will likely rule not legally binding.

Foreign Related Guarantee: ie a Guarantee to an Offshore Entity or a Forex Guarantee – Parent Company Guarantor must apply for SAFE approval and registration within 15 days of executing Guarantee. – otherwise unenforceable.

See – Article 42(3) of UCL

If Beneficiary seeks to enforce Guarantee it must apply for SAFE approval.

If Guarantor does not pay the beneficiary must sue Guarantor in court of competent jurisdiction.

**Preferred Alternative:** Join Parent Company as party to contract – and insert joint and several liability clause

# How to Secure Performance of Contract (cont'd)

---

- Mortgage
  - usually created over
    - Land Use Rights
    - Buildings
    - Machinery, vehicles and other assets
- Mortgage contract subject to registration requirements
- Mortgagee realizes its rights from the proceeds of sale of the mortgaged assets

# How to Secure Performance of Contract (cont'd)

---

- Pledge
  - Share Pledge
    - Pledge of shares require approval and registration

# Damages for Breach of Contract

---

- General Freedom of Contract Principle – full compensation for loss.
- **Article 113**
  - Damages equivalent to loss suffered due to the breach, including loss of expected economic interest, but not to exceed loss the party in breach foresaw or should have foreseen when signing the contract.
- Specific Performance also available  
(Article 109, 110)

- **Liquidated Damages** (Article 114, CL)
- Parties may stipulate in K
- Court or arbitral tribunal may reduce or increase amount depending on the actual loss incurred (see Supreme Court Interpretation – 13 May 2009)
- **Recommendation** – when drafting contract with Chinese party where possible apply fixed amounts for damages, e.g. with reference to percentage of total contract price or amount of payment instalments.
  - a clear calculation method / formula

# Supreme Court Interpretations

---

- Supreme People's Court's Interpretation on Several Issues Concerning the Application of the Contract Law (II) ("Interpretation") -13 May 2009

It Covers:

- a) Liability for bad faith in negotiations;
- b) Post-contract substantial change in circumstances;
- c) Modification of liquidated damages;

---

a) **Article 42 UCL** – negotiation in bad faith.

E.g. party B fails to file contract requiring registration - share transfer agreement, joint venture contract etc



---

Therefore:

- (i) Clearly spell out performance obligations of a party, either as conditions precedent or as express obligations.  
e.g. obtain approval or registration of contract with approval authorities

## b) Change of circumstances

The Interpretation introduces the concept of "change of circumstances" . A Party will be allowed to apply to the People's Court to modify or terminate the contract where:

- after the contract is concluded, a substantial change of circumstances occurs;
- the change of circumstances is unforeseeable when the contract is concluded;
- the change of circumstances is not caused by force majeure (which situation is dealt with by separate statutory provisions in the PRC);
- the change of circumstances is not a commercial risk; and
- it is obviously unfair to a party or the purpose of the contract would be frustrated if the parties continued to perform the contract.

**Question:** Undermines freedom of contract principles and “force majeure” is designed to already deal with this issue?

Risk – party may seek to avoid performance.

## c) Modification of liquidated damages

**Article 114** of the Contract Law provides that a party may petition the People's Court or an arbitration commission to increase the amount of liquidated damages if the sum stipulated in the contract is lower than the loss incurred. Similarly, if the amount of liquidated damages stipulated grossly exceeds the loss incurred, a party may petition the People's Court or an arbitral institution to reduce the amount as appropriate.

The Interpretation provides guidance on the application of this rule and states that:

- liquidated damages of 30% more than the actual loss incurred can be considered to grossly exceed the loss incurred triggering the courts power to reduce the amount of the liquidated damages;
- if the liquidated damages amount is lower than the actual loss, the court can increase the amount of the liquidated damages up to the amount of the actual loss.
- After the modification of the liquidated damages, the aggrieved party cannot seek any additional compensation for its loss.

# Alarm Bells

---

**But:** how will court assess actual loss. This is evidence of innocent party therefore difficult to see how defaulting party can adduce evidence that loss is overstated.

## Alarm Bells (cont'd)

---

- Concept of Liquidated Damages was to avoid risk of court intervention. This directive seems to undermine “freedom of contract” principles i.e. parties freely agreeing amount of damages.

**So:** May lead to preference for arbitration as arbitrators being “commercial men” less likely to interfere with concept of liquidated damages.

## See Also

### **SAIC-Measures for Supervision and Administration of Illegal Contract Acts-13 November 2010**

- Provides protection for consumer against standard form and printed contracts which impose excessive liabilities on a consumer for breach of contract.
- The Measures protect against three types of actions:
  - Contractual Fraud in obtaining money or valuables by means of fabricating facts or concealing truth.
  - Engaging in bribery, coercion or collusion with another person in the use of a contract.
  - Infringe upon the interests of the consumer by using a standard contractual clause to increase the liabilities of the consumer while reducing the liabilities of the business operator using the standard clause.

Sanctions – up to 3x illegal benefit but capped at RMB 30,000

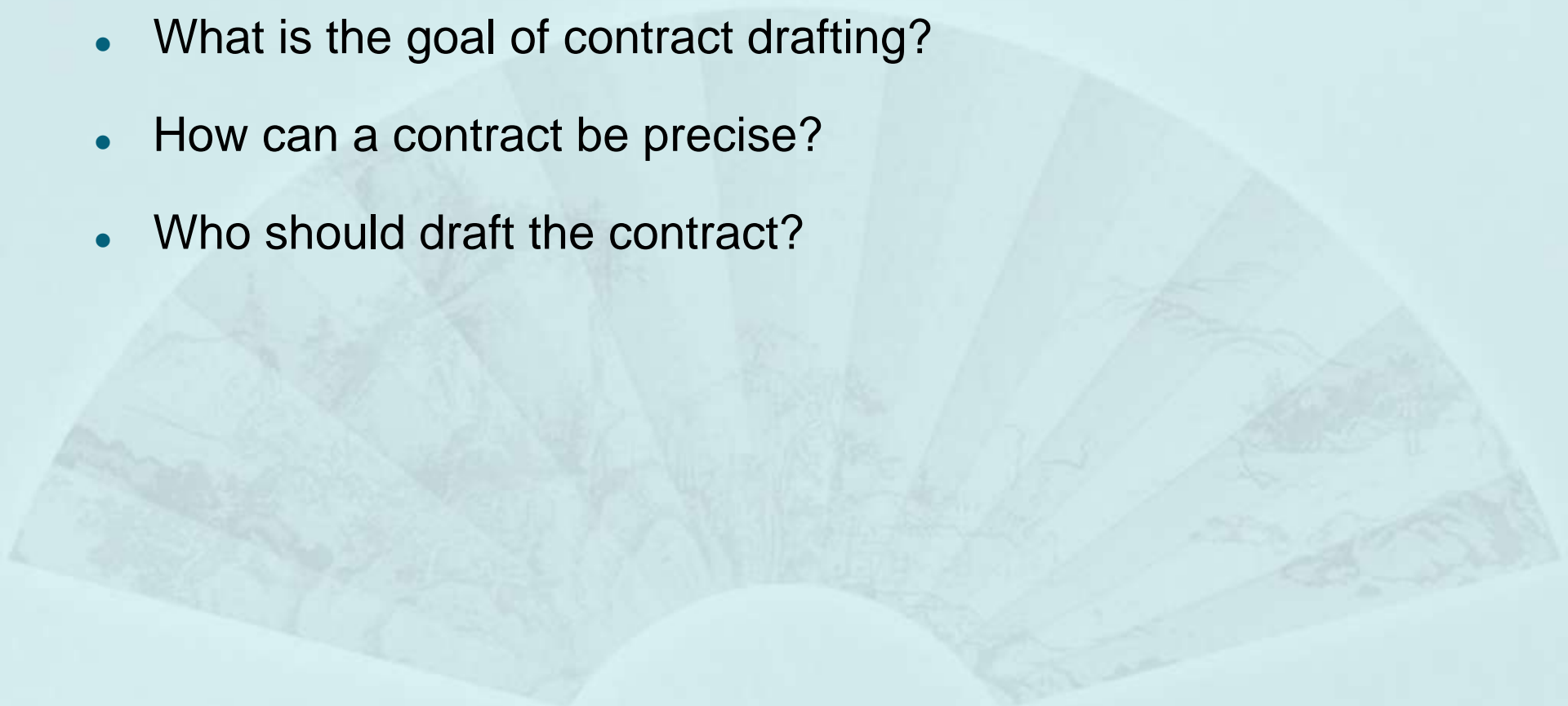
# Effective Contract Drafting

---

1. Introduction to Drafting
2. Contract Language
3. Principles of Contract Interpretation
4. Contract Drafting Basics
5. Contract Elements
6. Boilerplate Clauses
7. Conclusion

# 1. Introduction to Contract Drafting

---

- What is the goal of contract drafting?
  - How can a contract be precise?
  - Who should draft the contract?
- 



## 2. Contract Language

---

What makes contract language “special”?

- Precision
- Desire to avoid ambiguity

# Obligations, Authorizations and Conditions

---

- Use “will” to state a future fact
- Use “shall” to state an obligation
- Use “may” to state an option or a right
- Use “must” to state a condition precedent

# Plain English Drafting

---

- Short sentences
- Definite, concrete, everyday language
- Use active tense
- Separate paragraphs and sections, with headings, for separate concepts
- Avoid legal jargon or highly technical phrases and avoid use of Latin or other foreign languages

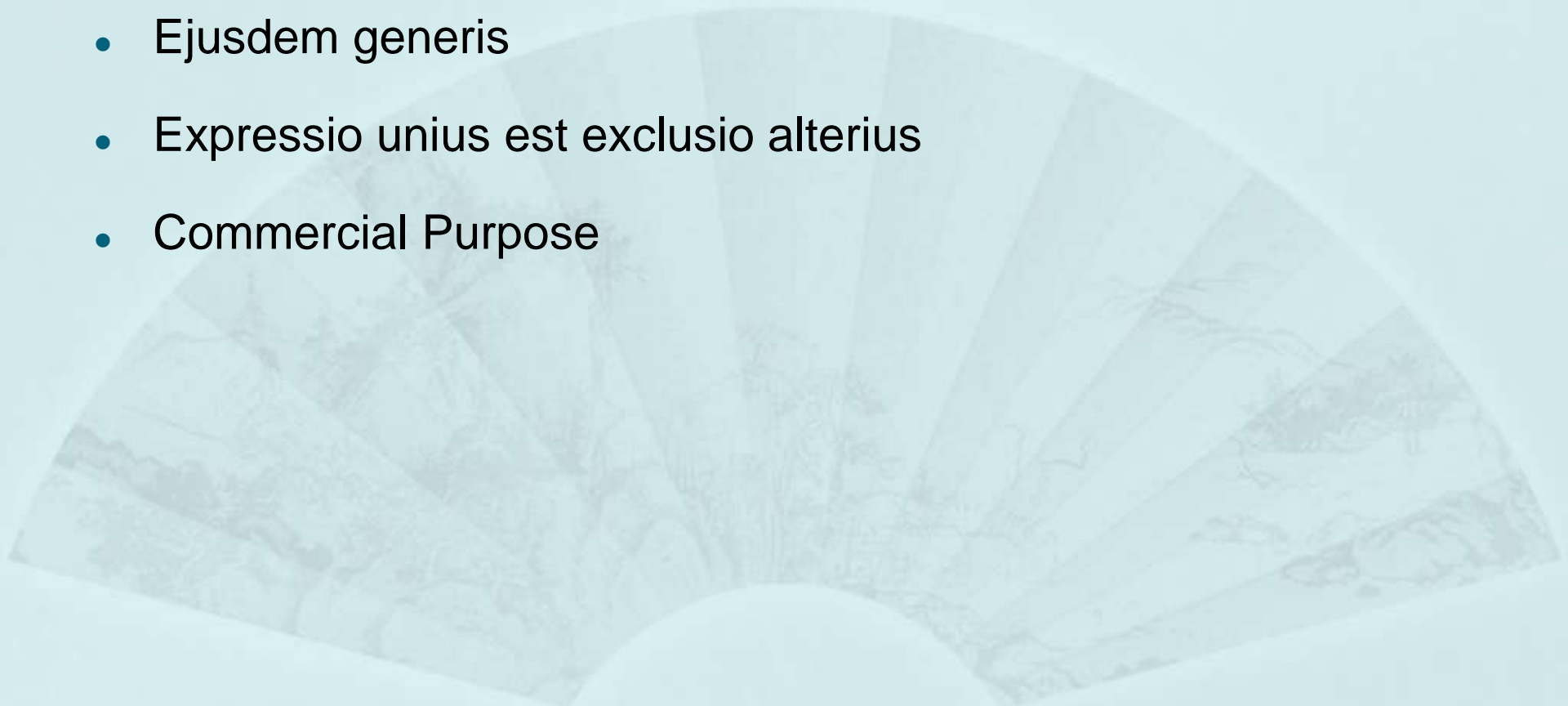
# 3. Principles of Contract Interpretation

---

- The document must be read as a whole
- The Literal and Golden Rules
- Ut res magis valeat quam pereat
- Contra Proferentem
- Noscitur a sociis

# Principles of Contract Interpretation

---

- Eiusdem generis
  - Expressio unius est exclusio alterius
  - Commercial Purpose
- 

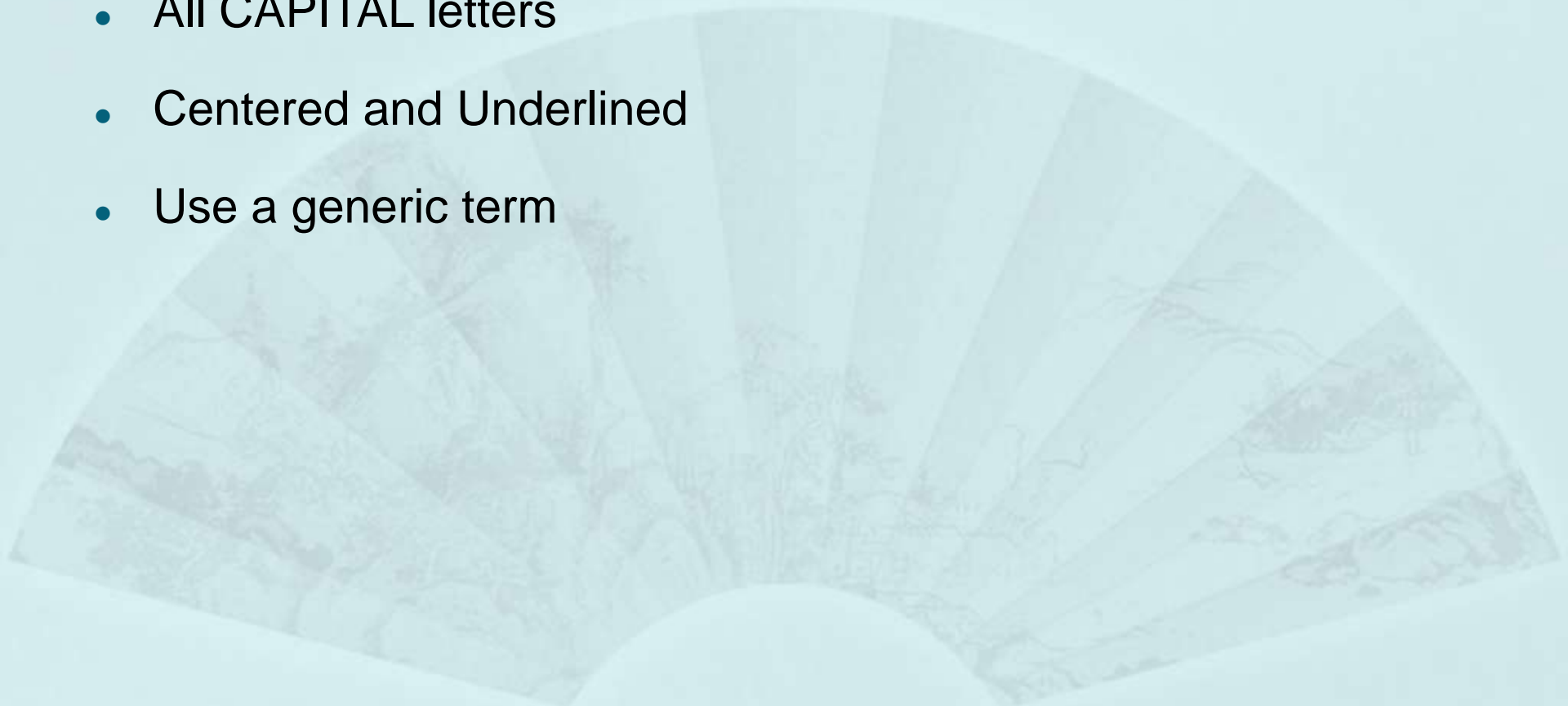
## 4. Structure of a Contract

---

- Title
- Introductory paragraph
- Preamble/Recitals/WHEREAS Clauses
- DEFINITIONS
- Operative Clauses
- Representations, warranties, covenants, indemnities, guarantees, releases
- Events of default and remedies
- Boilerplate
- Signature Block
- Exhibits and Attachments

# Titles

---

- All CAPITAL letters
  - Centered and Underlined
  - Use a generic term
- 

# Introductory Paragraph

---

Example:

This Agreement (hereinafter referred to as the “Agreement”) is made by and between ABC Limited (hereinafter referred to as “Seller”), with its registered office at 1701 Beijing West Road, Shanghai 200126, and XYZ Limited with its place of business at 19 Queens Road Central, Hong Kong (hereinafter referred to as “Purchaser”).



# Preamble/Recitals

---

- WHEREAS ... tells the story

Facts about:

- Relationship and goals of the parties
- Nature of the transaction
- Other related transactional documents

... The parties agree as follows:

# Definitions

---

## **Inclusive:**

- “Intellectual Property” means intellectual property as that term is generally used and includes all patents, copyrights, and trademarks.

(see sample)

## **Exclusive:**

- “Intellectual property” means patents, copyrights, and trademarks.

# Signature Block

---

The Parties agree to the terms of this Agreement above.

---

**Seller**

**ABC Limited.**

**By:\_\_\_\_\_**

**Name: John Smith**

**Title: Director**

**(chop)**

**Licensee**

**XYZ Limited**

**By:\_\_\_\_\_**

**Name: Kevin Chang**


**Title: Owner**

**(chop)**

---

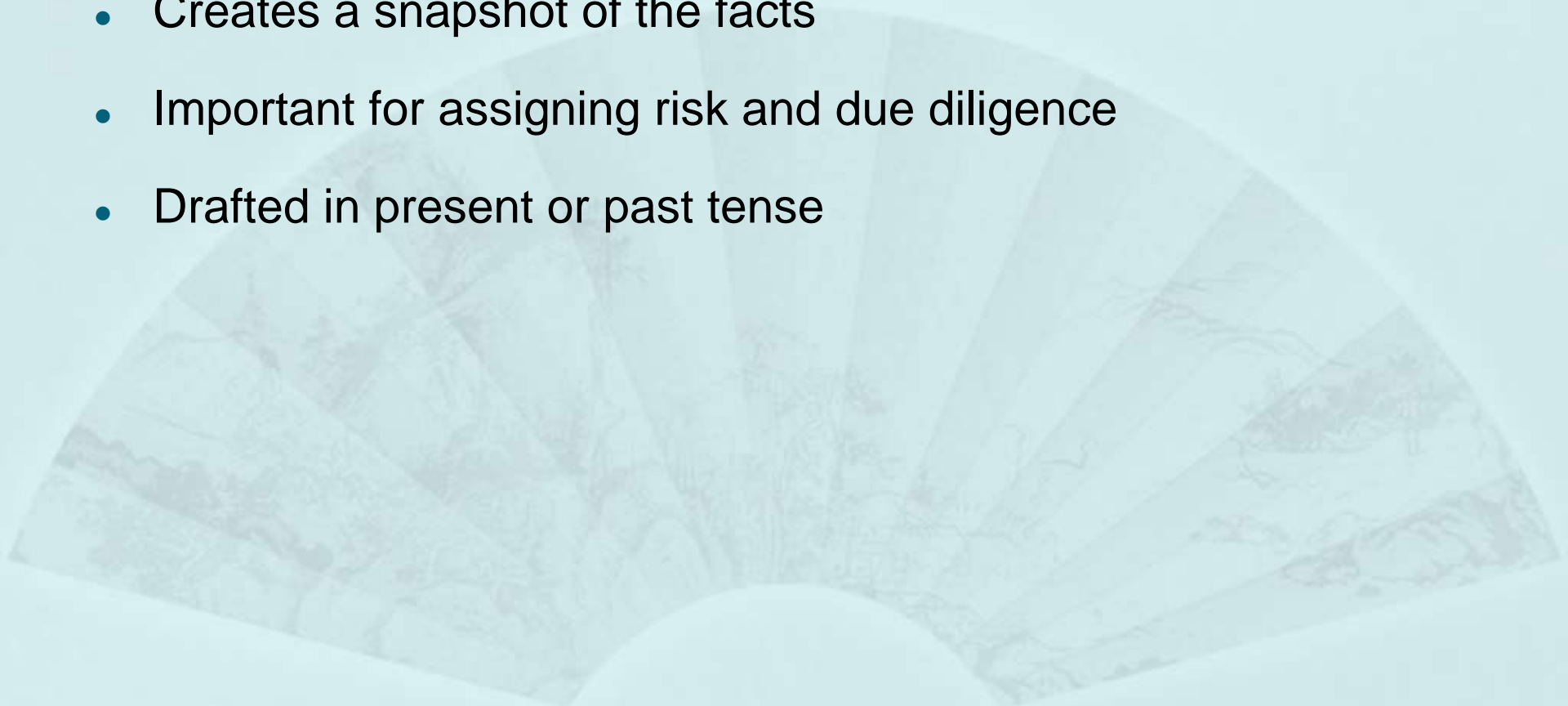
## 5. Contract Elements in Detail

---

- Representations and Warranties
  - Covenants
  - Conditions Precedent
  - Remedies
  - Language to soften provisions
- 

# Representations and Warranties

---

- Creates a snapshot of the facts
  - Important for assigning risk and due diligence
  - Drafted in present or past tense
- 

# Covenants

---

- Affirmative covenants
- Negative (Restrictive) covenants
- Financial covenants
  
- Example:

“Licensee shall pay licensor a royalty of five percent (5%) of Licensee’s selling price for each Licensed Product manufactured, used, or sold by Licensee in the Territory or imported by Licensee into the Territory.”

# Conditions Precedent

---

- Requirements that must be satisfied before one party has to perform or before the contract is enforceable



# Remedy Provisions

---

- Triggering Event → Remedy

Four types:

- Termination
- Acceleration
- Indemnification
- Liquidated Damages



## Remedy: Termination

- “In the event Purchaser defaults in the performance of any covenant or agreement made hereunder, as to payments of amounts due hereunder or otherwise, and such defaults are not remedied to the Seller’s satisfaction within ten (10) days after notice of such defaults, **the Seller may, thereupon terminate this Agreement.**”

## Remedy: Acceleration

---

- “Whenever, within the sole judgment of Seller, the credit standing of Purchaser shall become impaired, Seller shall have the right to demand that the remaining portion of the contract be fully performed within ten (10) days.”

# Remedy: Indemnification

---

- Breaching party indemnifies (pays back) innocent party for all costs, damages and losses suffered as a result of the breach.

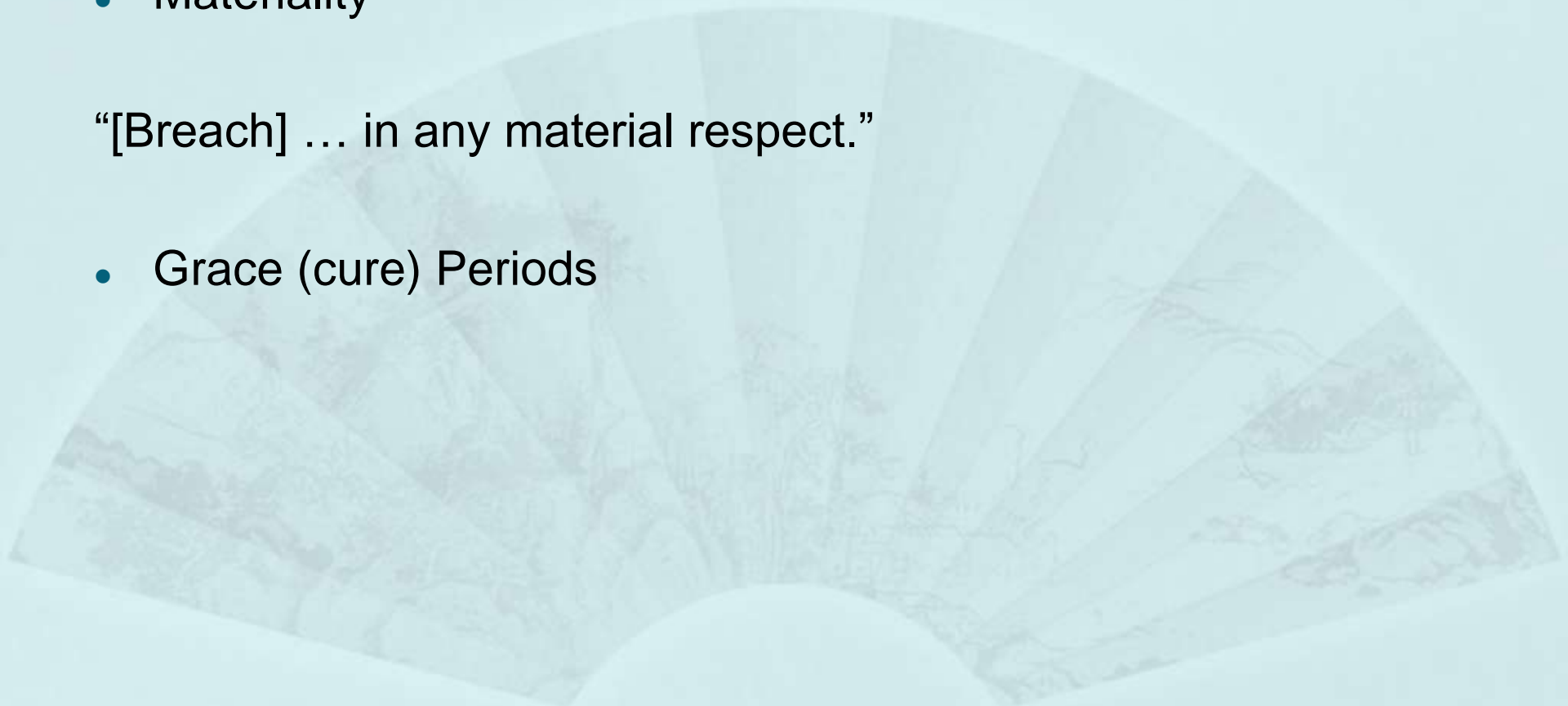
# Softening Remedies

---

- Materiality

“[Breach] ... in any material respect.”

- Grace (cure) Periods



# Softening Contract Provisions

**Stronger**



Good Faith

Reasonable Efforts

Diligent Efforts

Best Efforts

Within a Reasonable Time

## 6. Boilerplate Provisions

---

What does “boilerplate” mean?

- Miscellaneous
- Pre-litigation planning
- NOT unimportant!

# Arbitration

---

- Why go to arbitration?

## Example Clause:

“Any controversy or claim arising out of or relating to this Agreement, or its breach, is to be settled by arbitration administered by [organization] in accordance with its [subject matter] Rules.”

- Arbitration or Mediation?

# Choice of Law

---

- ALWAYS include this provision
- Which law should you choose?

## Example

“This Agreement and the rights and obligations of the parties hereunder shall be governed by, and construed and interpreted in accordance with, the laws of the Hong Kong Special Administrative Region.”



# Consent to Jurisdiction

---

- Choice of forum provision

Example:

“Each party shall submit to any court of competent jurisdiction for purposes of the enforcement of any award, order or judgment. Any award, order or judgment pursuant to arbitration is final and may be entered and enforced in any court of competent jurisdiction.”

# Counterparts

---

- Contract may be executed separately by parties
- Common for international agreements



# Headings

---

- What is the proper function of headings?

Example:

“The descriptive headings of the Articles, Sections and subsections of this Agreement are for convenience only, do not constitute a part of this Agreement, and do not affect this Agreement’s construction or interpretation.”

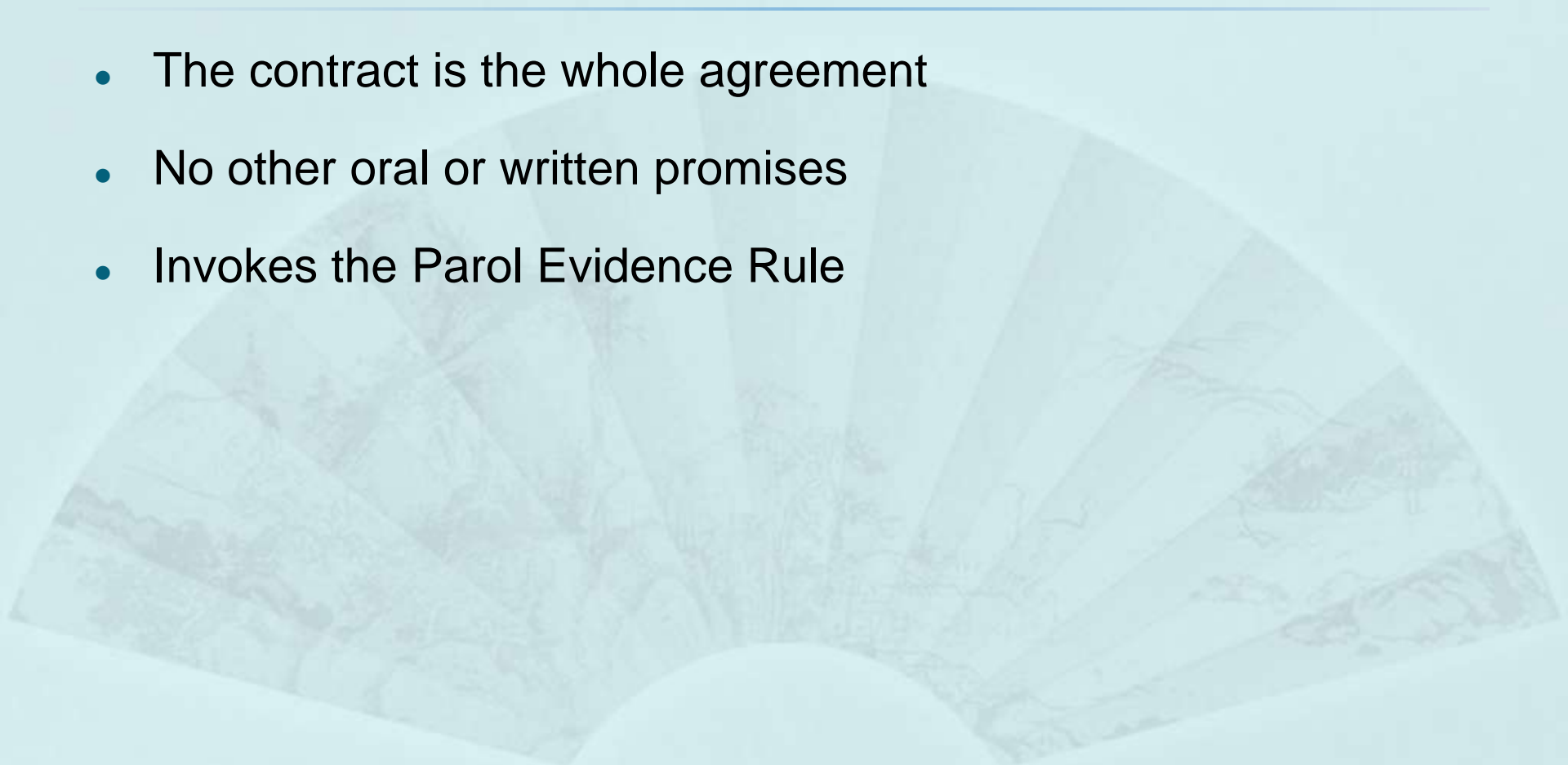
# Severability

---

- Remove (sever) void or unenforceable provision and remaining terms are still enforceable.

# Integration

---

- The contract is the whole agreement
  - No other oral or written promises
  - Invokes the Parol Evidence Rule
- 

# Waivers

---

- No Waivers
- No effect on failure or delay to enforce rights



# Amendments

---

- In Writing
- Signed
- Identify the original agreement by its date or contract no.

Example:

“The parties may amend this Agreement only by a written agreement, signed by the parties, that identifies itself as an amendment to this Agreement.”

# Costs and Expenses

---

- Parties cover their own expenses unless otherwise stated.
  - Minor, but it avoids arguments
- 



# Further Assurances

---

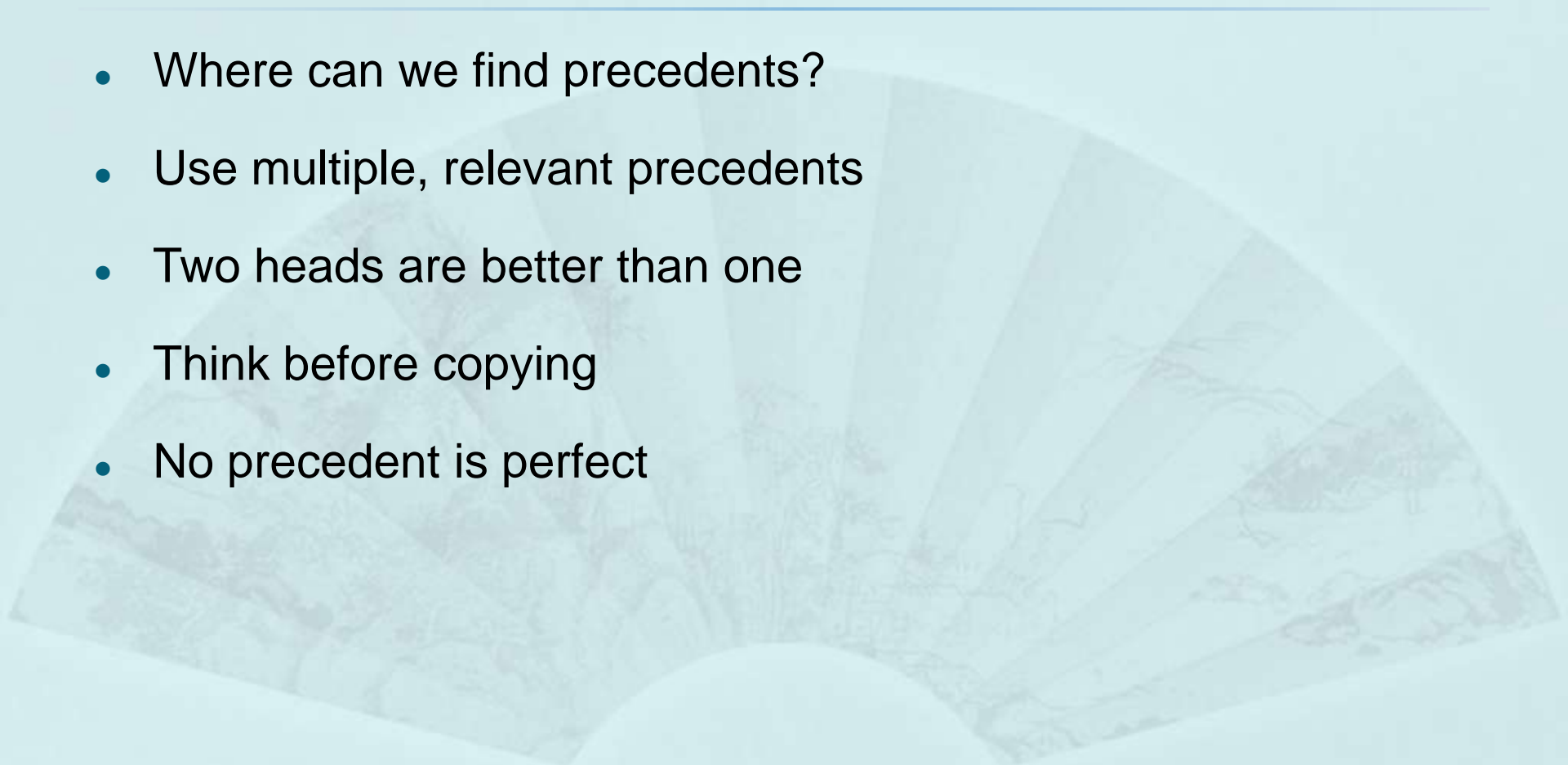
- Attempts to deal with unforeseen circumstances

Example:

“The parties agree to do such further acts and things and to execute and deliver such additional agreements and instruments as may be reasonably necessary to give effect to the purposes of this Agreement and the parties’ agreements hereunder.”

# Final Thoughts: Precedents

---

- Where can we find precedents?
  - Use multiple, relevant precedents
  - Two heads are better than one
  - Think before copying
  - No precedent is perfect
- 

# ESSENTIAL ISSUES IN A SALE OR PURCHASE CONTRACT

---

- Party Identification
- Subject Matter
- Quantity
- Quality
- Price
- Time Limit, Place and Method of Performance
- Liability for Breach
- Dispute Resolution
- Deposit or Advance Payment
- Special Terms

# Party Identification

- Exact name of contracting party is important
- Verify party's name is the same as on business license
- Subsidiaries often have similar names to head company but have independent legal status
- Failure to check and party may not exist
- Verify the party's scope of business and that business license is current.

**WHY**—some business scopes require additional licenses or certifications to perform contract.

Ask for all licenses.

# Subject Matter

---

- Means goods to be purchased or sold
- Ensure detailed specifications and descriptions for each product type

## Quantity

- Ensure clarity on exact number of units or amount of units
- Be precise on measurements, e.g. using “meters” or using weight as measurement (such as gram or metric ton) or assembled units (“100 pairs”) or (“100 bundles”)
- Imprecise terms on quantity can give rise to high losses

# Quality

---

- Contract should clearly define quality standards
- State clearly time limit for raising quality objections

**Note:** Article 62 of UCL—if parties do not specify product quality demands, contract performance will be governed by government standards which are often lower.

--if no government standard then industry standard may apply.

# Price

---

- Product price must be clearly stated
- Try and use both “unit price” and “total price” so if partial non-performance you can apportion or calculate the claim amount
- If the price is not clearly stated, Chinese law requires the application of market price at the time contract was performed.

# Time Limit, Place and Method of Performance

---

- Time limit clauses must clearly state “product delivery” dates and “payment date”
- Avoid terms such as “payment after delivery” or “product delivery after payment” – too vague and gives basis to delay shipment or payment
- Include a term which identifies a person to sign for receipt of goods
- If place of performance is not clearly stated the UCL will provide that place of performance is to be “at place where payee is located”.



# Measure of Liability

- Causes the most problems
- Try to avoid terms such as “breaching party will assume all liability for contract breach”
- A properly drafted liquidated damages clause is always recommended and the best method for calculating liquidated damages
- Party should also include calculation method for “foreseeable profit” in calculating indirect losses

**Remember** the Chinese Supreme Court Interpretations 2009 and draft accordingly.

# Dispute Resolution

---

- China doesn't recognize "ad hoc" arbitration
- Specify exact arbitration body (e.g. Suzhou Arbitration Commission or CIETAC, Shanghai branch)
- Jurisdiction should be considered based on your interest
- If litigation then note Article 25 of the Civil Procedure Law which provides that contracting parties may specify "the place where the contract is performed, where the contract is signed, where a party has its domicile etc."

# Deposit or Advance Payment

- Deposit and Advance Payment have different legal meanings under Chinese law.
- A Deposit is one method of providing security for a debt obligation. Once the debtor performs the debt obligation, the deposit must be deducted from the debt payment amount or returned to the debtor.
- Where debtor pays the deposit, no legal grounds exist for refund of deposit if debtor fails to perform its contract obligations.
- Where party receives the deposit and does not perform its obligation, Chinese law provides that the party must return (2 X the deposit) as a penalty.

# Special Terms

---

## Right to Offset

- From a Buyer perspective—make sure you have a right to offset any amount owed by the Seller against payments due to Seller

## **Remember:**

-- offset right does not exist unless clearly stated

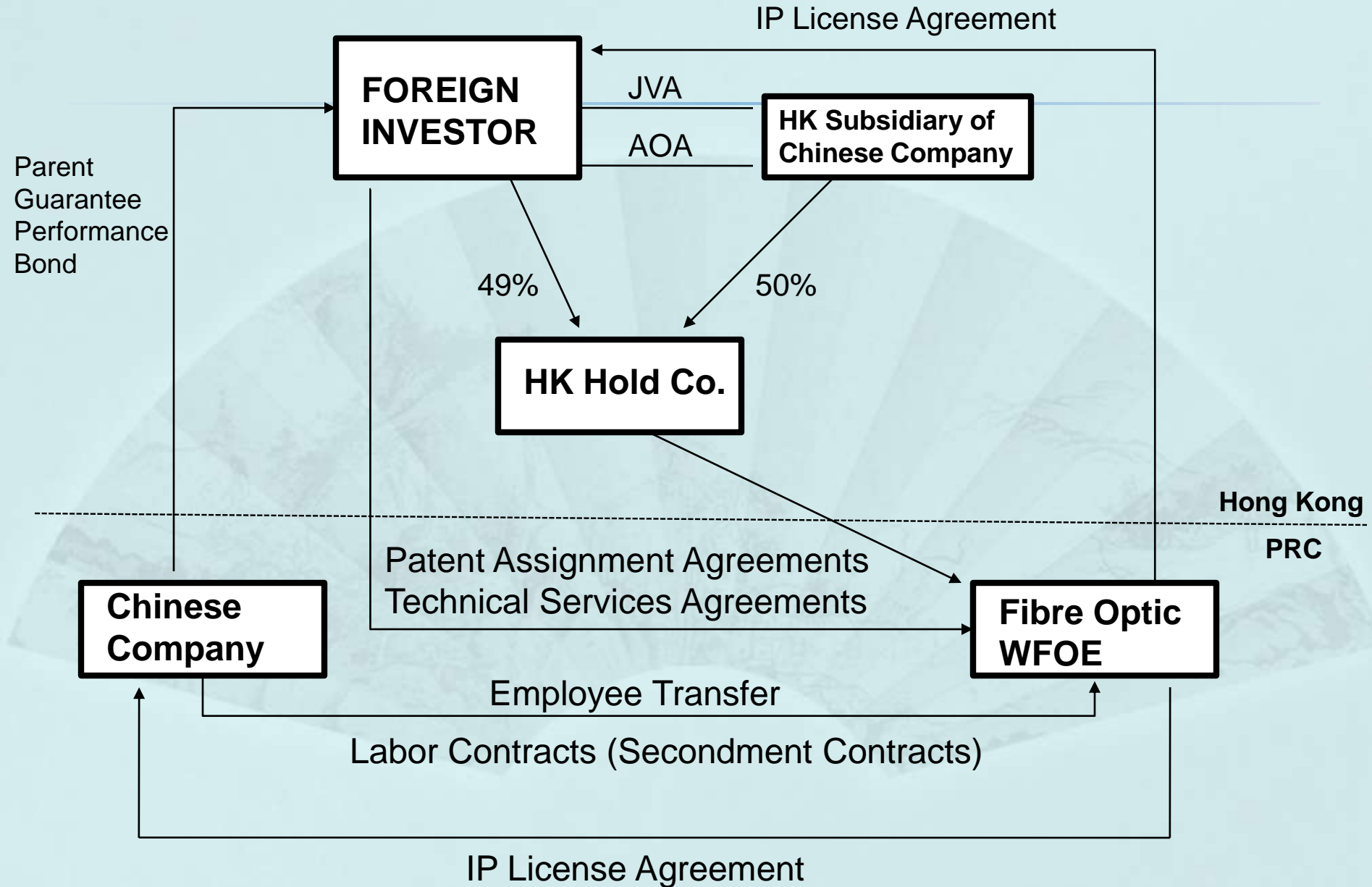
## Special Terms (cont'd)

---

### Romalpa Clause (Retention of Title)

- From a Seller perspective a term which provides that title or ownership of the goods is retained by the Seller until payment in full by Buyer.
- Useful where Buyer is placed in insolvency—goods do not form part of the Buyer's assets.
- See “Stoppage in Transit”—under Chinese law—Seller can seek an injunction to prevent delivery of goods.

# CASE STUDY



# Case Study (Background)

- \* Fibre Optic Cable Laying JVC in northeast China
- \* Foreign Investor was to acquire 49% interest in HK SPV set up by Chinese Investor
- \* HK SPV to then form a WFOE
- \* WFOE to enter into various agreements with each investor as follows:
  - (i) Technical Service Agreement
  - (ii) Future IP License Agreement
  - (iii) Patent Assignment Agreement
  - (iv) Technology Transfer Agreement
- \* Foreign Investor required Chinese investor to provide certain guarantees
  - (i) Bank Performance Bond – to guarantee capital contribution of 51% shareholder
  - (ii) Parent Company Guarantee – to guarantee performance of contractual obligations of SPV and WFOE under the JVA

# Contractual Issues

---

- Representations and Warranties in JVA
- Transaction / Ancillary Agreements
  - is governmental approval / registration required?
- Performance Bond / Parent Company Guarantee
  - is governmental approval / registration required



- Conditions Precedent

- Enforceability of ancillary agreements – i.e. conditions precedent
- Enforceability of ancillary agreements
  - (i) JVA signed and chopped
  - (ii) Capital Contribution to WFOE completed by both parties
  - (iii) Business License issued with required business scope and all governmental approvals and licenses obtained
  - (iv) Performance Bond and Parent Company Gtee signed, chopped, registered with SAFE and delivered to Foreign Investor.

# Indemnity Issues

---

- Ensure that WFOE obtained adequate indemnities from each assignor of IPR rights for potential third party ownership claims, in respect of patents and IPR assigned to the WFOE.

## Transaction Agreements subject to governmental approval / registration

- Parent company guarantee
- Performance bond
- Joint Venture Agreement
- IP Assignment Agreement (if restricted IP)
- Trademark License Agreement (STO registration to enable royalties to be paid back to foreign investor)

# Key Issue List

| No. | Agreement                    | Issue Definition  | Foreign Investor Position  | Chinese Investor Position | Settlement |
|-----|------------------------------|---|--|---------------------------|------------|
| 1   | Joint Venture Agreement      | Clause 6.1 Capital Contribution   | Foreign Investor wishes to make capital contribution after signing of ancillary agreements |                           |            |
|     |                              | Clause 2.2 (Branding)   | Wishes to brand product under WFOE's own brand   | Agreed                    |            |
| 2   | Technology License Agreement | Term of License<br>Scope of Use<br>Contract not to sue, Defend, Indemnities |  |                           |            |
| 3   | Technical Services Agreement | Termination on execution of JVA   |  |                           |            |

# Clients



Thank you for your attention!



[www.rhklegal.cn](http://www.rhklegal.cn)

Phone: 021 - 6288 8821

Fax: 021 - 6288 8823