



China Supreme People's Court's guidance on handling contracts affected by the economic crisis

The People's Republic of China (PRC) Supreme People's Court's (SPC) recent Interpretations and Guiding Opinion on PRC Contract Law provide much-needed guidance on several controversial areas that have regularly arisen in PRC arbitrations and litigations. They address some significant differences between PRC law and 'accepted' common law practice, and will be particularly important in the current economic climate. This briefing examines the new guidance and highlights the importance of ensuring that contracts are carefully drafted, and that peculiarities under PRC law are taken into account.

On 13 May 2009, the Supreme People's Court's (SPC) Interpretations (No. 2)¹ (the Interpretation) on the People's Republic of China (PRC) Contract Law² (the Contract Law) came into force. The Interpretation marked the culmination of eight years of work, and provided long-awaited clarification on a number of ambiguities which had become apparent in the Contract Law since it was first promulgated in 1999. Shortly thereafter, on 7 July 2009, the SPC issued another important document, the Guiding Opinion.³ The Guiding Opinion is noteworthy for two reasons:

- it addresses certain fundamental principles of the PRC law in considerably greater detail than any previous judicial pronouncement (including the Interpretation); and
- it acknowledges the significance of the economic crisis on existing commercial or contractual relationships, and provides the courts with guidance on issues which are likely to arise.

The importance of both the Interpretation and the Guiding Opinion has been amplified by a number of factors:

- in many Sino-foreign transactions, it is common practice to use precedents prepared under a different legal system (typically, under a common law system

such as Hong Kong, England or the US) and to adopt these for use in the PRC, without properly tailoring these to the PRC legal and regulatory system, even though such contracts contain a PRC governing law clause;

- added to this unsatisfactory situation is the PRC law's relatively undeveloped nature, particularly when dealing with complex commercial issues, where it can be both unpredictable and malleable; and
- the present economic crisis has exacerbated the situation, by encouraging defaulting parties to try their luck under PRC law, in an attempt to avoid performing their contractually agreed obligations.

The Interpretation and the Guiding Opinion provide much-needed guidance on several controversial areas under the Contract Law, which have regularly arisen in previous PRC arbitrations and litigations. As will be clear from the analysis below, they illustrate some significant differences between PRC law and 'accepted' common law practice, and underscore the importance of ensuring that contracts are carefully drafted, and that peculiarities under PRC law are taken into account.

Some key clarifications are as follows:

¹ Interpretations (No. 2) on Certain Issues Concerning the Application of the Contract Law of the People's Republic of China.

² Contract Law of the People's Republic of China.

³ Guiding Opinion on Several Questions Concerning the Trial of Civil and Commercial Contract Disputes.

Previous position under the Contract Law	Current position as a result of the Interpretation/Guiding Opinion	Significance
<p>Material change in circumstances The Contract Law allows for a contract that is obviously unfair at the time of its conclusion to be revoked or ‘amended’.¹</p> <p>At the time the Contract Law was drafted, there were discussions on whether to extend these provisions to cover a situation where there was a material change in circumstances following the conclusion of a contract. Eventually, following considerable debate, such an extension was not made.</p>	<p>The Interpretation and the Guiding Opinion now expressly recognise the doctrine of ‘change of circumstances’, which deals with the effect of a material change in objective circumstances following the conclusion of the contract. A material change in objective circumstances is defined as a change that:</p> <ul style="list-style-type: none"> □ was unforeseeable when the contract was entered into; □ is not excused by a force majeure event; □ was not part of the ‘commercial risks’ undertaken by a party; and □ creates a situation where continued performance of the contract would be obviously unfair to one party or the purpose of the contract would not be fulfilled. <p>In such cases, a party may request the court to modify or revoke the contract, and the court shall decide whether to do so based on principles of equity and in light of the actual circumstances of the case.²</p> <p>The Guiding Opinion elaborates on the principles to be applied.</p> <p>It notes that the current financial crisis is not a ‘sudden change’ but a ‘gradually evolving process’. To some extent, business entities should be able to foresee and gauge market risks. Courts will therefore strictly examine any claim that a change was unforeseeable, and will distinguish between mere commercial risks, and a material change in circumstances.</p> <ul style="list-style-type: none"> □ Commercial risks are inherent in business activities and where they materialise, they would not constitute an exceptional change justifying intervention by the court. □ In contrast, a material change in circumstances is not a risk that is inherent in the market system, and it cannot be foreseen by the parties at the time they entered into the contract. 	<p>In general, under the English common law system, a court or tribunal is not empowered to modify or amend the terms of a contract due to a change in circumstances.</p> <p>When the Interpretation was first issued, there were suggestions that the recognition of the change in circumstances doctrine might result in the courts adopting a more interventionist role in assisting parties who were adversely affected by the economic crisis.</p> <p>However, it is now clear that the SPC, through the Guiding Opinion, has sought to impose a more disciplined regime, to address the concern that parties may be too readily prepared to rely on the current economic crisis to evade their contractual obligations.</p> <p>It is often difficult to draw the line between what constitutes a ‘commercial risk’ and what is a genuine material change in circumstances. For example, during the Asian Financial Crisis, when the currencies of several developing economies dropped significantly, there was uncertainty over whether this could properly be considered a material (and unforeseeable) change in circumstances, or if this was simply part of the ordinary commercial risk of currency fluctuations. Moreover, there is clearly a concern over the ways in which different courts and tribunals may apply the same doctrine.</p> <p>Nevertheless, on balance, the Guiding Opinion is a much welcomed first step in providing some meaningful guidance on the broad parameters of this doctrine under PRC law.</p>

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<p>Adjusting agreed liquidated damages</p> <p>The Contract Law provides that where the amount of liquidated damages agreed upon by the parties is lower than the actual loss suffered by an innocent party, the innocent party may apply to the court or to an arbitral tribunal to increase the amount of damages.</p> <p>Conversely, if the amount agreed upon is ‘excessively higher’ than the actual loss suffered by the innocent party, the defaulting party may apply to the court or arbitral tribunal to reduce the damages.³</p> <p>Little guidance is provided on when the amount of liquidated damages would be deemed to be ‘excessively higher’.</p>	<p>The Interpretation clarifies that:</p> <ul style="list-style-type: none"> □ where a party applies to the court to <i>increase</i> the recoverable liquidated damages, any increase is limited to the <i>actual loss suffered</i>.⁴ Accordingly, the party requesting an increase in the amount of damages should include details of all actual losses in its request; □ conversely, where a party applies to <i>reduce</i> the recoverable liquidated damages, an amount of liquidated damages which is more than <i>30 per cent higher than the actual loss</i> will generally be regarded as being ‘excessively higher’ than the actual loss suffered;⁵ and □ a request for adjustment of liquidated damages can be raised either as a defence or as a counterclaim.⁶ <p>The Guiding Opinion reiterates that in adjusting the amount of liquidated damages, the principles of good faith and fairness play an important role, as does compliance with the letter and spirit of the Contract Law and of the Interpretation. Furthermore, courts should uphold the principle that liquidated damages are essentially compensatory in nature.</p> <p>In adjusting excessively high liquidated damages, courts should consider the specific circumstances of each case, taking the actual losses as the benchmark, and considering factors such as the following:</p> <ul style="list-style-type: none"> □ extent to which the contract has been performed; □ relative degree of fault attributable to the parties; □ loss of anticipated profits suffered by the innocent party; □ relative market power of the parties when entering into the contract; and □ whether standard form contract or standard clauses have been used. <p>Helpfully, the SPC also notes that the indiscriminate adoption of a fixed percentage or other ‘one size fits all’ approach should be avoided.</p> <p>The SPC also recognises that the burden of proof should be clearly defined. The defaulting party bears the burden to prove that the amount of liquidated damages is excessive, while the innocent party is to provide proof that damages are reasonable.⁷ It has been suggested in a publication by the <i>People’s Court’s Press</i> that the defaulting party therefore bears the burden of proving that the amount of damages is <i>prima facie</i> excessive. The burden then shifts to the innocent party, to justify the reasonableness of the amount of damages.⁸</p>	<p>The ability of the court to vary the parties’ bargain by adjusting the agreed liquidated damages has long been the subject of controversy among experienced foreign parties, not least because of the difficulty in predicting when the courts would intervene, and what benchmark would be applied to determine if the liquidated damages are ‘excessively higher’ than the loss suffered (and vice versa).</p> <p>The Interpretation, by fixing the benchmark at 30 per cent above the actual loss, has helped provide some certainty. However, this approach has also attracted some criticism, because it appears to rely on an unduly rigid benchmark. In particular, liquidated damages are fixed to deal with a wide range of breaches, and it is often not possible or practicable to ascertain in advance the likely losses which may flow from different breaches. Indeed, it is precisely the parties’ desire to avoid such difficulties, and the cost of estimating future losses, which drive them to agree on the remedy of liquidated damages.</p> <p>Given these concerns, the additional clarification provided by the Guiding Opinion is to be welcomed. Among others, it appears to move away from an overly mechanistic application of the rigid ‘30 per cent’ benchmark, and to focus on a range of other considerations.</p> <p>However, some factors stipulated in the Guiding Opinion may be cause for concern. For example, in adjusting excessively high liquidated damages, the courts are to look at a host of factors, and some of these are quite subjective (eg parties’ relative market power and degree of fault), and are of less obvious relevance.</p> <p>It is unfortunate that both the Interpretation and the Guiding Opinion focus only on when excessively high liquidated damages should be reduced, but not on when the SPC would intervene to <i>increase</i> the amount of liquidated damages if actual losses are more than the agreed liquidated damages.</p>

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<p>Claiming loss of profits</p> <p>The Contract Law provides that if a party breaches a contract and causes loss to another party, the measure of damages shall be equal to the loss incurred as a result of the breach, including the benefits which could have been obtained had the contract been duly performed.</p> <p>However, such damages may not exceed the loss which the defaulting party foresaw or ought to have foreseen (at the time the contract was entered into) as a possible consequence of the breach of contract.⁹</p>	<p>The Guiding Opinion classifies loss of anticipated profits into:</p> <ul style="list-style-type: none"> □ loss of production profits, eg for a buyer who suffers loss caused by a breach of contract by suppliers of equipment and raw materials; □ loss of operating profits, eg for a business which suffers loss due to its counterparties' breaches of leases and employment contracts; and □ loss of resale profits, eg for a business that sources goods for resale, which suffers loss caused by a breach of contract by suppliers of goods. <p>In calculating the loss of anticipated profits, the courts should consider all relevant factors such as:</p> <ul style="list-style-type: none"> □ <i>foreseeability of the loss</i>, excluding loss unforeseeable to the defaulting party; □ <i>mitigation</i>, excluding loss which was 'inappropriately expanded' by the innocent party; □ <i>benefits obtained</i>, by factoring in any benefits that the innocent party has gained due to the breach; and □ <i>contributory negligence</i>, by factoring in loss caused by any negligence of the innocent party. <p>The defaulting party will generally bear the burden of establishing the innocent party's failure to mitigate, the innocent party's contributory negligence and benefits obtained by the innocent party due to the breach. The innocent party, on the other hand, has to prove the loss of profits it suffered.</p> <p>As for foreseeability of loss, the innocent party may seek to prove that the loss it suffered was foreseeable. The court also has the discretion to take the initiative to determine this issue based on the facts of the case.¹⁰</p>	<p>Although the Contract Law recognises that a party may recover for damage suffered, including loss of anticipated profits, limited guidance is provided on how such profits are to be calculated.</p> <p>The Guiding Opinion is therefore to be welcomed, by providing much more detailed guidance on how profits are to be computed, and the limits to such profit claims. It also provides a more structured framework on how claims may be advanced.</p> <p>The introduction of the concept of contributory negligence in determining quantum of damages for a contractual breach is novel under PRC law, and it remains to be seen how this would operate in judicial practice.</p>
<p>Agency and apparent authority</p> <p>The Contract Law recognises the 'agency by estoppel' (or apparent authority) principle. Where an agent enters into a contract without the authority of its principal, but the counterparty reasonably believes that the agent is authorised to do so, the resulting contract is deemed to be valid.¹¹</p>	<p>The Guiding Opinion clarifies that to establish a valid contract under the agency by estoppel principle, the agent has to (objectively) appear to have authority for its actions. In addition, there is a subjective requirement that the counterparty, when entering into the contract, has to act in good faith and has to believe that the agent was authorised.</p> <p>The counterparty, in claiming that the agent was authorised, bears the burden of proving that there existed an objective manifestation of the agent's authority (eg a document supporting his authority or a common seal), that it acted in good faith and that it did in fact believe that the agent was authorised.</p> <p>In deciding whether the counterparty has acted in good faith, the courts should consider all factors surrounding the formation and performance of the contract and determine whether the counterparty has taken due care</p>	<p>The issue of when an agent has been authorised is of considerable significance in the PRC, and it is not uncommon for there to be disputes over whether an agent has in fact been properly authorised by his company.</p> <p>Indeed, in setting out the context for this guidance, the SPC itself notes that in the current economic climate, sub-contracting and sub-leasing are increasingly popular in major state construction projects. This has led to a great number of court cases over the authority of agents, and over the validity of contracts entered into by them.¹³</p>

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	<p>in entering into the contract. Relevant factors include the authenticity of the seal used, the mode and place for delivery of goods and whether the principal seemed to be aware of the agent's actions.¹²</p>	<p>Therefore, the guidance provided by the SPC is certainly helpful.</p>
<p>Effect of mandatory rules of law The Contract Law stipulates that a contract is void if it violates mandatory rules of law or regulations.¹⁴</p> <p>In practice, however, it was unclear whether violation of <i>any</i> mandatory rule would automatically render a contract void.</p>	<p>The Interpretation and the Guiding Opinion clarify that not all mandatory rules, if violated, would render the relevant contract void. Where the rule specifically provides that this is the case, then a contract that violates such a rule will be invalid.¹⁵</p> <p>However, where the mandatory rule in question does not expressly provide that failure to comply will render the contract void, a violation of the rule will not automatically render a contract void. Instead, the courts will have the discretion to decide if this is the case, based on the actual circumstances.</p> <p>The Guiding Opinion draws a further distinction between:</p> <ul style="list-style-type: none"> □ mandatory rules that merely regulate the <i>capacity</i> of a party to enter into a contract or the <i>manner of performance</i> of a contract; and □ mandatory rules that impact on the <i>formation</i> of a contract. <p>Where the rule impacts on the very formation of a contract, and the performance of the contract would harm interests of the state or the public, the contract will be rendered void.</p> <p>Where the rule simply regulates the capacity of a party to enter into a contract, or the manner of performance, it is not void <i>per se</i> but courts have the discretion to decide on its validity. In these circumstances, the Guiding Opinion also states that courts ought to exercise their discretion with caution, and should seek the views of the legislative authorities or a superior court where necessary.¹⁶</p>	<p>At face value, the effect of the original Contract Law provision is very broad, potentially striking down a wide range of contracts for violation of any mandatory rules.</p> <p>The Interpretation and the Guiding Opinion provide a more sophisticated way of analysing the effect of mandatory rules, and they recognise that in certain situations, a contract is not invalid even if it is in breach of a mandatory rule.</p> <p>Such clarification is helpful, because in developing jurisdictions such as the PRC, parties sometimes inadvertently run afoul of mandatory rules, and it would be simplistic to automatically regard all such contracts as void.</p>
<p>Transaction at undervalue and waiver of debts The Contract Law provides that if a debtor waives its right to monies due to it or transfers its assets for free or at an undervalue, a creditor who suffers loss may apply to the court to annul such an action.¹⁷</p>	<p>The Interpretation expands the creditors' rights to cover three other situations, where the debtor:</p> <ul style="list-style-type: none"> □ waives its right to debts not yet due to it; □ waives its rights to security for debts; or □ extends, in bad faith, the deadline for repayment of monies due to it, <p>thereby causing damage to a creditor. In these circumstances, the creditor may bring an action to annul the waiver or extension.¹⁸</p> <p>In practice, this provision will be of greater importance where the debtor is insolvent or in financial difficulties, in which case its waiver or extension would diminish the assets available for distribution, causing damage to its creditors.</p>	<p>This provision is likely to take on added significance in the present economic climate.</p> <p>At face value, the provision appears to be broad, by allowing the creditor to interfere in the debtor's actions even where the latter is not insolvent.</p> <p>However, both the Contract Law and the Interpretation provide that the creditor may interfere only if it suffers loss. In practice, therefore, this will be most easily established if the debtor is insolvent or it has otherwise failed to honour an obligation owed to the creditor.</p>

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<p>Anticipatory breach</p> <p>The Contract Law sets out a number of circumstances in which a party may suspend performance of its obligations under a contract¹⁹ or terminate the contract²⁰. Where a party states that it will not perform its contractual obligations, it may also be held liable before the due date for performance²¹.</p>	<p>The Guiding Opinion provides that, in accordance with the spirit of the relevant provisions in the Contract Law, where a party has fulfilled all its obligations under a contract and there is strong evidence suggesting that its counterparty will fail or refuse to perform its payment obligation, the court may bring forward the deadline for payment, or order that payment be due immediately.²²</p> <p>Examples of such evidence include where:</p> <ul style="list-style-type: none">□ the payee has expressly indicated that it will not perform its payment obligation;□ the payee's business licence has been withdrawn or cancelled or it has closed down;□ the payee has diverted property or spirited funds away in order to avoid debts; or□ the payee has forfeited its goodwill.	<p>The Guiding Opinion has clearly been issued with a view to protecting the interests of parties who have performed their contractual obligations, in situations where there is a clear risk that their counterparties will fail to perform their part of the bargain.</p> <p>However, it remains to be seen how effective this guidance will be in practice, and whether it will offer a meaningful remedy to the innocent party, prior to the due date for performance.</p>

Note: This table sets out a simplified summary of the relevant provisions and reference should always be made to the original provisions in Chinese, when dealing with specific transactions.

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¹ Article 54, Contract Law.

² Article 26, Interpretation.

³ Article 114, Contract Law.

⁴ Article 28, Interpretation.

⁵ Article 29, Interpretation.

⁶ Article 27, Interpretation.

⁷ Section II, Guiding Opinion.

⁸ Shen and Xi, *Understanding and application of the SPC Interpretation on Certain Issues Concerning the Application of the Contract Law (2009)*.

⁹ Article 113, Contract Law.

¹⁰ Section III, Guiding Opinion.

¹¹ Article 49, Contract Law.

¹² Section IV, Guiding Opinion.

¹³ Section IV, Guiding Opinion.

¹⁴ Article 52(5), Contract Law.

¹⁵ Article 14, Interpretation.

¹⁶ Section V, Guiding Opinion.

¹⁷ Article 74, Contract Law.

¹⁸ Article 18, Interpretation.

¹⁹ Articles 68 and 69, Contract Law. Circumstances include a significant deterioration in its counterparty's business and where its counterparty evades debts by diverting property or spiriting funds away.

²⁰ Article 94, Contract Law. This article concerns the situation where its counterparty has stated or indicated by conduct that it will not fulfil its payment obligation. See also article 167, Contract Law, which concerns a party's right to terminate a contract where a buyer defaults on its payment by instalments, such default amounting to one-fifth of the total price.

²¹ Article 108, Contract Law.

²² Section VI, Guiding Opinion.