ADVANT Beiten

CHINA: COMMERCIAL CONTRACTS CHOICE OF LAW & DISPUTE SETTLEMENT ESSENTIALS

Welcome to our new **ADVANT Beiten** edition of the China Commercial Contracts – Choice of Law and Dispute Settlement Essential Q&As! With this publication, we aim to provide you with essential information about China's regulatory framework on the matters of choice of law and dispute settlement in commercial contracts and to explain some of its core principles.

We do this intentionally in a way which seeks to draw your attention to key issues impacting foreign and domestic enterprises entering into commercial contracts in, or with relation to China. Hence, what we set out in this publication deals with some of the most common questions and situations brought to our attention. What can make these topics challenging is the complexities in understanding the differences between "domestic commercial contracts" and "commercial contracts with a '*foreign relation*'".

Thus, please read this publication to get a first understanding on what aspects to look at when making such determinations in relation to commercial contracts with a China connection and for any specific questions, please contact us anytime!

1. What are commercial contracts?

Commercial contracts are agreements regulating business relationships between individuals or businesses where they agree to perform some actions or refrain from doing others. Typical examples for commercial contracts are sales/purchase agreements, technology agreements, lease agreements, services agreements, etc.

When reading on, please bear in mind that this Q&A is only discussing commercial contracts!

This is important to remember because for commercial contracts on the one side, and contracts of a different nature on the other side, different rules and principles on choice of law and dispute settlement may apply.

2. Are the rules discussed in this Q&A the same for the People's Republic of China (PRC)/China Mainland as well as for the Special Administrative Regions (SARs) of Hong Kong, Macao and the Taiwan Region?

No, the rules discussed in this Q&A for commercial contracts are distinctly different for the PRC/China Mainland on the one side, and the SARs Hong Kong & Macao and the Taiwan Region on the other side.

This Q&A is written from the perspective of the regulatory framework of the PRC/China Mainland and this framework is substantially different from the regulatory frameworks applicable in the jurisdictions of SARs Hong Kong & Macao and the Taiwan Region. From a PRC/Mainland China legal perspective of commercial contracts, the SARs Hong Kong & Macao and the Taiwan Region are considered as "*foreign relations*".

3. Can I freely choose the applicable law for a commercial contract that I enter into in the PRC and/or with a PRC party?

No, because under PRC laws and regulations, the rule is that PRC law shall apply to commercial contracts, and only if a commercial contract has an element of a "*foreign relation*", one can choose a law other than PRC law.

If such "*foreign relation*" element exists in a commercial contract, the contractual parties can generally choose any law to apply to such contract, unless applicable PRC laws and regulations expressly prohibit or limit such choice.

The relevant principles are laid out in particular in the "*PRC Law on Application of Laws to Foreign-Related Civil Relations*" (*中华人民共和国涉外民事关系法律适用法*, **LAL**) in effect since 1 April 2011, as well as in the "*PRC Supreme People's Court* (**SPC**) *Interpretation on Several Issues Concerning the Application of the PRC Law on Foreign-Related Civil Relations (I)*" (*最高人民法院关于适用《中华人民共和国涉外民事关系法律适用法》若干问题的解释(一)*), **SPC Interpretation (I)**), in effect since 7 January 2013.

4. Why is it important to define which particular law shall apply to a commercial contract and what happens if such choice is missing?

Even in a contract between PRC parties only and with no apparent "*foreign relation*", we recommend to specify that PRC law applies because it (a) shows that the parties considered this aspect and (b) agreed on this particular "choice" of law (even though it wouldn't be for "choice" but mandatory in such a case if indeed no "*foreign relation*" prevailed).

It is of even greater importance in a commercial contract with a "*foreign relation*" to define which law shall apply to the contract (and the arbitration agreement, if existing) because if no such choice is made, the likelihood that a dispute arises over the applicable law is substantial. This risk is eminent because from our experience we know that by the time contractual parties start arguing over matters such as dispute settlement and applicable law, a dispute over the general contract performance has already arisen. In such a confrontational situation, it is most improbable to reach an amicable understanding over topics outside the actual breach/material dispute, such as e.g. the applicable law.

If the parties have not chosen the applicable law and cannot agree on which law shall apply, the law says that "the law of the closest connection to the contract" shall apply. As one can easily see, this is a rather broad-based principle, subject to interpretation. Wherever there is room for interpretation, there is also room for disagreement on how to conduct such interpretation. Hence, among others the SPC Interpretation (I) has provided some guidance on how to proceed if the parties have not chosen the applicable law in a contract for which the applicable law can be chosen freely. In such case, the court/arbitration tribunal may decide in accordance with the following provisions of the LAL and the "*SPC Interpretation on Certain Issues Concerning the Applicability of the PRC Arbitration Law*" (*最高人民法院关于适用《中华人民共和国仲裁法》若干问题的解释*), in effect since 8 September 2006:

- general commercial contracts (including the IPR transfer/license contracts) shall be governed by the law of the habitual residence of the party whose performance of obligations best reflects the characteristics of the contract or other laws having the most significant relationship with the contract;

- trust agreements shall be governed by law of the location of the trust property or the laws of the place of occurrence of the trust relationship;

- arbitration agreements: if the parties have not agreed upon an applicable law of an arbitration agreement, but have agreed upon the place of arbitration, the law of that place shall apply; if the parties have agreed upon neither an applicable law nor the place of arbitration, or they fail to clearly agree upon the place of arbitration, the law of the region where the court is located shall apply;

- contracts over property rights on movable property shall be governed by the law of the location where the movable properties can be found at the time of occurrence of the legal dispute;

- contracts over the change of property rights of movable property during transport shall be governed by the law of the transport destination;

- tort liability claims shall be governed by law of the location where the tort occurred, provided that where the parties concerned have a common habitual residence, law of the common habitual residence shall apply;

- product liability claims shall be governed by law of the habitual residence of the infringed party; where the infringed party chooses to apply law of the place of principal office of the infringer or of the place where the infringement occurred, or where the infringer does not engage in relevant business activities at the habitual residence of the infringed party, the law of the place of principal office of the infringer or of the location where the infringement occurred shall apply.

Still, the best option is to define exactly which law shall apply to a commercial contract and the arbitration agreement (if such is made in a contract). Such clear specification of the law avoids any ambiguity on this matter and eliminates a substantial source of dispute on such matter.

5. If no choice of law was made in the contract, can the contractual parties make such choice later?

Yes, at any time after the initial conclusion of the contract the parties can decide to mutually amend the contract and agree on a choice of law in accordance with the prevailing PRC regulatory framework.

If a dispute has already arisen and been brought to court or arbitration (if any arbitration agreement was effectively agreed under the contract), the latest point in time for determining the choice of law is decided as follows:

Litigation: According to SPC Interpretation (I), the parties shall agree on the selection or change the selection of applicable law no later than the end of the debate at the court of first instance. If the parties have not agreed on the applicable law in the contract, but the parties cite the law of the same country at the trial and no other objection is raised, the court may determine that the parties have agreed on the applicable law. Otherwise, the choice of law is defined in the manner explained under Sec. 4 above by the courts.

Arbitration: PRC regulations on arbitration do not provide a deadline for the parties to choose or change the applicable law. Therefore, the parties shall proceed in accordance with the corresponding arbitration rules of the respective arbitration institution. For example, the arbitration rules of the China International Economic and Trade Arbitration Commission (**CIETAC**) state that the arbitral tribunal shall decide the applicable law if the parties failed to agree on the applicable law or the chosen law conflicts with the mandatory provisions of China without giving any deadline during the process to make such choice. According to CIETAC's practice, the choice or change of applicable law may be agreed upon by all parties during the arbitration proceedings and submitted to the arbitral tribunal.

In order to validly implement internal rules and regulations that have a direct bearing on the interests of the employees (such as remuneration, working hours, rest and vacation, work safety and hygiene, insurance, benefits, employee training, work discipline and work quota management, etc.) a democratic implementation process involving all employees or their representatives is required. Such statutory implementation process of internal rules and regulations such as an Employee Handbook generally includes i) discussions with all the employees or employee representative congress (if any); ii) collection of comments made by all the employees or the employee representative congress (if any); iii) discussion of the comments with employee representatives or the trade union established within the company (if any); iv) issuance of the final version to all the employees.

6. What establishes a "*foreign relation*" in a commercial contract?

According to SPC Interpretation (I), if one or more of the following factors are present in a commercial contract, the contract can be deemed to have a "*foreign relation*":

- at least one contractual party is a "*foreign*"[1] or stateless natural/legal person or organization;

[1] "*foreign*" in this context refers to non-PRC/China Mainland and includes e.g. the SARs Hong Kong & Macao and the Taiwan Region.

- the habitual residence of at least one party is outside the PRC/China Mainland territory;
- the subject matter of the contract locates outside the PRC/China Mainland territory;
- the legal facts that establish, change or eliminate the civil relation governed by the commercial contract occurred outside the PRC/China Mainland territory;
- other circumstances prevail that may be deemed to establish a "*foreign relation*" in regard to the commercial contract.

Looking at the above criteria to establish a "*foreign relation*" in a commercial contract, one can say that if at least one of the contractual parties is a foreign enterprise (or other organization or natural person), this is generally sufficient to establish such a "*foreign relation*" and hence the freedom to choose the law applicable to the contract.

In that context, one must bear in mind that PRC-registered foreign-invested enterprises (**FIEs**) are considered domestic PRC legal persons. In other words, the fact that a foreign shareholder invested in a FIE is not sufficient to establish a "*foreign relation*". Therefore, in the absence of any other of the above-mentioned criteria that establish a "*foreign relation*", FIEs are not entitled based on their nature as FIE alone to choose the law applicable to the commercial contracts their enter into. There is one exception to this rule however: according to the "*SPC Opinions on Providing Judicial Protection for the Construction of Free Trade Zones*" (*最高人民法院关于为自由贸易试验区建设提供司法保障的意见*), in effect since 30 December 2016 and related judicial practices, contracts entered into by wholly foreign-owned enterprises (**WFOEs**) registered in the Free Trade Zones (**FTZs**) shall be deemed to have a "*foreign relation*" based on the fact alone that they are WFOEs registered in FTZs.

7. Which contracts must always apply PRC law and regulations, even if a "*foreign relation*" could be established?

For the following contracts, the applicable law must always be PRC law and any other choice of law is invalid (this understanding is derived from the LAL, SPC Interpretation (I) and the PRC Civil Code, in effect since 1 January 2021):

- cooperation contracts for the exploitation/development of natural resources in the PRC/China Mainland territory;
- contracts for the Sino-foreign equity joint venture enterprises in the PRC/China Mainland territory;

- contracts for the Sino-foreign cooperative joint venture enterprise in the PRC/China Mainland territory;
- contracts involving labour matters;
- contracts involving food or public health safety matters;
- contracts involving environmental safety;
- contracts involving financial safety such as foreign exchange administration;
- contracts involving anti-monopoly or anti-dumping matters;
- contracts where contractual parties intentionally create the "*foreign relation*" to circumvent the application of PRC laws and regulations.

8. Which other restrictions on choice of law are applied under PRC law for civil contracts with a "foreign relation"?

In certain cases, the LAL stipulate that contractual parties must restrict their choice of law to specific jurisdictions, based on the following principles:

- consumer contracts shall be governed by law of the habitual residence of the con_ sumer, or by law of the place where the goods or services are provided if the consumer so chooses, or if the business operator does not engage in relevant business activities at the habitual residence of the consumer;
- labour contracts shall be governed by law of the workplace of the employee; if it is difficult to determine the workplace of the employee, the law of the place of the principal office of the employer shall apply;
- labour dispatch service contracts shall be governed by law of the place of dispatch;
- contracts concerning the property rights for real estate shall be governed by the law of the site where the real estate locates;
- contracts for marketable securities shall be governed by law of the place where the right of the security is realized or by other law having the most significant relationship with the security;

- pledge contracts shall be governed by law of the place where the pledge is invoked;

- ownership contracts concerning intellectual property rights (**IPRs**) shall be governed by law of the place where the IPR ownership is claimed.

9. Besides the applicable law, can one also choose whether a dispute is adjudicated in a civil court or at an arbitration institution?

Generally, for domestic commercial contracts as well as for commercial contracts with "*foreign relations*", the parties can choose arbitration or litigation, but certain restrictions apply:

For **PRC domestic commercial contracts**, the PRC Civil Procedure Law (**CPL**) generally allows parties to commercial contracts to choose the locally competent Chinese People's Court by written agreement from among the following locations: defendant's or plaintiff's domicile, place of contract performance or signature or at other locations which have an actual connection with the dispute. Alternative to litigation at a Chinese People's Court, the parties may choose to submit any contractual dispute under a PRC domestic commercial contract to a PRC (but not to a foreign) arbitration institution.

For **commercial contracts with a "*foreign relation*"**, the "*SPC Interpretations on the Application of the Civil Procedure*" (*最高人民法院关于适用《中华人民共和国民事诉讼法》的解释*, **SPC CPL Interpretation**), in effect in its latest version since 10 April 2022, stipulate that generally parties may choose a PRC court or a foreign court with an actual connection to the dispute as venue of litigation, unless otherwise provided for in the applicable PRC laws and regulations. Alternative to litigation at a Chinese People's Court or foreign court, the parties to a commercial contract with a "*foreign relation*" may choose to submit any contractual dispute to a PRC (but not to a foreign) arbitration institution.

As said above, disputes arising from commercial contracts (whether domestic or with a "*foreign relation*") can generally always be resolved by arbitration. While it is generally understood and accepted that **administrative contracts** (i.e. agreements between the government and private parties pertaining to administrative law rights and obligations) cannot be submitted to arbitration, there is some discussion whether public-private partnership (**PPP**) contracts shall be regarded as commercial or administrative contracts. Often, disputes arising from PPP contracts have been deemed to be disputes of a civil and not an administrative nature but there is a degree of uncertainty in that regard.

Similarly, in case of civil **anti-trust disputes** there may be sometimes an issue whether

they can be considered arbitrable because they are not only disputes between contract parties, but also concern the public interests such as consumer interests.

IPR-related disputes are generally arbitrable (e.g. from IPR transfer/licensing agreements, tort claims, etc.) if the subject of the dispute is not related to the validity of a given IPR (such as the validity of a trademark or patent, a decision which is subject to the exclusive jurisdiction of the locally competent state authorities).

10. Is litigation or arbitration the better choice in a commercial contract?

There is not a uniform correct answer to this question, and it depends on the actual circumstances of the parties and the contract. However, some of the more generally applicable considerations that speak in favor of arbitration and against litigation in China are the following:

- control over the selection of arbitrators (though often to be taken from a panel of arbitrators devised by the arbitration institution);
- arbitration procedures tend to be more flexible and less formal than litigation and less time consuming than litigation;
- language(s) of arbitration can be freely chosen;
- arbitration proceedings and rulings are confidential and not public;
- foreign arbitral awards are enforceable in the PRC based on the "UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958" (**NY Convention**) while many foreign court rulings cannot not enforced in the PRC at all/only with great difficulty.

Some of the more generally applicable considerations that speak against arbitration are the following:

- arbitration awards are final and cannot be appealed in any second or third instance (what can often be done for first instance court rulings);
- the general cost of arbitration can be higher compared to the general cost of litigation, in particular if arbitrators are brought in from afar and depending on the arbitration fee schedules of individual arbitration institutions.

Also, one shall consider that some of the advantages that speak generally in favour of arbitration can in individual cases turn out to be disadvantages. E.g. if one ends up losing a case and hence faces the threat of enforcement action, it could in a cross-border context become an advantage that a particular local court judgment in one country cannot be enforced in another country if that is where the losing party resides.

Thus, an intelligent and knowledgeable decision on the applicable law and venue of dispute settlement will always require a bespoke solution considering the actual as well as the legal aspects of a particular contract and there is no "one size fits all" solution for these topics.

11. What items must be part of a valid arbitration agreement?

The currently valid PRC Arbitration Law (**AL**) reflects some but not all of the basic principles of the UNCITRAL Model Law on International Commercial Arbitration 1985 (UNCITRAL Model Law). While some rules such as party autonomy and separability of arbitration agreements apply under the AL as well, other aspects of the UNCITRAL Model Law do not apply in the PRC. E.g. thus far ad hoc arbitration is not recognized in China (that may change in the future because the current AL is currently under revision). Also, the AL itself does not provide for interim measures or emergency arbitrators rules in its current version. However, certain arbitration rules of individual PRC arbitration institutes reference interim measures as well as emergency arbitrator rules and hence forum shopping may be useful in that regard. Also, the pending revision of the AL should be monitored closely to see if changes in that regard will be reflected in the revised AL.

What one can say is that based on the current state of laws in China, an arbitration agreement that holds up under PRC laws and also covers other aspects that are typically relevant to the contract parties should at least contain the following items:

- specification that all disputes arising out of and in relation to the commercial contract shall be resolved by arbitration if within a defined time frame no amicable settlement could be reached;

- specification of which particular law shall apply to the contract and the arbitration agreement;

- specification of the arbitration institute and exact location (city) of seat of arbitration;

- explicit reference to the applicable arbitration rules;

- number of arbitrators and mode of appointment;

- language(s) of arbitration.

Depending on the actual contract, the parties, the scope of the contract, etc. certainly other items may be useful to cover in an arbitration agreement but that would require particular knowledge of a given contract. But having the above items covered should at least ensure to have a valid arbitration agreement. Also, looking at the recommended model clauses of particular arbitration institutions would generally at least achieve to have a text that would hold up at a particular arbitration institution in a given jurisdiction.

12. Can only domestic Chinese or also foreign court rulings/arbitration awards be enforced in China?

Court judgements and arbitration awards issued in China:

The CPL provides that domestic Chinese legally **effective judgments or orders** (**Rulings**) shall be enforced by the Chinese people's court of first instance or by the people's court at the same level as the court of first instance where the property subjected to enforcement is located. **Arbitral awards** (**Awards**) **issued by PRC-based arbitration institutions** shall be enforced by the intermediate people's court either at the domicile of the respondent or at the location of the assets subject to enforcement. The time limit for applications for enforcement is two years.

Court judgements issued outside China:

In principle, for a **foreign Rulings** to be recognized and enforced in China, the following conditions must be met:

- the country of the foreign court that rendered the Ruling has an international treaty or reciprocal relationship with the PRC regarding the recognition and enforcement of court judgments;

- the foreign Ruling is legally effective;

- the content of the foreign Ruling does not violate the basic norms of PRC laws and does not violate the sovereignty, security and public interest of the PRC;

- in the case of a default Ruling, the applicant shall also submit documents proving that defendant(s) has been legally summoned, unless the Ruling already makes a statement to that effect.

Looking e.g. at Italy, France and Germany, there is – as with many other western countries – no bilateral or multilateral treaty in place with the PRC that provides for the recognition and enforcement of court Rulings of the other country/regions. In such situation, the mutual recognition and enforcement of court Rulings of one such country in the PRC (and vice versa) depends on the existence of precedent of reciprocal enforcements of court Rulings between the given countries. For the aforesaid countries e.g, either such precedent does not exist at all or is so scarce that one cannot rely on reciprocal enforcements of German, Italian or French court Rulings in China (and vice versa). Thus, any contractual party from such countries planning to enforce its rights in the PRC is ill advised to choose a civil court in its home country as the dispute settlement venue in a commercial contract (unless the Chinese contract party would have substantial assets in any region where such home country Ruling could be enforced). One could still try to apply for recognition and/or enforcement of such a foreign Ruling in China, but probably the chances to get an affirmative decision is not very high.

The situation is different for Rulings rendered in countries/regions who have entered into bi- or multilateral agreements with the PRC that provide for the recognition and enforcement of Rulings of the other country/regions. E.g. Rulings from the SARs Hong Kong, Macao and from the Taiwan Region can be enforced in PRC and vice versa, subject to the provisions of the Arrangements on Mutual Recognition and Enforcement of Judgments in Civil and Commercial Cases by the Courts of Mainland China and of the SARs Hong Kong and Macao, and the SPC Provisions concerning the Recognition and Enforcement of the Civil Judgments Rendered by Courts in the Taiwan Region.

Arbitration Awards issued outside China:

China is a party to the NY Convention, subject to the reciprocity and commercial reservations under the NY Convention. Hence, an Award rendered concerning a commercial contract in a country being a party to the NY Convention and allowing enforcement of PRC-rendered Awards can be enforced in China. Since most all of American, European, Asian and African countries have signed the NY Convention, Awards from such countries on commercial contracts are generally enforceable in the PRC.

Awards made in the SARs Hong Kong, Macau or the Taiwan Region are treated as "foreign" Awards and are governed by the respective arbitration arrangements or rules as regards each of these regions with China and can generally also be enforced in China.

Foreign Awards not covered by the NY Convention can be recognized and enforced in China in accordance with relevant treaties or arrangements or based on reciprocity.

Enforcement applications in China for Awards under the NY Convention must be submitted to the Chinese intermediate people's court at either the domicile of the respondent or the location where the enforceable property is located.

Applications for recognition and enforcement of Awards under the NY Convection can be refused in the following situations:

- no valid arbitration agreement between the parties exists;
- the arbitral tribunal or the arbitration procedure was not composed/conducted in accordance with the agreement of the parties or other legal requirements;
- the subject matter of the dispute is not governed under the arbitration agreement or is not arbitrable;
- the Award is in conflict with public PRC policy.

First instance people's courts cannot refuse the recognition and enforcement a foreign Award without referring the decision to a higher people's court for review. Any decision made by a higher people's court on non-execution or refusal of recognition and execution is subject to final determination by the SPC.

The limitation period to apply for recognition and enforcement of a foreign Award is two years.

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