



HERBERT
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FREEHILLS



DISPUTE RESOLUTION
AND GOVERNING LAW
CLAUSES IN CHINA-RELATED
COMMERCIAL CONTRACTS

LEGAL GUIDE

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INTRODUCTION

WHAT IS THIS GUIDE?

Chinese law restricts both the choice of law and the types of dispute resolution mechanisms that can be used in China-related commercial contracts. As a result, drafting the governing law and dispute resolution clauses in these contracts is not straightforward.

This guide will help you understand:

- when the restrictions apply; and
- how to draft your China-related contracts so you do not fall foul of them.

The guide also explains a number of common traps to avoid to ensure your dispute resolution and governing law clauses are effective.

WHO IS IT FOR?

This guide is aimed principally at multinational companies who negotiate China-related commercial contracts, and need to understand the basics of Mainland Chinese law and practice that affect their choice of dispute resolution mechanism and governing law.

WHAT ARE THE KEY POINTS?

When choosing the **governing law** of your contract, the key point is that Chinese law restricts your choice in certain circumstances. These circumstances are set out in **Section 1**. Where any of them applies, Chinese law must govern the contract.

When drafting the **dispute resolution clause**, the key points are:

- arbitration is generally better than litigation;
- arbitration outside Mainland China is generally a better option for non-Chinese parties than arbitration inside Mainland China; but
- arbitration outside Mainland China is not always an option – Chinese law requires certain disputes to be arbitrated in Mainland China.

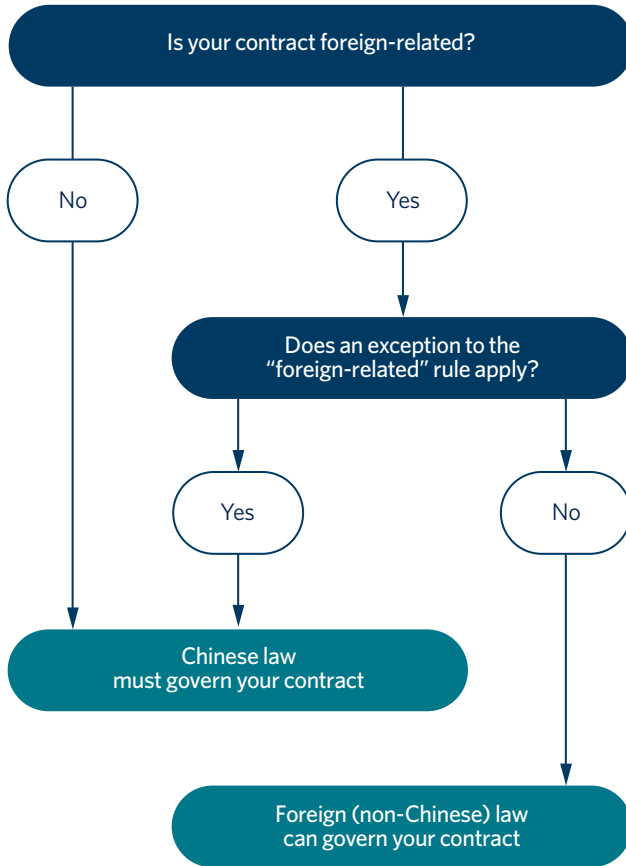
Section 2 explains these points in more detail and gives guidance on drafting effective dispute resolution clauses.

A number of common traps and areas of confusion can lead to a clause being invalid. **Section 3** explains these and how to avoid them.

The contents of this publication are for reference purposes only. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your particular circumstances should always be sought separately before taking any action based on this publication.

Information provided is accurate as at September 2016.

GOVERNING LAW

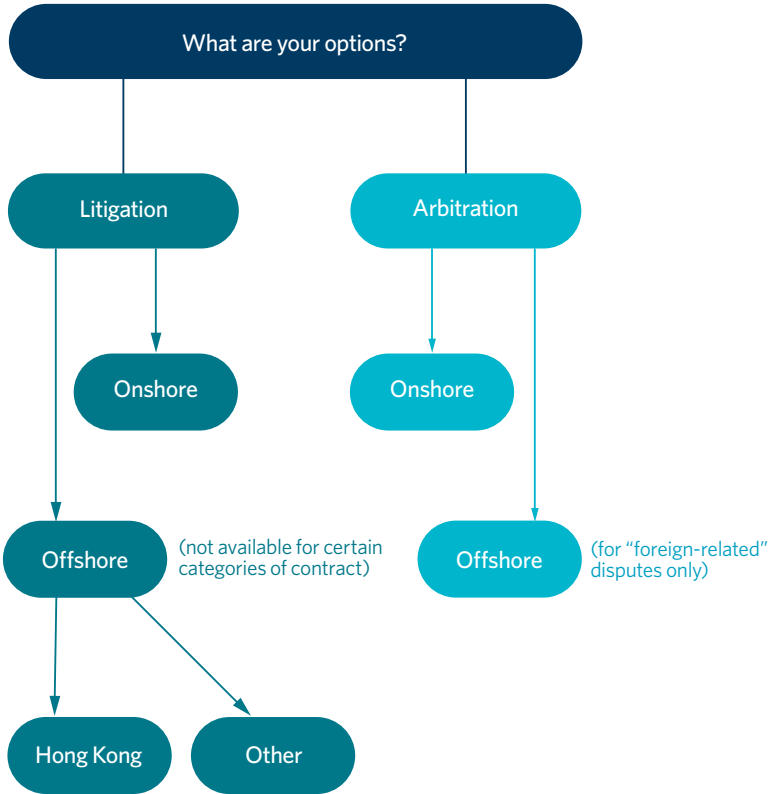


EXCEPTIONS

1. Certain categories of contract eg Sino-foreign JV*
2. Choice of foreign law conflicts with the "public interests" of Mainland China
3. Choice of foreign law is an attempt to avoid Chinese "mandatory laws, regulations or prohibitions"

** For some of the categories, there is no longer a legal requirement to apply Chinese law. However, it is strongly advised that you do so. See page 11.*

DISPUTE RESOLUTION



GOVERNING LAW CLAUSES

When drafting any contract, it is important to state expressly which law will govern it.¹

When negotiating a China-related contract, the parties should consider whether the contract will be governed by Chinese law or the laws of another country.

Non-Chinese parties typically prefer a non-Chinese law to govern their contracts. These parties will generally be more familiar with such laws and feel they offer greater certainty. However, Chinese law is – broadly – within the normal expectations of most non-Chinese parties. It is based largely on the UNIDROIT General Principles of International Commercial Contracts and reflects most basic principles of Western European civil law systems, albeit with certain special rules and some significant uncertainties.

Importantly, there are circumstances in which Chinese law must govern the contract.

BASIC RULE

The default position for China-related contracts is that only “foreign-related” contracts can be governed by a foreign law.² All other contracts must be governed by Chinese law.

WHAT IS A “FOREIGN-RELATED” CONTRACT?

A contract will be foreign-related if it fulfils one or more of the following conditions.³

1. At least one of the parties is “foreign”

For **companies**, this is determined by the place of incorporation. Companies incorporated under the laws of Mainland China (including foreign invested entities, joint ventures (JVs) incorporated in China and WFOEs) are not treated as foreign.⁴ Companies incorporated outside Mainland China (including in Hong Kong, Taiwan and Macau) are foreign for the purposes of this rule.⁵

For **individuals**, this is determined by nationality (not domicile or residence). PRC citizens (except for citizens of Hong Kong, Taiwan and Macau) are not foreign. Non-PRC citizens and citizens of Hong Kong, Taiwan and Macau are foreign. Stateless individuals are also treated as foreign.

2. The habitual residence of one or more parties is outside Mainland China

For **companies**, “habitual residence” is the jurisdiction where the company has its principal place of business.⁶

¹ In addition, if the contract contains an arbitration clause, that clause should state expressly which law governs the arbitration agreement (see page 29). The law governing the arbitration agreement may be different from the law governing the rest of the contract.

² Article 126 Contract Law, Article 3 Foreign-Related Civil Relations Law and Article 6 Foreign-Related Civil Relations Interpretation all allow parties to choose the law that governs a foreign-related contract. There are no provisions allowing parties to choose the governing law of a domestic contract. It is therefore generally understood that domestic contracts must be governed by Chinese law.

³ Article 1 Foreign-Related Civil Relations Interpretation and Article 522 2015 Interpretation on the Civil Procedure Law

⁴ In 2015, Mainland China published a Draft Foreign Investment Law. This law defines “foreign investor” to include entities incorporated in the Mainland but **controlled by** a foreign citizen, foreign enterprise or foreign organisation. While this would be a welcome development, the law is not yet in force. See also the discussion on *Siemens v Golden Landmark*, at page 27. It is unclear whether the SPC would apply the same principles in determining whether a contract between two entities incorporated in the Shanghai Free Trade Zone is a foreign-related contract. For the time being, we recommend applying the test as set out above.

⁵ Article 191 Companies Law

⁶ Article 14 Foreign-Related Civil Relations Law

For **individuals**, “habitual residence” is the place where the person has resided continuously for at least one year at the time when the foreign-related civil relationship is established, changed or terminated, and that forms the centre of his/her life. The definition excludes places where the individual receives medical treatment, is on secondment (“labour dispatch”), or performs public services.⁷

Applying the above definition, if a foreign company has a branch in Mainland China, it might be possible to argue that the Chinese branch has its “habitual residence” outside Mainland China. If the Chinese entity is an independent subsidiary company, it might be more difficult to argue that the principal office of that subsidiary is outside Mainland China.

3. The subject matter of the contract is outside Mainland China

This is determined by whether the subject matter of the contract is located outside China. For example, if the contract concerns land or goods outside Mainland China, it is likely to be treated as foreign-related. This applies regardless of the parties’ nationalities. For example, a contract between two Chinese parties to purchase land outside Mainland China would be foreign-related, and can be governed by a foreign law.

However, if the Chinese court considers that the cross-border element is artificial or minor, there is a risk that the court will treat the matter as domestic.⁸ The general understanding is that, if a substantial part of the contract is performed in

Mainland China, the presence of some indirect or subsidiary foreign factor will not qualify it as foreign-related under this heading. For example, a contract to build a factory in China is not foreign-related under this heading even if the factory is intended to produce goods for export to, eg, the US or Australia.

4. The occurrence, modification or termination of the civil legal relationship between the parties takes place outside Mainland China

The meaning of this remains uncertain. If a contract is executed, amended or terminated outside Mainland China, it may satisfy this limb of the test and be treated as foreign-related.

However, relying on this limb alone, in an otherwise purely domestic transaction, would be risky: the Chinese courts may refuse to treat the contract as foreign-related if they consider that the parties are relying on this limb purely to avoid having Chinese law govern the contract. For example, the mere fact that a contract was signed outside Mainland China may not be enough, in the eyes of a Chinese court, for the contract to be treated as foreign-related. If two Chinese parties meet in Hong Kong to execute or terminate a contract performed in China, and select a foreign law on that basis in order to avoid Chinese law, it is likely that a Chinese court would disregard that selection.⁹ Parties seeking to rely solely on this limb should at least be able to show that they have a legitimate commercial reason for executing, amending or terminating a contract outside Mainland China.¹⁰

⁷ Articles 1(2) and 15 Foreign-Related Civil Relations Interpretation

⁸ Article 11 Foreign-Related Civil Relations Interpretation

⁹ Article 11 Foreign-Related Civil Relations Interpretation

¹⁰ This position is supported by Article 11 Foreign-Related Civil Relations Interpretation.

5. “Any other circumstances that may be deemed foreign-related civil relationships”

This is a “catch-all” provision, with no express definition or test attached. In practice, it will operate to give a judge or arbitrator discretion to determine that a contract is foreign-related, even where it does not fall within any of the four more specific categories set out in Article 1 Foreign-Related Civil Relations Interpretation.

We are aware of a small number of cases in which a Chinese court has held that a contract between two Chinese parties was “foreign-related”, based on Conditions (3) and (4).¹¹ In these cases, the courts have relied on a combination of foreign elements that fall within Conditions (3) and (4). While Condition (3) may be relied upon with more confidence when two Chinese parties are engaged in a transaction which takes place outside China, the application of Condition (4) alone should be handled with extreme caution. However, it is important to remember that court decisions are not binding in China; the application of Conditions (3) and (4) will be determined on a case-by-case basis.

Usually, Condition (1) is the best and most certain condition on which to rely. Take advice before relying on Conditions (2), (3), (4) or (5).

WHICH FOREIGN LAW CAN BE CHOSEN?

In commercial practice it is common for parties to choose (for example) English law to govern an agreement, even if neither party is English. Historically, this arrangement was sometimes challenged by Chinese courts that were unfamiliar with international commercial practice. This is no longer the case. Article 7 Foreign-Related Civil Relations Interpretation supports international practice by confirming that parties to a foreign-related contract may select the law of any jurisdiction, even where it is unrelated to their contract.¹² In principle, therefore, a contract between eg an Australian party and a Chinese party can be governed by English law – or by Hong Kong, New South Wales, New York or any other foreign law.

However, there are exceptions.

EXCEPTIONS TO THE BASIC RULE

In certain circumstances, parties are required to select Chinese law as the governing law of the contract even where the contract is foreign-related. In other circumstances, parties are strongly advised to apply Chinese law.

¹¹ *Jiangsu Institute of Design for Geology and Mineral Resources v. Anhui Teng Jie Metal Materials Co., Ltd.* [2015] Xu Shang Xia Zhong Zi No. 00182 (江苏省地质矿产设计研究院与安徽腾捷金属材料有限责任公司企业借贷纠纷上诉案, (2015)徐商辖终字第00182号); *Dalian Hui Fengda International Trade Co., Ltd. v. Bank of East Asia (China) Co., Ltd. Dalian Branch*, [2015] Da Li Yi Min Zhong Zi No. 410 (大连汇丰达国际贸易有限公司与东亚银行(中国)有限公司大连分行财产损害赔偿纠纷管辖裁定书, (2015)大立一民终字第410号)

¹² See also Article 3 Foreign-Related Civil Relations Law: “The parties may expressly choose the laws applicable to foreign-related civil relations in accordance with the provisions of law”.