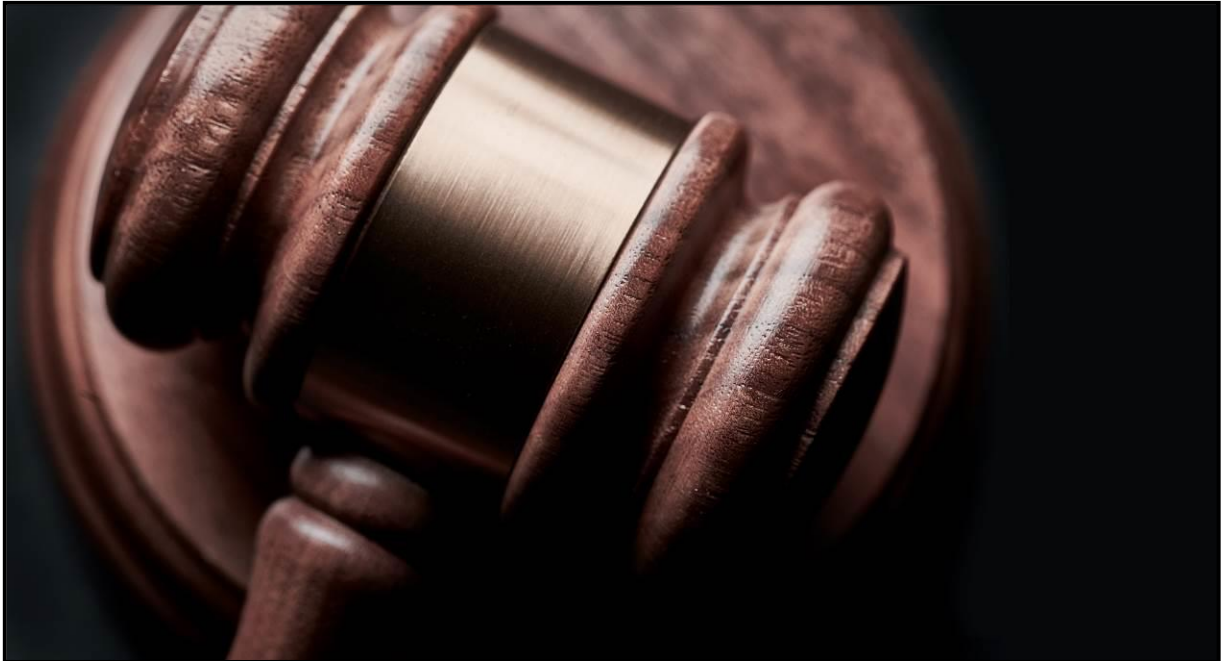


Understanding the Choice of Applicable Governing Law for Contracts in China

- China.direct.biz, by Daisy Du and Noam David Stern (23 July 2021)



When drafting any contract, it is important to decide on and expressly state the applicable governing law. Under PRC Law, it is the general principle that contracts without “Foreign-related Elements” shall be governed by the laws of the PRC whereby only foreign-related contracts can be governed by non-PRC laws. If a contract does not have any Foreign-related Elements, the parties shall not choose the jurisdiction of any overseas court or arbitration institution.

In the following, we will briefly introduce the basics of PRC Law and practices regarding the choice of governing law when Foreign-related Elements are involved in a contract and specify the special circumstances where PRC Law must govern even if Foreign-related Elements are involved. For the purpose of this article, PRC Law refers to Mainland China laws (excluding Hong Kong, Macau and Taiwan).

What is Considered Foreign-related Elements?

According to *Article 1 of the “Interpretation of Supreme People’s Court on Several Issues Relating to Application of the Law of the People’s Republic of China on Application of Laws to Foreign-related Civil Relations (1) (Amended in 2020) (“Interpretation 1 (2020)”)*, a foreign-related civil relationship may be determined by a People’s Court if it fulfils any of the following conditions:

1) One or two parties are foreign citizens, foreign legal persons, or other organizations or stateless persons.

Companies and organizations incorporated outside of the PRC including companies incorporated in Hong Kong, Macau and Taiwan are considered Foreign-related Elements. Companies incorporated in the PRC with or without foreign investment are considered domestic.

As to individuals, this shall be determined according to nationality. Non-PRC citizens are considered foreign. Citizens of Hong Kong, Macau, and Taiwan are considered Foreign-related Element for this purpose. Stateless individuals are also considered as Foreign-related Elements.

It is unclear whether a contract is Foreign-related if a contractual party is foreign but undertakes no rights and/or obligations under the contract. In precedence cases, the People's Courts have held different opinions.

2) Habitual residence of one or more parties is Outside the PRC.

For companies, habitual residence refers to the jurisdiction where the company has its principal place of business¹.

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 forms the center of his/her life. The definition excludes places where the individual receives medical treatment, is on secondment or performs public services.²

3) Subject matter of the contract is outside PRC.

This is determined by the location of the subject matter of the contract. It is the general understanding that if a substantial part of the contract is performed in the PRC, it will not be considered as foreign-related.

¹ Article 14 Foreign-Related Civil Relations Law

² Article 15 Interpretation (1) (2020)

If the contract relates solely to goods located outside the PRC, it is likely to be treated as foreign-related. If the subject matter is located outside of the PRC but the performance of the contract is related to the subject matter within the PRC, it may be considered as domestic³.

For example, if the seller firstly buys and imports goods to the PRC by itself and then transfers the goods to a buyer within the PRC, it is likely to be considered as domestic.

If the subject matter of a contract **indirectly** relates to foreign elements, it may not be considered as Foreign-related Elements under this rule.

As to a contract signed by two Chinese companies regarding the design and development of a software program operating on a platform located outside PRC, it may not be identified as a Foreign-related Element solely based on the location of the platform⁴.

In any case, if the People's Court considers that the Foreign-related Elements are not real or minor, there is a risk that the People's Court will treat it as domestic.

4) Legal fact that leads to the occurrence, modification or termination of the civil legal relationship between the parties takes place outside the PRC.

The application of this provision remains uncertain and shall be determined on a case-by-case basis.

For instance, according to the language of this provision, if a contract is signed, modified, or terminated outside the PRC, it is likely to be identified as a Foreign-related Element is involved.

However, it is risky to argue that a Foreign-related Element exists solely based on the location of the signing, amendment, or termination of the contract, especially if there are no other Foreign-related elements involved and the People's Court thinks this is done intentionally to avoid that PRC Law governs the contract.

³ (2018) Hu Min Shen No. 921

⁴ (2014) Hu Second Intermediate Civil Ren (Arbitral) No. 13

According to *Article 9 of the “Interpretation 1 (2020)”*: “Where a party concerned intentionally makes connection points of foreign-related civil relations in order to circumvent the mandatory provisions of the laws and administrative regulations of the PRC, the People’s Court shall determine that the dispute involves no application of foreign laws.”

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

This “catch-all” provision provides judges and arbitrators with the discretion to determine other situations that can be identified as Foreign-related Elements.

For instance, the Shanghai First Intermediate People’s Court determined in November 2015 in the case of “Siemens International Trading (Shanghai) Co., Ltd. vs Shanghai Golden Landmark Co., Ltd.” that two parties incorporated in the Shanghai Free Trade Zone (“FTZ”) are considered more than domestic. Furthermore, the subject matter of the contract - equipment stored in the Shanghai FTZ, where no Chinese taxes were payable on it before being transferred out of the FTZ to the buyer, was considered more than domestic.

The “*Supreme People’s Court Opinion on the Provision of Judicial Safeguards for the Construction of Pilot FTZs (2016)*” further supported this by stating that: “If two wholly-foreign owned enterprises registered in a pilot FTZ enter into an agreement and submit their disputes for arbitration outside the PRC, the People’s Courts should not hold such arbitration agreement invalid merely on the ground that the dispute concerned is not foreign-related”.⁶

The Beijing Fourth Intermediate People’s Court determined in August 2018 in the case of “Qingdao Xindeda Trading Co., Ltd. vs Tianjin Clothes Import and Export Holding Co., Ltd.” that the subject matter of the contract - goods located in the bonded area without customs clearance are goods that have not entered into the PRC and shall be considered as Foreign-related.

When determining if Foreign-related Elements are involved in a contract, the above first listed condition is the most certain to rely on while any other conditions shall be applied with further consideration.

⁶ Article 9, paragraph 1, Supreme People’s Court Opinion on the Provision of Judicial Safeguards for the Construction of Pilot Free Trade Zones (2016)

Choice of applying foreign laws

Article 7 of the “Interpretation (1) (2020)” states that “Where one of the parties claims that the choice of law under a contract should be invalid on the ground that such law is not actually associated with the foreign-related relation at issue, the People’s Court shall not uphold the claim.”

Accordingly, the parties concerned can agree on an applicable law that does not have an actual connection to contract. For example, a contract concluded between a Danish party and a Chinese party can be governed by Norwegian Law, Swedish Law or French Law, if they so wish.

However, the parties shall pay attention to contracts related to real-estate, securities, pledge of rights and so on as special restrictions may apply.

Invalidity of applying foreign laws

If the parties concerned choose non-PRC Law as the governing law for contracts that must be governed by PRC Law, the choice of non-PRC Law will be invalid⁸ and PRC Law shall apply.

If one or more of the parties concerned intentionally create a connection point to a foreign-related civil relation so as to avoid being subject to mandatory PRC laws and administrative regulations, the choice of law will be invalid⁹ and PRC Law shall apply.

Application of PRC Law to foreign-related contracts

PRC Law shall govern if:

- there are mandatory rules¹⁰ or the application of foreign laws will damage the public interests of the society of the PRC¹¹ such as protection of workers’ rights and interests, food or public health safety, environmental safety, financial safety (foreign exchange), anti-monopoly or anti-dumping.
- Sino-foreign equity contracts, co-operative JV contracts, and contracts for Sino-foreign co-operative exploration and exploitation of natural resources are performed in the PRC.

⁸ Article 4 Interpretation (1) (2020)

⁹ Article 9 Interpretation (1) (2020)

¹⁰ Article 4 Foreign-Related Civil Relations Law

¹¹ Article 5 Foreign-Related Civil Relations Law

Choose Governing Law with Care

When drafting a contract, it is important to determine and expressly state the applicable governing law as this can have a big impact on its enforcement in China. It is always suggested to get professional legal advice if you are uncertain what conditions apply to your contract and if you are permitted to freely choose the governing law. Getting this right from the start will give greater certainty and protection in case any commercial or legal dispute should occur.

Contact

Noam David Stern, Founder

noam@china-direct.biz

Mobile: +86 136 1169 1358

www.china-direct.biz

China-direct.biz is a specialized consultancy in Shanghai that offers practical advice and supporting services to foreign investors and mostly Scandinavian companies regarding market access, company set-ups and operations in China. Our management team has a strong legal and business background combined with many years of experience in assisting foreign-invested companies in China.

©Copyright 2021 All rights reserved. The information contained herein is of a general nature and the author cannot be held liable for the accuracy and validity of the information and opinions expressed. Reproduction or redistribution of this material is not permitted without prior written consent by the author and China-direct.biz.