Foreign Investment: Foreign Economic Contract Law

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On March 21, 1985, the Standing Committee of the National People’s Congress of the People’s Republic of China (PRC) passed the Foreign Economic Contract Law of the People’s Republic of China (the Law). On May 24, 1985, the State Council promulgated the Regulations of the People’s Republic of China Governing Contracts for the Import of Technology (the Regulations). The latter are the first regulations issued in conjunction with the Law. The Law and the Regulations are major steps in China’s drive to build a legal order that attracts foreign trade and investment.

Since 1979, China’s leader Deng Xiaoping and his reformist supporters have overseen the enactment of several important laws and regulations governing economic relations between Chinese and foreigners.1 The Foreign Economic Contract Law and the Regulations Governing Contracts for the Import of Technology are the most recent additions to this program of completing and reforming China’s law of foreign economic relations.2

The Foreign Economic Contract Law contains forty-three articles, divided into seven chapters covering “general provisions;” contract formation; performance and liability for breach; assignment; modification, rescission and termination; dispute resolution; and “supplementary provisions.”3 The Law governs nearly all economic contracts between enterprises or “other economic organizations” of the PRC and foreign individuals, enterprises or “other foreign economic organizations.”4 The Law does not apply to contracts for international trans-

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2. For analysis of Chinese laws and regulations governing economic relations, see generally Xiao, Sino-U.S. Trade Ties and Legal Exchange, BEIJING REV., July 7, 1985, at 21; Liu, Legal Protection for Investors in China, CHINA’S FOREIGN TRADE, April 1985, at 8.
4. Foreign Economic Contract Law, supra note 3, at art. 2.
portation, contracts which were formed and received proper approval before July 1, 1985, and contracts involving Chinese individuals.

Articles 7 through 15 of the Law set forth the law of contract formation. Foreign economic contracts must be in writing and signed by the parties. Agreements reached through exchanges of letters, telegrams or telexes are valid, but a contract is formed in such cases only when a confirming document is signed if one of the parties so requests. Some types of agreements, such as those establishing joint-ventures or involving technology imports, must be approved by the state before they become valid contracts. The Law also provides that contracts concluded by means of fraud or duress and contracts which “contravene the social or public interest” are void. Articles 12 through 15 list provisions which foreign economic contracts should normally contain. Most of these provisions would be included as a matter of course in a well-drafted business contract in the developed capitalist world.

Articles 16 through 18 establish the basic rules for performance and breach. Generally, parties must perform their contractual obligations. Non-performance or performance which does not comply with the conditions agreed to in the contract constitutes a breach. The prospective victim of a breach may suspend performance before a breach occurs if it has “concrete” or “definite” evidence that the other party cannot perform its obligations. Once a breach has occurred, the victim may seek damages or other remedies. The victim may also

5. Id. For a list of the types of contracts clearly included, see Cohen, The New Foreign Contract Law, China Bus. Rev., July–Aug. 1985, at 52.
6. In general, the parties to earlier contracts may agree to be bound by the new law. Foreign Economic Contract Law, supra note 3, at arts. 30–41. Application of this provision to three specific types of contracts is unclear, however. See infra note 54.
7. Contracts with Chinese individuals are excluded by negative implication. Foreign Economic Contract Law, supra note 3, at art. 2.
8. Id. at art. 7.
9. Id.
10. Such state-approval requirements are established by laws and regulations governing specific types of contracts, not by the Foreign Economic Contract Law itself. See Regulations of the People’s Republic of China Governing Contracts for the Import of Technology, reprinted in 21 J.L.M. 801 (1985) (unoff. trans.), at art. 4 (setting forth approval requirements for technology import contracts) [hereinafter cited as Regulations]; Law of the People’s Republic of China on Joint-Ventures Using Chinese and Foreign Investment, (1979), at art. 5 reprinted in 1 CHC, MOSER & NLE, supra note 1 [hereinafter cited as Joint Venture Law].
11. Contracts which are void on the latter grounds, however, may be made valid if the parties agree to remove the offending provisions. Foreign Economic Contract Law, supra note 3, at arts. 12–15.
12. Id. at arts. 16–18.
13. Id. at art. 17. The party which suspends must immediately inform the other party of its action. The other party can avoid suspension by providing a “full guarantee” of performance.
14. Id.
15. Foreign Economic Contract Law, supra note 3, at art. 19.
rescind the contract. If the contract contains “mutually independent” parts, the rescinding party may choose to cancel only some of the severable parts.

The provisions relating to damages are scattered among several articles. The core provision, article 19, states that the party in breach must compensate the victim for its losses. Compensation may not, however, exceed the losses which the party in breach should have foreseen at the time the contract was formed. Recovery is also limited by the victim’s duty to mitigate losses; the victim may not claim damages for additional losses which it could have avoided. In addition, a party which cannot perform its contractual duties because of the occurrence of an event of force majeure is relieved of at least part of its liability.

Parties to a foreign economic contract may stipulate liquidated damages and, apparently, penalty clauses. However, if the damages specified in the contract are deemed “excessively” higher or lower than actual losses, a damage clause may not be enforced. In such circumstances, a party may seek a ruling by an arbitral body or court adjusting the liability of the party in breach. In addition to being entitled to recover damages for breach, a party may be compensated for losses resulting from the invalidity of a contract if the other party is responsible for the contract’s invalidity.

Articles 28 through 36 govern modification, rescission, and termination. Unilateral rescission is permitted not only in the event of breach but also when an event of force majeure has prevented performance or when conditions stipulated in the contract as grounds for rescission have arisen. A contract is terminated when it has been fully performed, when a court or arbitral body orders the contract

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16. Id. at art. 29. On the obligation to give notice to the other party and, in some cases, to seek state approval, see id. at arts. 32, 33.
17. Id. at art. 50.
18. Id. at art. 19. On damages, see generally Nee, The Foreign Economic Contract Law: Practice Commentary, in 1 Chu, Mosher & Nee, supra note 1, at 1.
19. Foreign Economic Contract Law, supra note 3, at art. 22.
20. The party claiming force majeure must promptly inform the other party, however. Id. at arts. 24, 25. Force majeure is defined as: (1) an event which the parties could not have foreseen when they concluded the contract, the effects of which cannot be avoided or overcome; or (2) an event defined as force majeure in the contract. Under article 21, when both parties are in breach, they should “share the responsibility.” Id. at art. 21. However, the law does not indicate how to allocate liability. Id.
21. Id. at art. 20. See also Nee, supra note 18, at 2 (noting the possibility of valid penalty clauses).
22. Foreign Economic Contract Law, supra note 3, at art. 20
23. Id. at art. 11.
24. Id. at art. 29.
terminated, or when the parties agree to end the contract. A contract may be modified by written agreement among the parties, but if the contract is one which originally required state approval, the parties must also obtain the consent of the original approving authority.

Articles 26 and 27 permit assignment of contract rights and duties. If a contract did not originally need state approval, a party may assign its rights and obligations to a third party provided that the other original party consents. If the contract originally required state approval, the parties must obtain the consent of the original approving authority (unless the contract as originally approved contained a clause permitting assignment without state approval).

Articles 37 and 38 set forth procedures for resolving contract disputes. Parties must first attempt to resolve their differences through private negotiations or relatively informal mediation. If the parties are unable or unwilling to resolve their dispute in this manner, they may invoke an agreement to arbitrate. Such an agreement must be written, but it need not have been part of the original contract. Indeed, an effective agreement to arbitrate can be reached after the dispute has arisen. The parties may specify non-Chinese arbitral bodies. In the absence of an agreement to arbitrate, the parties may bring suit in Chinese courts.

Article 5 provides rules for determining which law a court or arbitral body must apply in resolving a contract dispute. Chinese law governs the resolution of disputes involving contracts for equity joint-ventures, cooperative joint-ventures, or cooperative exploration and development of natural resources. In other cases, the parties may agree on the law

25. Foreign Economic Contract Law, supra note 3, at art. 31. Rescission and termination leave unaffected contract provisions governing dispute resolution, accounting and liquidation. Id. at arts. 34-36.
26. Id. at arts. 31, 33.
27. Id. at art. 26.
28. Id. at arts. 26, 27. But see Nee, supra note 18, at 2-3 (reporting reluctance by Chinese authorities to approve assignment in some cases).
29. Foreign Economic Contract Law, supra note 3, at art. 37. See also id. at art. 3 (requiring that contracts be concluded in accordance with the principles of achieving agreement through consultation).
30. Id. at art. 37.
31. Id.
32. Id.
33. Id.
34. Id. at art. 38. See also Li, New Law on Semi-Foreign Economic Contracts, China Trade News, May 1985, at 6, but in Cohen, supra note 5, at 53 (article 38 seems to indicate that an agreement to arbitrate bars the parties from bringing suit in Chinese courts).
35. Foreign Economic Contract Law, supra note 3, at art. 5. In an equity joint venture, Chinese and foreign parties make investments in a new, legally distinct entity. In a "cooperative" or "contract" joint-venture no new legal entity is created. Rather, each side contributes various inputs of capital, raw materials, technology and labor. Lubman, Foreign Investment in China: Legal Problems and Some Perspectives on Them, in BUSINESS TRANSACTIONS WITH CHINA, JAPAN
which will govern the handling of disputes.\footnote{\textsuperscript{36}} If the parties have not agreed on choice of law, the law of the country with the "closest relation" to the contract will be applied.\footnote{\textsuperscript{37}}

In enacting new laws, the practice of the PRC since 1979 has been first to pass a general law and later to issue more detailed and specialized regulations.\footnote{\textsuperscript{38}} The Foreign Economic Contract Law has followed this pattern. The Regulations of the People's Republic of China Governing Contracts for the Import of Technology (the Regulations) are the first set of regulations elaborating the legal requirements for a specific type of foreign economic contract.\footnote{\textsuperscript{39}} The Regulations contain thirteen articles. They govern all contracts between Chinese and foreigners to transfer or license patent rights or other industrial property rights, to provide "technical know-how" in a variety of fields, and to provide technical services.\footnote{\textsuperscript{40}} Article 12 charges the Ministry of Foreign Economic Relations and Trade (MOFERT) with interpreting the Regulations.\footnote{\textsuperscript{41}}

Several articles define the conditions for a valid contract to import technology. Under article 4, all technology import agreements must be approved by MOFERT or by agencies authorized by MOFERT before they can become a binding contract.\footnote{\textsuperscript{42}} Article 3 provides, essentially, that imported technology must promote economic efficiency, economic development, safety, environmental protection, the development of new products, or the expansion of exports. Also,
Imported technology must be "advanced" and "practical." Although "advanced" is not defined in the Regulations, a high official in MOFERT's legal department has said that the term generally means the "advanced world level of the late 1970's and 1980's."43

Article 9 lists nine "unfair restrictive requirements" which may not be included in a technology import contract without the special authorization of the appropriate approving authority. For example, article 9 generally prohibits contract provisions which (1) require the recipient to buy raw materials, spare parts, equipment or "unnecessary" technology or technical services from the supplier party; (2) restrict the quantity, variety or sales price of products the recipient produces using the technology; (3) "irrationally" restrict the recipient's export markets or sales channels; or (4) prohibit the recipient from continuing to use the technology after the contract terminates.45 As the last restriction indicates, technology import contracts are not simply leasing agreements but are contracts to sell technology to Chinese parties.46

Article 6 requires the supplier to guarantee that the technology it provides will be able to achieve the "technological targets" stated in the contract. Such performance standards must be included in a contract for the import of technology.47 Article 7 seeks to protect the supplier against breaches of confidentiality by the recipient. The recipient's duty not to divulge seems to be limited, however, to portions of the technology specified in the contract as confidential.48

The Law, and to a lesser extent the Regulations, should generally provide enhanced access and greater certainty for foreign investors and businesses in their commercial relations with China.49 The Law and

43. Id. at art. 3.
44. Beijing Rev., Jan. 21, 1985, at 17 (interview with Liu Yimin, director of the Treaty and Law Department of MOFERT). Although the statement predates the Regulations, it may be important as a general statement of MOFERT's views.
45. A MOFERT official has admitted that, under "special circumstances," the restrictions on contract provisions set forth in article 9 "can be made flexible." F.B.L.S., June 5, 1985, at K12.
46. Torbert, Technology Transfer to China Under the New Regulations, East Asian Executive Reports, Sept. 1985, at 14. No technology import contract may have a term of more than ten years unless the approving authority grants special permission. Regulations, supra note 10, at art. 8.
47. Id. at art. 3.
48. Id. at art. 7.
49. Western commentators view the the Law as a major step toward a more open legal order for China's international economic relations. Cohen, supra note 5, at 52-54. Noble, China's Foreign Economic Contract Law: Introduction, Nat. 23 Int'l M. Supp. 797 (1983); Luhman & Rundt, Another Legal Milestone, China Trade Rev., May 1985, at 12. Chinese sources have also stressed that the Law and much other legislation enacted since 1979 is intended to promote foreign involvement in the Chinese economy (and thereby to accelerate economic development). Foreign Economic Contract Law, supra note 3, at art. 1. Jingji Ribao (Economic Daily), March 22, 1985, at 1, reprinted in F.B.L.S., April 11, 1985, at K17, 11. supra note 34, at 1.

The Regulations, particularly articles 4, 6, and 9, appear to adopt a more restrictive tone than the Law. This restrictive tone may be explained, in part, by the economic atmosphere in which the Regulations were promulgated. See infra note 62 and accompanying text.
the Regulations are more "liberal" than the relatively recent and once-radical local regulations of the Shenzhen "Special Economic Zone" that provided the model for the national provisions.\(^{50}\) The Law and the Regulations are also much less restrictive and more complete than equivalent laws in many developing countries.\(^{51}\) Many of the provisions in the Law, in particular, are very much in keeping with international business practices and American contract law.\(^{52}\) At minimum, the dozens of articles in the Law and the Regulations provide some ground rules for Chinese and foreign contract negotiators. This should reduce the high transaction costs that have been the cause of complaints from foreign parties.\(^{53}\)

The Law and the Regulations do not present an entirely favorable picture for foreign enterprises and investors, however. Both the Law and the Regulations are part of a rapidly developing and still incomplete system of economic regulation in China. Thus, it is hardly surprising that the Law and, to a lesser extent, the Regulations leave unanswered many important questions. For example, will the Law apply to equity joint-venture, cooperative joint-venture, and natural resource exploration and development contracts formed prior to the effective date of the Law?\(^{54}\) Will lawful actions by the Chinese gov-

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50. See Regulations of the Shenzhen Special Economic Zone Governing Economic Contracts Involving Foreign Parties (1984); Provisional Regulations Governing the Importation of Technology into the Shenzhen Special Economic Zone (1984), reprinted in 2 CHU, MOSER & NEE, supra note 1, at 145. See also NEE, Special Economic Zones, Practice Commentary, in 2 CHU, MOSER & NEE, supra note 1, at 16–17; Cohen, supra note 5, at 52–53. Compare Regulations, supra note 10, at art. 9 with the Shenzhen Provisional Regulations, at art. 18, which ban "unfair and unnecessarily restrictive" provisions in general and do not provide for exemptions in "special circumstances."

51. See Hormick, Secured Lending in the ASEAN Countries in LEGAL PROBLEMS OF CAPITAL INVESTMENT AND SECURED LENDING IN THE ASEAN COUNTRIES (Wickers ed. 1983) at 131 (pointing to restrictive laws and absence of law as impediments to the formation of foreign loan contracts in several Asian Less Developed Countries). See also Lee, Formation of Contract and Contract Law through Multinational Joint-Ventures: Indonesia, China and the Third World, 17 INT'L. LAW. 257 (1985) (describing the possibility of forming joint-ventures and developing practical foreign economic contract law through reliance on the "law of the contract" in Indonesia, with comparisons to China).

52. The parallels may be still closer in practice. Since the legal reform began in earnest in 1979, China has generally been willing to accept the "law of the contract" made by the parties if it does not contravene existing law. Lubman, supra note 55, § 4.02, c.f. Foreign Economic Contract Law, supra note 3, at art. 40, § 4 (the "grandfather clause"). In early 1985, Chinese attorneys who had "responsibilities" for negotiating contracts with foreigners indicated that "they are now more amenable to negotiating and concluding extensive 'Western style' commercial contracts which spell out numerous areas of performance and risk." Sobel, supra note 49, at 810.

53. See, e.g., Lubman, supra note 55, § 4.02 (noting the advantages and disadvantages of a sparse legal framework and reliance on the "law of the contract" in negotiating and forming joint ventures).

54. Article 40 of the Foreign Economic Contract Law states that contracts of these three types formed prior to the law's effective date "may still be performed according to the stipulations of the contracts." Chinese authorities might view the term "may" as giving Chinese state agencies, not the parties, discretion to determine whether the terms of the contract or the subsequent Chinese law governs. Cohen, supra note 5, at 52–53. See supra note 6.
ernment which frustrate the purpose of a contract count as events of force majeure?\(^5\)

In addition, what types of liquidated damages and penalty clauses will Chinese authorities be willing to enforce?\(^5\) On what terms will they approve requests for rescission or assignment of contracts (under the Law) and requests for exemption from prohibitions of “restrictive” terms (under the Regulations)?\(^7\) What contracts will they consider to contravene the “social or public interest” or to violate the principles of “equality and mutual benefit”? How will they reconcile the Regulations’ conflicting requirements that imported technology be both “advanced” and “practical”?\(^8\) Finally, how will Chinese officials resolve future conflicts between existing laws and the new Law and Regulations?\(^9\)

Many of these questions may be answered in ways which prospective foreign parties may not like and which could ultimately undermine the generally “liberal” or “open door” line of the Law. However, it is unlikely that Chinese authorities will frequently invoke unreasonable or illiberal interpretations of “public and social policy” or “equality and mutual benefit” grounds to void foreign economic contracts unless there is a major shift in China’s foreign economic policies. If such a shift were to occur, Chinese authorities probably would not view any of the provisions of the Foreign Economic Contract Law as meaningful constraints. For the present, Chinese officials have spared no effort to assure foreign investors and businessmen that no such policy reversal lies ahead. The pattern of Chinese politics, policy and law-making since 1979 provides substantial grounds for giving credence to their assertions.\(^6\)

Further, although the Regulations may seem more restrictive than the Law, future elaborations of the Law will not necessarily be as unfavorable to foreign financial and business interests. The restrictive

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\(^5\) For example, one account reports that the draftsmen of the law indicated that the denial of an export license “under a law in effect when the contract was signed” would not be considered an event of force majeure. They added, however, that the law permits a contract provision declaring that no contract is formed until an export license is granted. Lubman & Randt, supra note 49 at 12; See supra note 20.

\(^6\) See supra note 42, 43 and accompanying text.

\(^7\) See supra note 44 and accompanying text. Such conflicts seem likely. Technology developed in advanced industrial economies during the late 1970’s and 1980’s may not yet be well-suited to China’s still underdeveloped and capital-scarce economy.

\(^8\) See, e.g., Cohen, supra note 5, at 53 (discussing a conflict between the Foreign Economic Contract Law and the Joint Venture Law).

character of the Regulations must be attributed in part to the unusual circumstances in which they were promulgated. The leadership had recently announced that importing technology was China's "major development task," and that past technology imports had been "inadequately managed." In the leadership's view, decentralization of the authority to enter into contracts to import technology had encouraged inefficient duplication of technology imports. Such wasteful practices could not be tolerated in a period of sharply declining foreign exchange reserves. The policy prescription was a rather specific one: stricter central management of technology imports.62

Finally, the presence of some provisions which foreign parties will find objectionable or onerous is inevitable. Even Deng Xiaoping and the most reformist leaders are committed to building "socialism with Chinese characteristics." While the meaning of the phrase remains ambiguous,63 it surely does not mean that the Chinese government will break completely with past practices or accept any terms which foreign parties might think to propose. Moreover, there are still powerful leaders who are deeply skeptical about "open door" and market-oriented policies. Deng and his allies cannot lightly dismiss opposition and criticism from such sources, especially when the newly reformed economy is experiencing serious growing pains (as it has been since the first quarter of 1985).64 Thus, while China's new Law and Regulations are clearly less than ideal for foreign parties, they offer the most attractive terms foreigners can reasonably expect for the foreseeable future.

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61. Xiao, China Enters New Stage of Economic Development as Technology Reform Equipment Imports, China Trade News, June 1985, at 1. (Interview with MOFERT vice minister Wu Yuming, outlining the new policy and the past problems.)


63. See, e.g., ECONOMY, Oct. 16, 1985, at 17.

64. For an argument that laws which do not break our sharply with the PRC's prior practices are advantageous to foreigners, see Allen, Credit and Security: Economic Orders and Legal Relations, 33 (Rev. & Coop. L.Q. 12-38 (1984).