



Supreme People's Court Interpretation on General Provisions of the Contract Part of the *PRC Civil Code* Released

On 5 December 2023, the Supreme People's Court ("SPC") of the People's Republic of China (the "PRC") promulgated the *Interpretation of the SPC on Several Issues Concerning the Application of the General Provisions of the Contract Part of the Civil Code of the PRC* (the "**Interpretation**"). The Interpretation has entered into effect at the same day of its promulgation, i.e. on 5 December 2023.

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1. Background and Overview

a) Background

The *PRC Civil Code*, which constitutes the PRC's first combined codification of the civil law ever, had entered into effect on 1 January 2021. Concurrently with the entering into effect of the *PRC Civil Code*, numerous existing laws and regulations, among them the former *PRC Contract Law* first effective as of 1 October 1999, have been abolished.

In addition and among others, also the *Interpretation of the SPC on Several Issues Concerning the Application of the PRC Contract Law (I)* and the *Interpretation of the SPC on Several Issues Concerning the Application of the PRC Contract Law (II)* (collectively, the "**Previous Interpretations**") had been abolished as of 1 January 2021.

During the period between the abolishment of the Previous Interpretations and the entering into effect of the new Interpretation, legally speaking, no official interpretations of the SPC had been applicable to the General Provisions of the Contract Part of the *PRC Civil Code*. However, according to our observations, certain contents of the Previous Interpretations were still frequently used by PRC People's Courts in practice during such interim period.

b) Overview

The Interpretation consists of 9 sections and 69 Articles in total. The sections of the Interpretation are as follows:

- (1) General Rules;
- (2) Conclusion of Contracts;
- (3) Validity of Contracts;
- (4) Performance of Contracts;
- (5) Preservation of Contracts;
- (6) Modification and Assignment of Contracts;
- (7) Termination of Contractual Rights and Obligations;
- (8) Liability for Breach of Contract; and
- (9) Supplementary Provision.

The Interpretation directly refers to and deals with relevant stipulations of the General Provisions of the Contract Part of the *PRC Civil Code*. The Interpretation provides for a comprehensive and detailed guidance and interpretation of the topics referred to above.

Together with the Interpretation, the SPC also released 10 related typical cases. The SPC's views on the 10 related typical cases are generated from and in line with the provisions of the Interpretation. Although, legally speaking, the PRC is not a case-law jurisdiction, courts have been required to apply the law by referring to methods embodied in similar guiding and typical cases published by the SPC since around a decade ago. Therefore, also the 10 typical cases related to the Interpretation are of great importance for the judicial practice in the PRC.

2. Key Aspects of the Interpretation

In the following, we focus on several key aspects of the Interpretation, which may be frequently encountered in daily practice with regard to contracts or which provide for changes compared to the Previous Interpretations.

a) Conclusion of Contracts

(1) General

According to Article 470 of the *PRC Civil Code*, the contents of a contract shall be agreed upon by the parties, and generally include the following clauses: (i) names and domiciles of the parties; (ii) subject matter; (iii) quantity; (iv) quality; (v) price or remuneration; (vi) time limit, place and method of performance; (vii) liability for breach of contract; and (viii) method to settle disputes.

However, the Interpretation makes it clear that not all of the items referred to above constitute *essentialia negotii* on which the parties must have reached agreement in order to validly conclude a contract. Article 3 of the Interpretation stipulates that if the parties dispute the formation of a contract, and the People's Court can determine (i) the names of the parties, (ii) the subject matter, and (iii) the quantity, it shall generally determine that the contract has been formed, unless otherwise provided by law or otherwise agreed upon by the parties. If the formation of a contract can be determined according to the provisions of the preceding sentence, the People's Court shall determine the omitted content of the contract in accordance with Articles 510 and 511 of the *PRC Civil Code*, among others.

(2) Preliminary Contracts

Preliminary contracts are rather commonly used in different kinds of transactions, especially in more complex ones.

According to Article 495 of the *PRC Civil Code*, a subscription order, purchase order, pre-order, etc., in which the parties agree to conclude a contract within a certain period of time in the future, shall constitute a preliminary contract. Where one party fails to perform the obligation to conclude an actual contract as agreed in the preliminary contract, the other party may request such party to bear the liability for breach of the preliminary contract.

The Interpretation further specifies several criteria on how to recognize the formation of a preliminary contract, breach of a preliminary contract, etc. We summarize relevant provisions of the Interpretation as follows:

- A preliminary contract shall be formed if (i) the parties, by signing a subscription order, purchase order, or pre-order, etc., or by paying a deposit, agree to conclude an actual contract within a certain period of time in the future; and (ii) the content of the actual contract to be concluded in the future, such as the parties and the subject matter, can be determined (see Article 6, 1st paragraph, of the Interpretation).
- A preliminary contract shall not be formed if (i) the parties, by signing a letter of intent, a memorandum (of understanding), etc., only express their intent of a transaction but they do not agree to conclude an actual contract within a certain period of time in the future; or (ii) the contents of the actual contract to be concluded, such as parties and the subject matter, are difficult to be determined (see Article 6, 2nd paragraph, of the Interpretation).
- An actual contract (and not only a preliminary contract) shall be formed if (i) the parties, by signing a subscription order, purchase order, or pre-order, etc., have agreed on major contents of the contract, such as the subject matter, quantity, price or remuneration, etc., which meets the conditions for formation of a contract stipulated in Article 3, 1st paragraph, of the Interpretation; and (ii) it is not explicitly agreed that a contract shall be concluded separately within a certain period of time

in the future, or they so agree, and one party has performed the contract and the other party has accepted it (see Article 6, 3rd paragraph, of the Interpretation).

- It shall constitute a failure to perform the obligations under a preliminary contract if, after a preliminary contract became effective, a party (i) refuses to conclude an actual contract; or (ii) fails to enter into an actual contract due to acting contrary to the principle of good faith during the negotiations (see Article 7, 1st paragraph, of the Interpretation).

When determining whether a party acted contrary to the principle of good faith during the negotiations on conclusion of a contract, the People's Court shall take into account whether the conditions proposed by the party during the negotiations evidently deviate from the content of the preliminary contract, whether it has made reasonable efforts to negotiate, and other factors (see Article 7, 2nd paragraph, of the Interpretation).

- After a preliminary contract became effective, if a party does not perform the obligations thereunder, the other party may claim for compensation of its losses caused thereby. The amount of such compensation shall follow the agreement between the parties, or, if no agreement exists, shall be decided by the People's Court by taking into comprehensive consideration factors such as the completeness of the contents of the preliminary contract and the fulfillment of conditions for concluding the actual contract, and other factors (see Article 8 of the Interpretation).

Based on the above wording, it is noteworthy that upon conclusion of an effective preliminary contract, in case a party refuses to conclude the actual contract, the other party cannot request the conclusion of the actual contract, but it can only claim for compensation of its losses.

According to an answer given by the SPC to the question of a reporter, currently the *PRC Civil Compulsory Enforcement Law* is in the process of being drafted. It may be the case that the *PRC Civil Compulsory Enforcement Law*, if it enters into effect in the future, will provide for different stipulations in this regard, e.g. that the conclusion of an actual contract can be requested and compulsorily enforced on the basis of an effective preliminary contract. It remains to be seen what will apply in this regard.

In any case, when drafting and/or entering into Letters of Intent or Memoranda of Understanding, the parties should be aware of the above and very clearly stipulate whether, and if so what stipulations, shall be binding or non-binding as well as whether there shall be an obligation to enter into an actual contract or not at a later time. Otherwise, there is a risk to be held liable to compensate the counterparty due to a breach of a preliminary contract.

(3) General Terms and Conditions / Standard Terms

Article 496, 1st paragraph, of the *PRC Civil Code* defines "standard terms" as terms drawn up by one party in advance for repeated use and not negotiated with the other party at the time of contracting.

Article 496, 2nd paragraph, of the *PRC Civil Code* further provides that where standard terms are adopted for contracting, the party providing the standard terms shall define the rights and obligations between the parties under the principle of fairness, remind in a reasonable manner the other party to note the terms excluding or limiting the liability of the party providing the standard terms or which are otherwise related to the material interest of the other party, and explain the terms upon request of the other party. If the party providing the standard terms fails to perform the reminding or explanation obligations, resulting in the other party failing to note or understand the terms in which it

has a material interest, the other party may argue that the terms have not become a part of the contract.

The Interpretation contains, *inter alia*, the following provisions on standard terms:

- If contract clauses comply with the provisions of Article 496, 1st paragraph, of the *PRC Civil Code*, and either party claims that the contract clauses are not standard terms only on the grounds that the contract is prepared based on the model text of a contract, or the parties have expressly agreed that the contract clauses are not standard terms, the People's Court shall not uphold the claim (see Article 9, 1st paragraph, of the Interpretation).
- Where a party engaged in business activities claims that the contract clauses that it draws up in advance, without negotiation with the other party, are not standard terms only on the grounds that they have not actually been used repeatedly, the People's Court shall not uphold the claim, unless there is evidence that the contract clauses are not intended for repeated use (see Article 9, 2nd paragraph, of the Interpretation).
- Where the party providing abnormal standard terms reminds the other party to pay attention to the terms excluding or limiting the liability of the party providing the standard terms, excluding or limiting the rights of the other party, or which are otherwise related to the material interest of the other party, by using writing, a symbol, a font, or any other noticeable sign that is ordinarily sufficient to attract the attention of the other party when entering into the contract, the People's Court may determine that it has performed the reminding obligations as specified in Article 496, 2nd paragraph, of the *PRC Civil Code* (see Article 10, 1st paragraph, of the Interpretation).
- Where, at the request of the other party, the party providing the abnormal standard terms provides an ordinarily understandable written or oral explanation of the definitions, content, and legal consequences of the terms related to the material interest of the other party, the People's Court may determine that it has performed the explanation obligation under Article 496, 2nd paragraph, of the *PRC Civil Code* (see Article 10, 2nd paragraph, of the Interpretation).
- Last, the party furnishing the standard terms shall have the burden of proof that it has performed the reminding or explanation obligations. In case of an electronic contract entered into on the Internet or any other information network, if the party providing the standard terms claims to have performed its reminding or explanation obligations only on the grounds of using a checkbox, a pop-up window, or any other means, the People's Court shall not uphold the claim unless the party furnishing the standard terms provides evidence of compliance with the provisions of the preceding two paragraphs of Article 10 of the Interpretation (see Article 10, 3rd paragraph, of the Interpretation).

b) Validity of Contracts

(1) General Provisions

Article 13 of the Interpretation clarifies that if a contract falls under any circumstance rendering it invalid or revocable, and either party claims its validity on the grounds that the contract has been filed for recordal with the relevant administrative agency or approved by the approval authority or that the modification or transfer of property rights, among others, has been registered according to the contract, the People's Court shall not uphold the claim.

According to Article 15 of the Interpretation, a People's Court shall determine the rights and obligations between the parties based on the actual content of the contract, regardless of the name of the contract. If the rights and obligations claimed by the parties are inconsistent with those determined in accordance with the contract, the People's Court shall ascertain the true civil legal relation between the parties based on factors such as the background of contracting, the purpose and structure of the transaction, performance, and whether the parties have falsified the subject matter of the transaction.

Both the above stipulations actually bring nothing new. However, they emphasize again that (i) records, registrations and approvals with governmental authorities cannot heal invalidity of a contract or make a revocable contract irrevocable, and (ii) that not the name or the form of a contract is decisive but its actual content.

(2) Validity of Contracts in Violation of Mandatory Provisions

- (i) Article 153, 1st paragraph, of the *PRC Civil Code* states that, a civil juristic act in violation of mandatory provisions of laws or administrative regulations is void, unless such mandatory provisions do not lead to the invalidity of the civil juristic act.

Article 16 of the Interpretation specifies that, in case of a contract in violation of mandatory provisions of laws or regulations, under any of the following circumstances where the legislative purpose of the mandatory provisions can be achieved by having the perpetrator assume administrative or criminal liabilities, the People's Court may, in accordance with Article 153, 1st paragraph, of the *PRC Civil Code*, determine that such a contract is not void due to violation of the mandatory provisions:

- Although the mandatory provisions are aimed at maintaining social public order, the actual performance of the contract only has an obviously minor impact on social public order, and determining invalidity of the contract would lead to an unfair and unjust outcome.
- The mandatory provisions are aimed at safeguarding the State's interests such as taxes, land transfer fees and other national interests, or the legitimate interests of other civil subjects rather than the civil rights and interests of the parties to the contract, and determining the validity of the contract will not affect the achievement of the purpose of such provision.
- The mandatory provisions are aimed at requiring one of the parties to strengthen risk control, internal management, etc., and the other party does not have the ability or obligation to examine whether the contract violates mandatory provisions, and determining the invalidity of the contract would cause the other party to bear adverse consequences.
- One party violates mandatory provisions when concluding the contract, and fails to redress the violation in good faith when it subsequently has the ability to do so.
- Other circumstances stipulated by laws and judicial interpretations.

The last bullet point above refers to all other circumstances where laws or judicial interpretations clearly state that the contract in violation of certain mandatory provisions can still be valid. For example, according to Article 706 of the *PRC Civil Code*, the parties' failure to register a lease contract in accordance with the provisions of laws and administrative regulations does not affect the validity of the contract.

Regarding the validity of a contract in violation of mandatory provisions, the Previous Interpretation only stated that it should be a violation of "provisions that have

mandatory effectiveness" which results in invalidity of a contract. Further, the SPC had given some guidelines in its *Circular Fa [2019] No. 254* on how to distinguish between "provisions that have mandatory effectiveness" and "mandatory provisions on administration". In addition, we note from the Draft for Comments version of the Interpretation that, regarding this topic, the SPC initially intended to specify the circumstances under which a contract violating mandatory provisions is invalid, and not the other way around when a contract which violates mandatory provisions is still valid as done in the final Interpretation.

In our view, compared to the Previous Interpretation and the Draft for Comments version of the Interpretation, the final Interpretation may be clearer and more practical by stipulating 5 circumstances where the violation of mandatory provisions will not lead to the invalidity of a contract.

- (ii) Article 17 of the Interpretation further clarifies that where a contract does not violate mandatory provisions of laws and administrative regulations, but falls under any of the following circumstances, the People's Court shall determine the contract to be invalid in accordance with Article 153, 2nd paragraph, of the *PRC Civil Code*: if the contract in question
- affects political, economic, military, or other national security;
 - affects social stability or fair competition, harms the public interests, or otherwise disrupts the public order; or
 - deviates from social morality or family ethics, destroys personal dignity, or otherwise violates customs.

The Interpretation further states that when determining whether a contract violates public order and good morals, the People's Court shall uphold the *core socialist values*, take into account the motive and transaction purpose of the parties, the intensity of regulation by government departments, the frequency of similar transactions by the parties within a specified period, the social consequences of their acts, and other factors, and provide sufficient reasons in the adjudicative document. If, to suit their daily needs, the parties conduct a transaction that neither has significant impact on the public order, nor affects national security, nor violates good morals, the People's Court shall not determine the contract to be invalid.

Despite the last sentence in the preceding paragraph, all the aforementioned criteria are still extremely vague and uncertain, and give the People's Court nearly unlimited discretion on how to determine the case. It remains to be seen whether there will be further explanations or interpretations in the future which will provide more guidance and certainty on this.

(3) Representation of a Company

Under PRC law, every company shall have 1 legal representative, and it is not possible to have more than 1 legal representative. The legal representative can only be the Chairman of the Board of Directors, the Executive Director (if there is no Board of Directors) or the General Manager of the company.

According to Article 61 of the *PRC Civil Code*, the legal representative has the legal power to represent the company in accordance with the law or the company's Articles of Association. The legal representative is the only person in a PRC company with statutory representation rights. The legal consequences of the civil activities conducted by the legal representative in the name of the company shall be assumed by the company. Any restriction on the representation power of the legal representative in the Articles of

Association or by a relevant company organ, such as the Shareholders' Meeting, of the company cannot be held against *bona-fide* third parties.

According to Article 504 of the *PRC Civil Code*, where the legal representative concludes a contract *ultra vires*, i.e. by exceeding his or her internal representation power, such an act is still valid, and the contract is binding on the company, unless the counterparty knew or should have known that the legal representative acted *ultra vires*.

In addition, every company in the PRC shall have a general company seal and finance seal (and may have additional non-mandatory seals, such as a contract seal, customs seal, invoice seal, etc.). The seals are also used to represent the company. In practice, it is very common that a person other than the legal representative of the company concludes contracts on behalf of the company by using company seals without the signature of the legal representative.

With regard to the representation power of the legal representative, the power of agency of other staff members and the company seal, the Interpretation provides for detailed provisions on whether or not a contract shall be considered binding on the company under different scenarios. We summarize relevant stipulations as follows:

(i) Legal Representative

With regard to a company's legal representative, Article 20 of the Interpretation provides the following:

- Where laws or administrative regulations restrict the representation rights of the legal representative and stipulate that a respective matter related to a contract must be decided by the company's governing or decision-making body (such as the Shareholders' Meeting or the Board of Directors), or shall be decided by the company's executive body (such as the General Manager), and the legal representative concludes the contract in the name of the company without the required authorization, if the counterparty failed to conduct a reasonable examination and claims that the contract is binding on the company, seeking liability for breach of contract, the People's Court shall not uphold the claim. However, if the company was at fault, the People's Court may judge that the company shall be liable for compensation according to Article 157 of the *PRC Civil Code*, *mutatis mutandis*. Article 157 of the *PRC Civil Code* states that after a juristic act is void, revoked, or determined as having no binding force, the property obtained by the actor as a result of the act shall be restituted; if restitution is impossible or unnecessary, indemnification shall be made at an estimated price. The party at fault shall compensate the other party for any loss suffered as a result of the act; or if both parties are at fault, they shall assume corresponding liabilities respectively, except as otherwise provided for by any law.

Under the same circumstances as set out above, if the counterparty has fulfilled its obligation of a reasonable examination, resulting in an "apparent representation", the People's Court shall proceed in accordance with Article 504 of the *PRC Civil Code*. I.e., where the legal representative of a company entered into a contract *ultra vires*, the representation shall be effective, and the contract shall be effective against the company, unless the counterparty knows or should have known that he or she acted *ultra vires*.

- Where the matter involved in a contract is not beyond the scope of the legal representative's representation rights according to laws and administrative regulations, but it is beyond the limits on the legal representative's representation rights as set out in the Articles of Association or the governing

body (such as the Shareholders' Meeting) of the company, the counterparty's claim shall be upheld that the contract is binding on the company and the company shall bear the default liabilities, unless the company can prove by evidence that the counterparty knew or should have known that the legal representative acted *ultra vires*.

- If, after assuming civil liability, the company seeks to recover losses caused by an *ultra vires* act from the legal representative at fault, the People's Court shall uphold the recovery, unless otherwise provided by the law or any other judicial interpretation.

(ii) Staff Members Other Than the Legal Representative

With regard to a company's staff members other than the legal representative, Article 21 of the Interpretation provides the following:

- Where a staff member of a company concludes a contract in the name of the company in respect of matters beyond the scope of the authority of the staff member, and the counterparty claims that the contract is binding on the company, seeking liability for breach of contract, the People's Court shall not uphold the claim. However, where the company was at fault, the People's Court may judge it liable for compensation according to Article 157 of the *PRC Civil Code, mutatis mutandis*. If the above situation constitutes an "apparent agency", the People's Court shall proceed in accordance with Article 172 of the *PRC Civil Code*. I.e., where an actor still performs an act of agency without a power of agency, beyond his or her power of agency, or after his or her power of agency terminates, the act shall be valid if the counterparty had reason to believe that the actor had the required power of agency.
- If matters related to a contract fall under any of the following circumstances, the People's Court shall determine that the staff member acted beyond the scope of his or her authority when concluding a contract:
 - matters that shall be resolved by the governing or decision-making body (such as the Shareholders' Meeting or the Board of Directors) of the company in accordance with law;
 - matters that shall be decided by the executive body (such as the General Manager) of the company in accordance with law;
 - matters that shall be carried out by the legal representative of the company on behalf of the company in accordance with law; or
 - matters that shall not be handled as per his or her authority under normal circumstances.
- Where the matter related to a contract is not beyond the scope of authority which is determined in accordance with the preceding bullet point, but is beyond the limits on the scope of authority of the staff member as set by the company, and the counterparty claims that the contract is binding on the company, seeking liability for breach of contract, the People's Court shall uphold the claim, unless the company can prove by evidence that the counterparty knew or should have known such limits.
- If, after assuming civil liability, the company seeks recovery from the staff member who acted intentionally or is grossly negligent, the People's Court shall uphold such recovery in accordance with the law.

(iii) Company Seal

With regard to a company's company seal, Article 22 of the Interpretation provides the following:

- Where the legal representative or a staff member concludes a contract in the name of the company and does not go beyond his or her authority, and the company claims that the contract is not binding on it only on the ground that the seal affixed on the contract is not the recorded seal, or is a forged seal, such claim shall not be upheld.
- Where the contract is concluded in the name of the company but is only signed or fingerprinted by the legal representative or staff member without being affixed with the company seal, if the counterparty can prove that the legal representative or staff member has acted within his or her authority, the contract shall be determined binding on the company, unless the parties had agreed that affixation of the company seal is a condition for establishing the contract.
- Where the contract is only affixed with the company seal without signatures or fingerprints, if the counterparty can prove that the contract is concluded by the legal representative or staff member within the scope of his or her authority, the People's Court shall determine that the contract is binding on the company.
- Under the circumstances as set out in the 3 bullet points above, if the legal representative or staff member entered into the contract beyond his or her power of attorney, constituting apparent representation or apparent agency under Articles 504 or 172 of the *PRC Civil Code*, the People's Court shall determine the contract as binding on company. I.e., although the legal representative or staff member exceeded his or her representation right or power of agency, the contract is binding on the company,
 - in case of the legal representative, unless the counterparty knew or should have known that the legal representative acted *ultra vires*; or
 - in case of a staff member, if the counterparty had reasons to believe that the said person had authority.

Via the above, the SPC provides detailed and comprehensive, but also rather complicated, guidance on what the parties should pay attention to when concluding a contract. In short, if only the signature or the company seal is used when concluding a contract, there is still some risk that the person who signed the contract or affixed the seal thereon went beyond the scope of the authority. Therefore, it is recommended to check that the signing person really has the authority to do so, and one should request that a contract is both signed by an authorized person and affixed with the company seal. The safest is if the legal representative signs and the company seal is affixed. In addition, considering that scenarios in practice may be very complex, one should always keep in mind to satisfy its duties of reasonable care and review with regard to the representation rights of the persons acting for the counterparty.

(iv) Malicious Collusion

- Where the legal representative or a staff member maliciously colluded with the counterparty to enter into a contract in the name of the company, thereby harming the legitimate rights and interests of the company, the company's claim not to bear civil liability shall be upheld by the People's Court (see Article 23, 1st paragraph, of the Interpretation).

- In addition, the company's claim that the legal representative or staff member shall assume joint and several compensation liabilities together with the counterparty for the losses caused by the malicious collusion, shall be upheld by the People's Court (see Article 23, 2nd paragraph, of the Interpretation).
- A malicious collusion can be determined by applying the following criteria, according to Article 23, 3rd paragraph, of the Interpretation:
 - The company is obliged to first provide preliminary evidence on the malicious collusion.
 - Based on the above preliminary evidence and taking into comprehensive consideration of factors such as the transaction customs between the parties, whether the contract was obviously unfair at the time of conclusion, whether relevant persons achieved unjustifiable benefits, the performance of the contract, the People's Court shall determine whether there is a high probability of the malicious collusion between the legal representative or staff member and the counterparty.
 - If the answer to the above bullet point is yes, the People's Court may request the said persons to make statements on the relevant facts such as the process of conclusion and performance of the contract, or to provide corresponding evidence.
 - If the said persons refuse to make the statement without justifiable reasons, or the statement made is not reasonable and no corresponding evidence can be provided, the People's Court may determine that malicious collusion has taken place.

c) Performance of Contracts

(1) Unforeseeable Change of Circumstances

Article 533 of the *PRC Civil Code* states that, after a contract is formed, where a fundamental condition upon which the contract is concluded has significantly changed which was unforeseeable by the parties when concluding the contract and which is not a commercial risk, if continuing performance of the contract is obviously unfair to one of the parties, the party who is adversely affected may re-negotiate with the other party; where no agreement is reached within a reasonable period of time, the parties may request the People's Court or an arbitration institution to modify or rescind the contract. The People's Court or arbitration institution shall modify or rescind the contract in compliance with the principle of fairness by taking into consideration of the actual circumstances of the case.

The above provision refers to the principle of an unforeseen change of circumstances, which is a major change other than a commercial risk. Article 32 of the Interpretation further clarifies that:

- Price fluctuations due to policy adjustments, abnormal changes in the market supply and demand or any other factor, which are not a commercial risk and which could not have been foreseen by the parties at the time of conclusion of the contract, can constitute an unforeseeable change of circumstances, if continuing performance of the contract is obviously unfair to one of the parties.

However, if the contract is related to (i) commodities in an active market whose price is subject to long-term considerable fluctuations or (ii) risky investment financial products, such as stocks and futures, this shall not constitute an unforeseeable change of circumstances.

- In case of an unforeseeable change of circumstances according to Article 533, 1st paragraph of the *PRC Civil Code*, where a party requests to modify the contract, the People's Court shall not rule to rescind the contract. Where one party requests to modify the contract and the other party requests to rescind the contract, the People's Court shall rule to modify or rescind the contract in accordance with the principle of fairness.

Further, when the People's Court decides whether to modify or terminate a contract in accordance with the provisions of Article 533 of the *PRC Civil Code*, it shall take into comprehensive consideration factors such as the time of occurrence of the major changes to the basic conditions of the contract, the status of the re-negotiation between the parties, and the losses which will be caused to the parties due to the modification or rescission of the contract. The time of modification or rescission of the contract shall be stated in the judgment.

- Where the parties agree in advance to exclude the application of Article 533 of the *PRC Civil Code*, such agreement shall be determined by the People's Court as void.

d) Preservation of Contracts

As to so-called "subrogation", according to Article 535 of the *PRC Civil Code*, if the debtor neglects to exercise its claims or the collateral rights relating to the claims (against the debtor's debtor), thereby affecting the creditor's realization of due claims (against the debtor), the creditor may petition a People's Court to subrogate the exercise of the debtor's rights against the debtor's debtor in the creditor's own name, unless such rights belong exclusively to the debtor.

As to so-called "revocation", according to Article 539 of the *PRC Civil Code*, where a debtor transfers its property at a low price which is manifestly unreasonable, acquires by transfer the property of another person at a high price which is manifestly unreasonable, or provides security for an obligation owed by another person, thus affecting the realization of the obligation owed to the creditor, and the party opposite to the debtor knows or should have known the circumstances, the creditor may request the People's Court to cancel the act of the debtor.

The Interpretation provides some further provisions on the application of the above rights. The Interpretation, *inter alia*,

- clarifies that the following rights may be regarded as rights which "belong exclusively to the debtor" according to Article 535, 1st paragraph, of the *PRC Civil Code*:
 - claims for child support, support for elderly parents, or spousal support;
 - claims for personal damages;
 - claims for labor remuneration, except for the excess over the necessary standard of living of the debtor and his dependents;
 - claims for payment of basic pension insurance benefits, unemployment insurance benefits, or a subsistence allowance, among others, to protect the basic living of the parties;
 - other rights strictly personal to the debtor;

(See Article 34 of the Interpretation);

- in line with the *PRC Civil Code*, expands the scope of rights that can be exercised by subrogation, which are no longer limited to claims of "monetary payment" and include not only the rights that the debtor enjoys, but also accessory rights related thereto;

- clarifies that after the creditor initiates a lawsuit on the right of subrogation, if the debtor or the debtor's debtor raises an objection on the ground that they have concluded an arbitration agreement on the relationship between the debtor and the debtor's debtor, such objection shall not be upheld. However, if the debtor or the debtor's debtor applies for arbitration proceedings in respect of the relationship between them before the first hearing, the People's Court may suspend the subrogation lawsuit in accordance with the law (see Article 36 of the Interpretation); and
- stipulates that where the creditor applies for compulsory enforcement based on effective legal documents resulting from the creditor's lawsuit against the debtor or from lawsuit on the right of revocation, the People's Court may take compulsory enforcement measures against the rights which is enjoyed by the debtor against the debtor's debtor to achieve the creditor's rights. Further, if the creditor applies for preservation measures against the debtor's debtor's assets in a revocation lawsuit, the People's Court shall grant permission in accordance with law (see Article 46, 3rd paragraph, of the Interpretation).

e) Liability for Breach of Contract

(1) Compensation Liability

Article 584 of the *PRC Civil Code* states that, where a party fails to perform its contractual obligation or its performance does not conform to the agreement so that the other party suffers losses, the amount of compensation shall be equivalent to the losses caused by the breach of contract, including the benefits expected to be obtained should the contract had been performed, except that it shall not exceed the possible losses caused by the breach that the breaching party foresaw or should have foreseen at the time of conclusion of the contract.

According to the above and the Interpretation, the amount of compensation, i.e., the losses caused by the breach of contract to the non-breaching party shall be equal to (i) the losses of benefits which are expected to be obtained should the contract had been performed; plus (ii) other losses caused thereby:

- Item (i) can be calculated based on production profit, operating profit or resale profit, etc., that can be obtained by the non-breaching party, by deducting expenses and other reasonable costs incurred by the non-breaching party in conclusion and performance of the contract (see Article 60, 1st paragraph, of the Interpretation).
- Where the non-breaching party exercised its right to rescind the contract and conducted a substitute transaction, it shall be upheld by the People's Court that item (i) is determined according to the difference between the substitute transaction price and the contract price, unless the substitute transaction price obviously deviates from the local market price at the time of the substitute transaction. In the latter case, it shall be upheld to use the difference between the local market price and the contract price (see Article 60, 2nd paragraph, of the Interpretation).
- Where the non-breaching party exercised its right to rescind the contract but did not conduct a substitute transaction, it shall be upheld that item (i) is determined based on the difference between the market price at the place where the contract is performed at the time of the breach and the contract price (see Article 60, 3rd paragraph, of the Interpretation).
- If a party to a fixed-term contract requiring successive performance of obligations fails to pay the price, rent, or any other monetary obligation, and the other party requests rescission of the contract, if the People's Court, deems that the contract should be rescinded, the People's Court may fix a reasonable period for the non-breaching party to seek a substitute transaction based on the party's claim, in

reference to the parties of the contract, the type of transaction, price changes, remaining performance period, and other factors, and then calculate item (i), deducting the cost of performance payable by the non-breaching party according to the price or rent, among others, for the period.

If the non-breaching party argues that item (i) should be determined based on the price or rent, among others, for the remaining performance period after rescission of the contract, minus performance costs, the People's Court shall not uphold the argument, unless the remaining performance period is less than a reasonable period for seeking a substitute transaction.

(See Article 61 of the Interpretation).

- Where item (i) is difficult to be determined by the approaches as stated under this lit. e) (1) above, it shall be determined in accordance with the principles of fairness and good faith by taking into comprehensive consideration of factors such as the benefits obtained by the breaching party from its breach, the degree of fault of the breaching party and other circumstances of the breach (see Article 62 of the Interpretation).
- According to Article 584 of the *PRC Civil Code*, the amount of compensation "shall not exceed the possible losses caused by the breach that the breaching party foresaw or should have foreseen at the time of conclusion of the contract".

Such criteria shall be determined, based on the purpose of the parties to conclude the contract, by taking into comprehensive consideration of factors such as the parties of the contract, the contents of the contract, the transaction type, the usage of trade, the negotiation process and other factors, and in accordance with the losses that other parties to civil legal relations in the same or similar situation as the breaching party foresaw or should have foreseen at the time of concluding the contract (see Article 63, 1st paragraph, of the Interpretation).

- As to item (ii), i.e. other losses caused by the breach, e.g. if the non-breaching party shall compensate a third party as a result of the breach by the breaching party, such other losses shall also be upheld if the breaching party foresaw or should have foreseen them at the time of concluding the contract (see Article 63, 2nd paragraph, of the Interpretation).
- Where the non-breaching party does not take appropriate measures to prevent the expansion of the losses, or is also at fault, or obtained additional benefits, or reduced necessary expenses due to the breach by the breaching party, at the request of the breaching party, the corresponding amounts for the above shall be deducted when determining the amount of compensation for the losses due to breach of contract (see Article 63, 3rd paragraph, of the Interpretation).

(2) Liquidated Damages

According to Article 585 of the *PRC Civil Code*, the parties to a contract may agree that the breaching party shall pay liquidated damages of a certain amount based on the circumstances of the breach, or may agree upon the method for calculating the amount of compensation for losses resulting from breach of contract. If the agreed amount of liquidated damages is lower than the losses incurred, a People's Court or an arbitration institution may, upon the request of the relevant party, increase the amount; if the agreed amount of liquidated damages is excessively higher than the losses incurred, a people's court or an arbitration institution may, upon the request of the relevant party, make an appropriate reduction. Where the parties to a contract have agreed upon the amount of

liquidated damages for delayed performance, the breaching party is still required to perform the obligations after paying the liquidated damages.

With regard to liquidated damages, the Interpretation, largely in line with the Previous Interpretations clarifies the following:

- The breaching party, claiming an appropriate reduction of the liquidated damages on the grounds that they are significantly higher than the loss caused by the breach of contract, shall bear the burden of proof. The non-breaching party, claiming the reasonableness of the liquidated damages, shall also provide corresponding evidence (see Article 64, 2nd paragraph, of the Interpretation).

This is in line with the previous and current practice. The relevant party claiming a reduction or an increase, bears to burden of proof for its claim. Therefore, according to PRC law, liquidated damages mainly have the effect to lead to a shift in the burden of proof.

- If either party argues that the liquidated damages should not be adjusted only based on a contractual prohibition, the People's Court shall not uphold the argument (see Article 64, 3rd paragraph, of the Interpretation).
- If a party requests a reduction in liquidated damages, claiming they are significantly higher than the losses caused by the breach of contract, the People's Court shall make an assessment and adjudicate based on the following factors: losses specified in Article 584 of the *PRC Civil Code* (i.e., generally, all direct, indirect and consequential losses to the extent that they have been foreseeable by the breaching party at the of conclusion of the contract) by taking into account factors such as the parties of the contract, the transaction type, the performance of the contract, the degree of fault, the background of the contract performance, and other relevant factors, according to the principles of fairness and good faith (see Article 64, 4th paragraph, of the Interpretation).
- If liquidated damages exceed 30% of the losses caused, the People's Court may generally determine them significantly higher than the losses (see Article 64, 5th paragraph, of the Interpretation).
- If a party breached the contract in bad faith and requests a reduction of liquidated damages, the People's Court shall generally not uphold the request (see Article 64, 6th paragraph, of the Interpretation).

3. Conclusion

The Contract Part is one of the core parts, if not the most important part, of the *PRC Civil Code*. Contracts are relevant for and used in basically all kind of business transactions and fields of law, and are, therefore, of paramount importance for all kind of business operations as well as the economy and society as a whole. The Interpretation provides a detailed and rather comprehensive guidance and interpretation on various topics and important issues related to the General Provisions of the Contract Part of the *PRC Civil Code*.

In our view, the Interpretation will play a major role regarding the PRC contract law in combination with the *PRC Civil Code*.

Although the practical impact of the Interpretation remains to be seen, it is to be expected that the Interpretation will lead to a higher degree of legal certainty in the PRC and, therefore, will be beneficial for companies and individuals entering into contracts governed by PRC law.

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