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PRC's Supreme People's Court Permits PRC Courts to Modify Contract Terms in Response to Commercial Risks

The global financial crisis has prompted the Supreme People's Court (the "Supreme Court") to release a significant ruling that authorizes PRC courts to take actions to re-allocate commercial risks that might not have been clear to the parties at the time of contract formation.

The most significant point in the "Interpretations II on Several Issues Concerning the Application of the Contract Law of the People's Republic of China" ("Interpretations"), effective 13 May 2009, is that the Supreme Court articulates for the first time a "Changes in Circumstances Principle." The principle permits PRC courts to rule on possible revision or termination of contracts, under certain conditions, in response to unforeseen events.

In this regard, the Interpretations state:

In the event of significant changes after conclusion of a contract, which are not foreseeable by the contracting parties at the time of entering into the contract, not attributable to *force majeure* and not considered as commercial risks, and further performance of the contract will cause obvious unfairness to one party or will cause the purpose of the contract to be impracticable, the courts are entitled, if one party so requests, to rule on changing or terminating the contract based on principles of fairness and the actual circumstances of the case.

With such language, the Interpretations appear to permit a contract party to petition a PRC court for a determination that unforeseen and significant commercial changes have occurred since entering into the contract, such that the contract's agreed-upon terms may be subject to modification or even termination. This right of a PRC court seems to exist

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even where the parties have agreed in the contract that the parties will look exclusively to an international arbitration body to resolve any disputes between them.

According to one Supreme Court official, to prevent local abuses, the Supreme Court will require that a court that is at least one level higher than the original court receiving the application will examine and decide whether to approve the lower court's decision.

In addition, the Interpretations add that local courts should consider the place of signing agreed upon by the parties as the place of signing for all legal purposes, even if the contract was actually signed in another location – a significant point, because the place of signing determines the court jurisdiction and governing law under which the contract is interpreted. Thus even if a contract is signed in the another country, if the contract recites that it was entered into at a particular location in China, that recitation will give the court in the agreed-upon location jurisdiction to act in the case.

The Interpretations also address the issue of liquidated damages. The Contract Law of the PRC states that "If the stipulated liquidated damages grossly exceed the loss incurred, a party may petition a people's court or an arbitral institution to reduce the amount appropriately." The Interpretations clarify the phrase "grossly exceed" to mean "greater than 130% of the loss incurred." Although the intention of the Supreme Court was to provide courts with a measurable standard for interpreting the extent of liquidated damages stipulated by parties to a contract, critics have noted that this degree of specification may jeopardize the freedom of the contracting parties in interpreting what constitutes "grossly exceed" between themselves. Further, liquidated damages will often be specified in situations where the calculation of actual damages may be unduly burdensome or impossible, and the present Interpretations could be interpreted to restrict the use of liquidated damage provisions in such situations.

Also under the Interpretations, after the establishment of a contract subject to approval or registration as stipulated by relevant laws and administrative regulations, if the contracting party obliged to apply for the approval or registration of the contract fails to do so in accordance with the law or the contract, that party is to be considered as "performing other acts which violate the principle of good faith." Consequently, the relevant people's courts may, upon request, require that party to execute certain formalities based on the specific circumstances of the case, for which it will bear the costs and any losses incurred. Joint venture contracts between China-based companies and companies outside China are a common example of such contracts; usually, both parties agree that the China-based party will submit the contract for approval. If the China-based party fails to do so, this clause legally protects the party from outside China from the consequences of that failure.

One practical question that may prove critical to many

companies is whether the Interpretations apply to contracts for which arbitration has been selected as the means of resolving any disputes between the parties. Although, theoretically, judicial interpretations issued by the Supreme Court should be valid only within China's judicial system, a large number of arbitrators have made, or have intended to make, reference to China's judicial interpretations as a component of arbitrations involving China-based parties.

The Interpretations provide many other term definitions and clarifications of the Contract Law. For more information, contact a member of the Squire Sanders China team.

The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice.

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