

### Key Points

- Letters of intent and term sheets may be considered to be binding
- Affiliated certificates must be provided
- Risk is automatically allocated unless otherwise stipulated
- Product inspection issue is further clarified
- Increased possibility that liquidated damages will be reduced to actual losses

### Background

On 1 July 2012 the judicial interpretations by the PRC Supreme People's Court (SPC) concerning sale and purchase contracts (the "Interpretation") took effect. The Interpretation covers many basic aspects of the existing PRC Contract Law. In theory, the SPC's interpretations only offer guidance for the local people's courts; however, in practice such interpretations are commonly regarded as having the same effect as a new law or regulation.

Though it remains to be seen how local courts and other bodies will implement the Interpretation, we offer the following comments and recommendations regarding the Interpretation.

### Highlights of the Interpretation

- Legal Effect of an LOI/MOU

Given the increasing number of disputes arising in the context of pre-contract arrangements (e.g., in connection with a letter of intent or a memorandum of understanding), the Interpretation states that if parties agree to enter into a formal sale and purchase contract with a specified time period, any party that fails in such obligation could be liable to the other party. In other words, in the absence of a clear and explicit stipulation, a provision will be considered a binding obligation between the parties that they have entered into a definitive agreement.

**Squire Sanders recommendation:** Consider including a clause in the letter of intent, memorandum of understanding, term sheet, or similar document to specify that the document is not binding, excluding clauses such as confidentiality, governing law, dispute resolution and exclusivity.

- Affiliated Certificates

The PRC Contract Law requires that the seller deliver to the buyer all relevant documents and information in accordance with the agreement between the parties or trade usage. The Interpretation clarifies that the "relevant documents and information" must include "insurance policy, warranty certificate, invoice, VAT invoice, product approval certificate, quality warranty certificate, quality inspection certificate, commercial inspection certificate for import and export, certificate of origin, user manual, packaging slip, etc."

**Squire Sanders recommendation:** Ensure that all applicable and required certificates are provided with the products being sold, unless otherwise explicitly agreed.

- Risk Allocation

According to the Interpretation, in the absence of an intention to the contrary, a buyer will be liable for any loss or damage to the subject matter after it is delivered to the buyer or its carrier.

**Squire Sanders recommendation:** If there is any special agreement regarding risk allocation between the parties, explicitly state such allocation clearly in the contract.

- Product Inspection

There are several clarifications in the Interpretation regarding inspection of the subject matter of the contract including: (i) in the absence of any specific agreement regarding an inspection period, if the buyer executes a delivery slip or other confirmation upon receipt that confirms the product quantity, quality, or specification, then the buyer will be considered to have inspected the subject



matter in terms of quantity and appearance; (ii) if the seller delivers the product to a third party per instructions from the buyer in which the product standard agreed between the buyer and seller is different from the standard agreed between buyer and the third party, then the standard between buyer and seller shall prevail; (iii) in the absence of any agreement to the contrary, a seller will not be excused from liabilities regarding quality simply on the grounds that the buyer has already paid for or used the product, as long as the buyer raises the quality issue within an agreed or reasonable period.

**Squire Sanders recommendation:** Be cautious in addressing quality issues in sales and purchase contracts.

- Default Liabilities

The Interpretation does not alter the principle that liquidated damages as a result of a breach of contract should equate to actual losses, but it does offer the following clarifications: (i) Despite an agreement to exclude a seller's liability for product defect, if the seller either does not disclose the defect intentionally or due to gross negligence, the agreed liability exclusion will not apply; (ii) a buyer must not claim for a product defect if it was known to the buyer prior to the agreement, unless the buyer was unaware at the time of agreement that the defect would reduce the basic functionality of the product; (iii) in the absence of any prior agreement, a penalty for overdue payment must refer to the corresponding guidance of the People's Bank of China on late payment interest on a loan; and (iv) in the event of any contract termination due to default, a liquidated damage clause in the contract will still apply.

Another important point in the Interpretation regarding default liability concerns a clause under the Contract Law that if the liquidated damages stipulated by the parties are either higher or lower than the actual loss incurred, a party may petition the

court to reduce or increase the liquidated damages amount to the amount of the actual damages. Previously, this clause has not been commonly implemented because courts typically will not introduce the issue unless a party raises it. The Interpretation, however, stipulates that if one party to a lawsuit demands liquidated damages and the other party does not request the court to reduce the liquidated damages to the actual loss, the court must now enquire if that party believes the damages to be fair.

**Squire Sanders recommendation:** China appears to be moving toward the position of judicial authorities in many other jurisdictions where penalties are discouraged and liquidated damages allowed principally where it is impossible or highly impractical to compute actual damages. Given this change, parties to contracts in China should no longer regard liquidated damages provisions as a tool for penalizing a breach by the other party.

For more information on how these issues may affect your business, contact a member of the Squire Sanders.

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The contents of this update are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations nor should they be considered a substitute for taking legal advice.

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