



## CHINA'S SUPREME PEOPLE'S COURT ISSUES CLARIFICATION AND INTERPRETATION OF THE CONTRACT LAW

On April 24, 2009, the Supreme People's Court of the People's Republic of China (the "SPC") issued the "Interpretation II of the Supreme People's Court on Several Issues concerning the Application of the Contract Law of the People's Republic of China" ("Interpretation II"), which came into force on May 13, 2009.

The release of Interpretation II was driven by two major factors. First, it was felt that the "Interpretation I of the Supreme People's Court on Several Issues concerning the Application of the Contract Law of the People's Republic of China" ("Interpretation I") issued by the SPC in 1999 did not adequately deal with many of the issues arising out of the changed social circumstances in the 10 years since its release.

Secondly, the ongoing global financial crisis led to an increase in the number of contract disputes since the second half of 2008. By way of example, in the first quarter of 2009, first instance courts in China heard more than 790,000 cases concerning contractual

disputes, an increase of 13.75 percent compared to the number for the same period in 2008. These contractual disputes accounted for 53.46 percent of all civil and commercial cases at first instance in 2009.

### THE SCOPE OF INTERPRETATION II

Interpretation II has 30 articles divided into six parts. The six parts are: (1) conclusion of contract; (2) validity of contract; (3) performance of contract; (4) termination of contractual rights and obligations; (5) liabilities for breach of contract; and (6) supplementary provisions. In this *Commentary*, we will concentrate on five specific issues:

- Commercial impossibility
- Standard form clauses
- Registration of contracts
- Set-off of debts
- Liquidated damages

**Commercial Impossibility.** Interpretation II enshrines the legal principle of *rebus sic stantibus* in Article 26. The legal doctrine of *rebus sic stantibus* allows for contracts to become inapplicable because of a fundamental change in circumstances. This is akin to the English legal concept of frustration or impossibility. Article 26 provides that parties can modify or terminate a contract where:

- a) A substantial change of circumstances occurs after the contract is concluded;
- b) The change of circumstances is unforeseeable when the contract is concluded;
- c) The change of circumstances is not caused by force majeure;
- d) The change of circumstances is not a commercial or business risk; and
- e) It is obviously unfair to a party, or the purpose of the contract would be frustrated, if the parties continued to perform the contract.

In such circumstances, a party can file a request for the modification or rescission of the contract, and the court shall decide whether to modify or rescind the contract under the principle of fairness and in light of the facts of the case.

The doctrine of frustration or impossibility is designed to solve the problem of obvious unfairness after conclusion of a contract. Even if the contract was fair at the time of its conclusion, if there is a fundamental change afterward that would impose substantial losses on one party or would make the contract deviate from its original purpose, the contract can be modified or rescinded.

Two things need to be emphasized for the application of Article 26. First, the changed circumstances cannot have been caused by a force majeure event, and secondly, the court must strictly differentiate between a situation of frustration and normal market risks.

**Standard Clauses.** Interpretation II admits the validity of certain standard form clauses if, at the time of concluding a contract, the party providing the standard form clauses adopted special characters, symbols, fonts, and/or other

signs sufficient to arouse the other party's attention to the content of the standard form clauses regarding liability exemptions or restrictions in favor of the party providing the standard form clauses. The same applies if the first party made an explanation of the standard form clauses according to the requirements of the other party.

However, the SPC is aware of the disadvantages of standard form clauses, in particular their negative impact on customers. Accordingly, Interpretation II requires that the party providing the standard form clauses must bear the burden to prove that it has fulfilled the obligation to make reasonable prompting and explanation. The court will revoke or invalidate such clauses if the party relying on the clauses fails to perform these obligations.

**Registration of Contracts.** Although contracts that need to be approved or registered under a relevant law or administrative regulation for their effective conclusion in China are fewer than before, there are still some types of contract, particularly in the construction field, that require registration. If these contracts have not been approved or registered, there will be no contract existing, and thus the innocent party cannot request the other party to assume liability for breach of contract.

Interpretation II provides that after the formation of a contract that does not become effective until it is approved or registered under a relevant law or administrative regulation, if the party that has the obligation to apply for the approval or registration (the "registration party") fails to do so, such a failure shall fall within the scope of "any other act in violation of the principle of good faith" provided in Article 42(3) of the Contract Law. The court may rule that the other party could go through the relevant formalities by itself, and the registration party shall be liable for compensating the other party for the expenses incurred and the losses actually caused to the other party as a result of the registration party's failure.

**Set-off of Debts.** Interpretation II stipulates for the first time the order of debts that can be set off. In other words, where the debtor's repayment is not enough to pay off all debts of the same type owed to the same creditor, the repayment

should follow the following waterfall scheme: (1) the agreement concerning the order of debts to be set off between the debtor and creditor shall be firstly obeyed; (2) a due debt shall be set off; (3) a debt for which no guaranty is provided to the creditor or the guaranty provided to the creditor is in the smallest amount shall be set off; (4) a debt with a heavier debt burden, in the event that the guaranty amounts are equal, shall be set off; (5) debts shall be set off in the order of the dates of maturity of the debts; and (6) debts with same due date shall be set off in proportion to each other.

If the repayment is not enough to pay off all debts, and if there is no agreement between the parties, the debtor shall pay interest and expenses besides the primary debt in the following order: (1) expenses incurred for realizing the creditor's rights; (2) interest; and (3) the primary debt.

**Liquidated Damages.** If a party requests the court to increase the liquidated damages under paragraph 2 of Article 114 of the Contract Law, the amount after the increase shall not exceed the amount of the actual losses suffered by that party; after the increase, the court shall reject further requests for compensation for losses by the innocent party.

On the other hand, if a party requests a proper reduction of the liquidated damages under paragraph 2 of Article 114 of the Contract Law, the court shall make a ruling on the basis of the facts of the case and under the principle of fairness and good faith. If the liquidated damages agreed upon by the parties exceed the losses actually incurred by 30 percent, they shall be generally deemed as "significantly higher than the losses incurred," and the parties could then request the court to decrease the liquidated damages.

The SPC has now clarified that "significantly higher" in effect means 30 percent higher than actual losses. Accordingly, provided that an owner's liquidated damages are less than 30 percent higher than its actual losses, such liquidated damages should stand, even though they are greater than the actual losses suffered.

## CONCLUSION

Overall, these interpretations by the SPC are a welcome clarification of the law as it affects contracts in China. In many ways the SPC is taking a very practical and pragmatic approach to contractual disputes, which is consistent with approaches adopted in many foreign jurisdictions.

The frustration or impossibility doctrine is now enshrined in Chinese law, and this helpfully expands on the existing good faith and force majeure provisions under Articles 8 and 117 respectively of the Contract Law. In effect, Interpretation II recognizes what amounts to an economic force majeure, or even commercial impossibility situation.

With regard to the 30 percent threshold for excessive liquidated damages, the SPC is following its previous interpretation concerning commercial real estate sale and purchase contracts, effective on June 1, 2003, which provided that significantly higher liquidated damages could be reduced to 30 percent above the actual losses.

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*The author wishes to thank Jiang Zhou and Cao Shu in the Beijing Office for their assistance in the preparation of this Commentary.*

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