



Distribution in China – Legal Issues  
Part III. Pre-Contract Matters

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## The Distribution Contract

### PRE-FORMATION ISSUES

#### PRE-FORMATION MEMORANDUMS OF UNDERSTANDING AND LETTERS OF INTENT

Under Chinese law, there is a cause of action for a breach of “pre-contract.” For example, if a letter of intent or memorandum of understanding is entered into and states that a sales and purchase contract will be formed within a certain period, then one party may bring a cause of action against the other party if the other party refuses to enter into that sales and purchase contract.<sup>1</sup>

#### REFUSAL TO DEAL

A dominant undertaking in the Chinese market is prohibited from refusing to trade with another trading party without justification.<sup>2</sup> This prohibition includes both refusing to engage in new transactions with trading counterparties and delaying or interrupting existing transactions without justification.<sup>3</sup> This prohibition can affect undertakings with relatively low market shares, since an undertaking having a market share as low as 10 percent can be presumed to be in a dominant market position. In addition, there is a presumption of dominance for a group of three undertakings if the three undertakings combined have 75 percent of the market and each of them has at least a 10 percent market share.<sup>4</sup>

A dominant undertaking is also prohibited from refusing, without justification, to give its trading counterparties access (under reasonable trading conditions) to necessary utilities if those trading counterparties require the utilities for manufacturing or “operating” activities.<sup>5</sup> While it is unclear what the scope of this provision may be, it could conceivably apply not only to electricity, gas and water, but also to the distribution of internet access or network technology (software), as well as other specialized inputs that might be characterized as “utilities” necessary for manufacturing and other operating activities.

The State Administration for Industry and Commerce (SAIC) has indicated some factors that it will take into account when assessing any justification for conduct that may be regarded as an abuse of dominance. One factor is whether the practice is conducted on the basis of “ordinary operating activities” and “ordinary interests.” Another factor is how the practice will affect economic efficiency, public interest and economic development.<sup>6</sup>

The National Development and Reform Commission (NDRC) has also issued a regulation providing that a dominant undertaking must not, without justification, refuse to deal with a trading party in a “disguised” manner by fixing an excessively high sale price or an overly low purchasing price.<sup>7</sup> However, the NDRC has

<sup>1</sup> 2012 Interpretation of Supreme People’s Court.

<sup>2</sup> Anti-Monopoly Law, *supra* note 80, at art. 18.

<sup>3</sup> SAIC Regulation 54 of 2010, art. 4.

<sup>4</sup> Anti-Monopoly Law, *supra* note 80, at art. 19.

<sup>5</sup> SAIC Regulation 54 of 2010, art. 4.

<sup>6</sup> SAIC Regulation 54 of 2010, art. 8.

<sup>7</sup> NDRC Regulation 7 of 2010, art. 13.

also indicated that in such circumstances, there are several acceptable justifications for refusing to trade, including the following:

- An extremely bad credit record or a continuous deterioration in operations that may cause great risk to “more secure commerce”
- The ability of the trading counterparties to purchase the same kinds of products or substitute products from others at reasonable prices<sup>8</sup>

#### AGENCY AND THE AUTHORITY TO ENTER INTO A CONTRACT

##### The Legal Representative

China’s Contract Law provides that if the legal representative or the person in charge of an organization exceeds the limits of her or his power in entering into a distribution contract, “the act of representation shall be effective unless the counterpart is aware or ought to be aware of the excess of the limit of power.”<sup>9</sup>

##### Company “Chop” or Seal

If a contract is for the cross-border sale of goods, and the U.N. Convention on International Sale of Goods, which China ratified in 1998, applies, a binding contract is formed at the moment of acceptance of the offer to sell.<sup>10</sup> This acceptance can be made by a statement or other conduct of the offeree that indicates assent to the offer.<sup>11</sup> Frequently this is done by signing a document that sets out the terms of sale.

Chinese law acknowledges that a contract can also be formed by oral agreement. In addition, the Contract Law provides that where “the parties enter into a contract in the form of a contract instrument, the contract is executed at the time when both parties place their signatures or affix their seals onto the instrument.”<sup>12</sup> Affixing to a contract the corporate seal or “chop” is therefore sufficient to legally bind the company to the contract. However, it is normal business practice to also require the signature of a legal representative or other corporate office holder of the contracting Chinese company.<sup>13</sup> When contracting between or among individuals, it is not unknown for individuals to execute the contract by affixing a fingerprint to the contract, rather than a signature. It is now clear that a contract bearing only the individual’s fingerprint will be equivalent to one having the individual’s signature under seal.<sup>14</sup>

In China, the corporate seal or chop is frequently required to lodge documents with various authorities, including customs, tax and corporate regulators. The seal or chop is also often required to enter into contracts in China. Therefore, business can come to a standstill if the chop is controlled by a recalcitrant or obstructive general manager, director or employee.

<sup>8</sup> NDRC Regulation 7 of 2010, art. 13.

<sup>9</sup> Contract Law, *supra* note 81, at art. 50.

<sup>10</sup> The U.N. Convention on International Sale of Goods came into force in China on January 1, 1988: International Sales Law, Enderlein and Maskow (Oceana Publications Inc., New York, 1992), page 4.

<sup>11</sup> United Nations Convention on Contracts for the International Sale of Goods (1980), art. 18.

<sup>12</sup> Contract Law, *supra* note 81, at art. 32.

<sup>13</sup> Contract Law, *supra* note 81, at art. 50.

<sup>14</sup> Note 5, 2009 Explanation of Supreme People’s Court on Questions Arising Under the PRC Contract Law.

The corporate chop should be strictly controlled and only accessible to a very limited number of trusted individuals. Under normal circumstances, a distributor should never be given access to a supplier's chop, because the chop can be misused, either deliberately or mistakenly, to create an assumption of agreement to enter into a binding legal relationship. There is at least an assumption that a contract has been validly entered into if the distributor's chop appears on a contract, even if misused or applied mistakenly. In addition, if the distributor fails to return the chop, it can be extremely difficult to conduct business without it, because it can take weeks to have a replacement registered with the authorities in China.

### **CORRUPTION AND BRIBERY**

In China, gifts and payments to government officials and employees of state-owned enterprises (SOEs) are of great concern. A 2012 publication of the Commercial Service of the U.S. Department of Commerce stated bluntly that "Corruption remains endemic in China."<sup>15</sup> In the health sector, bribery has become so common that the Ministry of Health has issued draft guidelines that may require both patients and doctors to sign a mutual non-bribery agreement before hospitalization.<sup>16</sup>

The giving of gifts, cash or items of value by either a supplier or distributor can give rise to administrative or civil liability. In a worst-case scenario, such actions may even cause criminal liability under Chinese and foreign laws, such as the U.S. Foreign Corrupt Practices Act (FCPA) and the U.K. Bribery Act.

Under Chinese law, the giving of incidental gifts such as mooncakes,<sup>17</sup> bottles of wine, dinners and other relatively small gifts is normally deemed legal if it is for promotional purposes. However, gifts of cash or anything of value for an improper purpose, such as obtaining or retaining business, will generally be regarded as bribery and considered illegal. It should be noted that both the bribe offeror and the offeree commit an offense under Chinese law.

Under Chinese law, "official" bribery is an offer of property to a state functionary in return for a benefit or assistance in obtaining an improper benefit. Significantly, "state functionary" includes doctors or medical workers in a state hospital, as well as employees of an SOE. Under Chinese law, not all employees of an SOE are regarded as government officials. Article 93 of the Criminal Law defines "state functionary" as "employees of state-owned companies, enterprises, institutions and people's organizations who are engaged in public services, and persons who are appointed and sent by state organs, state-owned companies, enterprises and institutions to non-state-owned companies, enterprises and institutions and mass organizations to engage in public services, and other persons who are engaged in public services according to law."<sup>18</sup>

The U.S. FCPA defines a "foreign official" as "any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or departments, agency, or instrumentality."

<sup>15</sup> U.S. Commercial Service, "Doing Business in China: 2012 Country Commercial Guide for U.S. Companies," 92.

<sup>16</sup> "No-Bribery Agreement to Be Signed in Hospitals," *China Daily* (Aug. 2, 2012).

<sup>17</sup> A Chinese bakery product traditionally eaten during the Mid-Autumn Festival.

<sup>18</sup> *Zhonghua Renmin Gonghe Guo Xing Fa* (中华人民共和国刑法) [Criminal Law of the People's Republic of China] (promulgated by the Nat'l People's Cong., Mar. 14, 1997, effective Oct. 1, 1997), art. 93.

U.S. enforcement agencies generally consider employees of SOEs that are major players in primary sectors, such as banking, energy, telecommunications, and oil and gas, to be “foreign officials” regardless of title, rank or position. Interactions with such personnel will therefore be governed by the anti-bribery provision of the FCPA. FCPA risks in China are complicated by this broad definition of a “foreign official.”<sup>19</sup>

Those who facilitate bribery also commit an offense under Chinese law and may be punished as principal offenders. Because a distributor and its employees or other representatives might be regarded as a facilitator of a bribe, the supplier and the distributor itself would be prudent to include a clause in a distribution agreement that explicitly requires the distributor and its employees, agents and representatives to refrain from engaging in any conduct that would or might be regarded as bribery. Immediate termination of the distribution agreement for breach of such an anti-bribery provision is appropriate.

#### COMMERCIAL BRIBERY

In China, there is also a crime of “commercial” bribery, punishable under both the Criminal Law and the Commercial Bribery Regulations. Commercial bribery is the offering of “property or other means” by a business person to an entity, company or individual in order to sell or purchase merchandise. There is no requirement for the involvement of a state entity or state official. The definition of “property” includes cash or material objects, including those disguised as promotional fees, service charges, consultancy fees, commissions, financial support or reimbursements. However, the Commercial Bribery Regulations exclude from the definition of “property” small promotional gifts given according to business customs. Note also that giving “off-the-books” or secret commissions, discounts or rebates may be considered commercial bribery. Both the offeror and offeree are criminally liable for commercial bribery. As previously discussed, civil liability for such conduct can also arise under the Anti-Unfair Competition Law.

A distribution agreement should include strict requirements on the proper recording of transaction documentation and correspondence, any negotiated discounts, rebates, commissions, fees, reimbursement of travel or accommodation expenses, or other payments or property provided to a customer, employee or representative of another entity or company.

#### THE FCPA AND THE U.K. BRIBERY ACT

The FCPA prohibits a multitude of parties<sup>20</sup> from making corrupt payments to foreign officials for the purpose of obtaining or retaining business. There have been numerous investigations and a number of convictions in the United States, as well as very heavy settlement “fines” paid by U.S.-listed companies that arose out of their operations in China. Settlements of FCPA enforcement actions in the United States indicate that smaller penalties are likely if the company has a significant compliance program.

Companies with a presence in the United Kingdom (not only U.K.-registered companies) must comply with the U.K. Bribery Act. This act makes it a criminal offense to fail to prevent bribery of foreign officials by a

<sup>19</sup> See discussion, *infra*.

<sup>20</sup> Including U.S. companies and their employees and agents; U.S. citizens; any companies that are listed in the United States and their employees or agents; and any companies or their employees or agents, whether U.S. or not and whether listed in the United States or not, that commit a violation while in the territory of the United States.

person “associated” with an organization or company. An associated person is one who performs services for or on behalf of the organization or company. The U.K. Bribery Act allows for an “adequate procedures” defense, which limits liability for companies that have instituted compliance programs to prevent bribery. Therefore, a compliance program that includes agents and distributors could be critical for defending a company against a charge of bribery and reducing any penalties that might arise out of either the U.K. Bribery Act or the FCPA.

Given the broad scope of offenses under the FCPA and U.K. Bribery Act, a best practice that could be instituted by any business under the jurisdiction of these two laws is to institute an anti-bribery compliance program for its Chinese operations. In addition, businesses should consider including appropriate provisions in their distribution agreements to better ensure that the compliance program is implemented, monitored and followed.

Because of the statutory protection of, and incentives provided to, whistleblowers, there is always a possibility of investigations against multinationals by the Chinese, U.S. or U.K. authorities on the basis of a whistleblower’s report. Serious consideration should therefore be given to drafting a distribution agreement with provisions that require the distributor to take the following actions, for example:

- Refrain from any questionable conduct and report such conduct to the supplier
- Assist in the design or implementation of an anti-bribery compliance program
- Actively cooperate in any audit or investigation
- Confirm, prior to payment, that the identity of any holder of an account for the payment is the intended recipient
- Confirm that no part of any payment to the distributor will be paid illegally, either directly or indirectly, to a state functionary or government official

The Chinese authorities have been known to inform U.S. authorities if they become aware of conduct that is potentially in breach of the FCPA. Further, disgruntled employees in China are increasingly using the threat of an FCPA violation to obtain benefits they might not otherwise receive.

## **GENERAL CONTRACT ISSUES**

### STANDARD FORM CONTRACTS OR “CONTRACTS OF ADHESION”

Particular care must be taken in China when using a standard form contract with numerous distributors or franchisees, or when incorporating standard forms or clauses into a distribution contract. China’s Contract Law provides that the party making use of a standard form contract must use reasonable means to clearly highlight to the other party the provisions in the contract that limit or eliminate the liability of the party providing the standard form, and on request must provide explanations to such provisions.<sup>21</sup>

Further, certain types of provisions are not valid in a standard form contract, including those that exclude the user from any liability, increase the liability of the other party or exclude important rights of the other party.

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<sup>21</sup> Contract Law, *supra* note 81, at art. 39.

## CONFIDENTIALITY AND STATE SECRETS

If a supplier or its distributors are dealing with an SOE, particular care should be taken when either gathering what might be regarded in other countries as market information about an SOE, or transferring, disclosing or using commercial and technical information related to an SOE or the markets in which an SOE operates.

China's State-Owned Assets Supervision and Administration Commission and the State Council introduced new rules in 2010 that re-categorize a "commercial secret" of an SOE as a "state secret."<sup>22</sup> These new rules mean that the traditional trade secrets of an SOE, such as business and technical information, may now be considered state secrets and subject to China's State Secrets Law and the Criminal Law.

Disclosure or use of a state secret is potentially a criminal offense, so disclosure or use of information previously categorized as an SOE's commercial secret can potentially lead to criminal liability. Once any information in a document is deemed a state secret, then the information should not be reviewed, copied, circulated or removed. If a supplier anticipates that its distributor will have dealings or compete with an SOE, it should ensure that there are appropriate contract clauses in its distribution agreement to address this issue. For example, a distribution agreement might include in a confidentiality clause a guarantee from an SOE that no documents provided by the distributor will include any state secrets.

## EXCLUSION OF LIABILITY

In China, a contractual provision is invalid if it purports to exclude liability for physical injury to the other party, or excludes liability for gross negligence or intentional damage.<sup>23</sup> As mentioned above, standard contract clauses formulated in advance by a party for repeated use and not as the result of negotiation with the other contract party are also invalid if the party providing the standard clauses excludes itself from liability or imposes greater liabilities on the other party.<sup>24</sup>

## DISPUTE RESOLUTION

Unless a distribution agreement has some "foreign" aspect<sup>25</sup> to it, a dispute must be settled in China, in the Chinese language, by the Chinese courts or an official Chinese arbitration body (arbitration commission). If the distribution agreement has a foreign aspect, then arbitration outside China is likely acceptable, and an award by a foreign arbitration tribunal is enforceable in China.<sup>26</sup> However, if a foreign-invested enterprise (FIE) in China is involved in a dispute, the status of the FIE is not deemed as a foreign aspect. There must be some other foreign aspect. If a Chinese party has limited dispute resolution experience outside China, arbitration in Singapore or Hong Kong using the Singapore International Arbitration Centre, United Nations Commission on International Trade Law, International Chamber of Commerce or Stockholm Arbitration Rules would likely be agreeable to a Chinese party.

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<sup>22</sup> Art. 3 and 11 of the Interim Provisions on Protection of Commercial Secrets of Centrally Administered SOEs.

<sup>23</sup> Contract Law, *supra* note 81, at art. 53.

<sup>24</sup> Contract Law, *supra* note 81, at art. 39, 40.

<sup>25</sup> *E.g.*, there is a clause for supply of equipment or grant of a license to use proprietary knowledge provided by a non-Chinese entity from outside China.

<sup>26</sup> China has ratified the New York Convention on Recognition and Enforcement of Arbitral Awards.

If the dispute concerns the use of the supplier's trademark and there is no arbitration provided for in the trademark license, a consultation procedure must be followed before court proceedings in China can be commenced. For trademark disputes, there is also an alternative to court proceedings enabling any interested party to submit the dispute to the Administration of Industry and Commerce (AIC) for settlement. Thereafter, court proceedings can be commenced if a party is dissatisfied with the AIC decision.<sup>27</sup>

#### TERMINATION COMPENSATION

China has no requirement mandating payment of any compensation or indemnity to a commercial agent or distributor upon termination or expiry of the agreement. If the agreement provides for compensation upon termination or expiry, the Contract Law will apply. Care should be taken, however, to ensure termination has been properly and clearly exercised and communicated to the terminated distributor.

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<sup>27</sup> Zhonghua Renmin Gonghe Guo Shangbiao Fa (中华人民共和国商标法) [Trademark Law of the People's Republic of China] (promulgated by the Standing Committee of the Nat'l People's Cong., Oct. 27, 2001, effective Dec. 1, 2001) art. 53.

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